

# Research on the Bankruptcy Law and Its Reference

Tiantian Liang

Northeast Petroleum University at Qinhuangdao,  
Qinhuangdao, 066004, China

## Abstract

With the deepening of the economic globalization, corporation plays a more and more important role in the world. Corporation as a great invention owns an independent personality, which brings us booming economy. But once abused intentionally, it will degenerate into an instrument to defraud the creditors or the public. In order to decrease its negative effects and sustain the booming market, “Deep Rock” doctrine as well as the Disregarding of the Corporate Entity, is firstly used in the Anglo-American legal families to regulate the corporation, although China accepted the institution of disregarding of the corporate entity in the new Company Law of the People’s Republic of China, “Deep Rock” doctrine is still neither embraced in it or in the newly enacted Law of the People’s Republic of China on Enterprise Bankruptcy. This article especially presses on the comparison between the tow foresaid doctrines and aims to give the practical method to apply it in China.

**Keywords:** *Bankruptcy Law, Disregarding of the Corporate Entity, “Deep Rock” Doctrine.*

## 1. Introduction

The statistics gave a surprising result that 90 percent of the voters support the legitimacy of homosexual marriage with only 3.4 percent against it and that 70 percent of them understand and support homosexual behavior. The data may be higher than it in real life because of the netizens’ more open and tolerant attitude; nevertheless it’s an obvious signal conveying the message that there has been a trend towards increasing visibility, recognition, and legal rights for the homosexual, including marriage and civil unions, parenting rights, and equal access to health care.

“Deep Rock” doctrine is a rule of bankruptcy law in the United States, which is developed by the U.S. Supreme Court in the case of Taylor v. Standard Gas Co., 306 U.S. 307 (1939). The rule requires that, where a subsidiary corporation declares bankruptcy and an insider or controlling shareholder of that subsidiary corporation asserts claims as a creditor against the subsidiary, loans made by the insider to the subsidiary corporation may be deemed to receive the same treatment as shares of stock owned by the insider. Therefore, the insider’s claims will be subordinated to the claims of all other creditors, i.e. other creditors will be paid first, and if there is nothing left after other creditors are paid then the insider gets nothing. This also applies (and indeed the doctrine was first

established) where a parent company asserts such claims against its own subsidiary.

The insider or controlling shareholder of the subsidiary corporation usually owns more information and is easier to transfer the capital than the other creditors. The application of “Deep Rock” doctrine changes the unequal condition. Since the establishment of the doctrine, it has been widely used to avoid the abuse of the equitable rights of the creditors when it is added the existence of a “planned and fraudulent scheme”, the doctrine is also called “Equitable Subordination Rule” or “Subordination Rule”

## 2. Application of “Deep Rock” Doctrine

Actually it is a breach of the traditional redress procedure in bankruptcy, and exists as an exception of the law. It can not be perverted in the judgment, otherwise the advantages of the corporate will be drained and the country will lose a booming market. To handle it, find a proper test in the judgment becomes necessary, for the absence of reasonably objective tests in this area has led to considerable confusion and some inconsistency in results. The secular world is complex; the texts for subordination under the Deep Rock doctrine differ in degree or kind from the tests applicable to Piercing the Corporate Veil. In its original U.S. Supreme Court case of Taylor v. Standard Gas Co., 306 U.S. 307 (1939), the test is whether the subsidiary was undercapitalized at the time that it was established, and can thereby be shown to have been mismanaged for the parent corporation’s benefit, while in the case Pepper v. Litton, it changed into whether the “planned and fraudulent scheme” exists or not.

## 3. Comparison between the “Deep Rock” Doctrine and the Disregarding of the Corporate Entity

As is said in the foregoing statement—independent personality and limited liability are two footstones of the modern company, but as the Cumming—Bruce LJ said: “The court will use its power to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal

efficacy of the corporate structure under consideration.” His words can be a kind of description of the Disregarding of the Corporate Entity which means in order to achieve justice, the court sometimes will take the corporate as some partners’ business and call them to pay off the loans instead of the corporate.

Both of the two doctrines—the “Deep Rock” doctrine and the Disregarding of the Corporate Entity—are developed by the U.S. Supreme Court case and then enacted in the statute law. They are used to avoid the abuse of the corporate entity and protect the creditors. The basis of the “Deep Rock” doctrine is internally same with the Disregarding of the Corporate Entity, and the difference only exists in the extent. Both of them starts from four moral obligations which is confirmed on legal level—honesty, fairness, legal obligation comes first and no intentional obstruction on the payment for the creditors. However, the two doctrines are independent and their differences are as follows:

### 3.1 Different Ways in Application

The theory of the “Deep Rock” doctrine relies on the Act of Fraudulence Property Diversion which adjusts the relationship between the ordinary creditor and obligor. It allows the creditor withdraw the diversion the obligor made on his property. Before the invention of the “Deep Rock” doctrine, the court intends to solve the problem by adoption of the Disregarding of the Corporate Entity. It denies the subsidiary corporation as an independent entity, so the parent corporation should commit responsibility of its corporation. However, the “Deep Rock” doctrine does not have to disregard the corporate entity. It achieves just between the parties by making the insider inferior to the other creditors.

### 3.2 Different Spheres in Application

The “Deep Rock” doctrine is mainly used in the bankruptcy procedure while the Disregarding of the Corporate Entity is not only applied in the bankruptcy but also in the torts, tax and contract. The later is much wider than the former.

### 3.3 Different Punitive Degrees

The Disregarding of the Corporate Entity not only denies the credits the corporate owed the insiders or the parent corporate but forces them to commit joint and several liabilities when the corporate capital is not enough to refund the other credits. On this point, it is a punitive legal doctrine. But only on terms of just does the “Deep Rock” doctrine apply, and the insider or the parent corporate is subordinated to the other creditors. It merely strips their privilege on the refund. Therefore the “Deep Rock”

doctrine is less punitive than the Disregarding of the Corporate Entity.

### 3.4 Different Onus Probandi

Whether the Disregarding of the Corporate Entity is applied or not is a matter of fact which is left to the jury. The court should take these essences into account—under capitalization, fraud, commingling of asserts, failure to follow the corporate formalities and the control in order to decide whether the corporate is a instrument, dummy or the other ego of other people or corporate. The unjust is so terrible that the court has to denies the entity’s existence. The plaintiff often should prove that the behavior of the shareholders shows nothing about the corporate as an independent entity but to indicate that it is totally an instrument of them. Whereas when it comes to the “Deep Rock” doctrine bases on the ordinary doctrines such as equity and honesty. Technically, the plaintiff just needs to prove that there is cheat and dishonesty on the whole.

## 4. The Reference of the “Deep Rock” Doctrine for China

Generally, in the U.S.A. there are only some fundamental regulations scattering in some state legislation about the Disregarding of the Corporate Entity, such as Tex.BCA, 1997. In practice, the judges especially the Supreme Court judges decide how to apply it. Compared with the U.S.A., we have been somewhat prior to it, for in the new Company Law of the People's Republic of China , the Disregarding of the Corporate Entity principle is clearly listed in Article 20 but the “Deep Rock” doctrine is not clearly alleged in the law, neither does the Bankruptcy Law. Since we belong to the civil law legal family, judicature should follow the legislation, and the judges’ power can not be expanded as wide as their counterparts in the U.S.A. Although it is unnecessary to totally follow the U.S.A., the doctrine is a practical one, with reference to the foreign legislation, we’d better enact rules or something else in the form of the secondary law to guide the exerciser. Meanwhile, it can be taken into consideration to embody it into the procedure of the bankruptcy, and then embrace it into the Bankruptcy Law.

## 5. Conclusions

In conclusion, the solutions to embrace the “Deep Rock” doctrine into our existing system are as follows: Firstly, clarify it in a special charter in the Company Law of the People's Republic of China, as the basic legal premises for the application of the “Deep Rock” doctrine; secondly, considering the unity of the bankruptcy procedure, the

main procedure regulations should be embodied in the Bankruptcy Law, along with the other subordinate law to form a regulation system.

## References

- [1] Seung-Hyun Lee, Mike W. Peng ,Jay B. Barney, " Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective", *The Academy of Management Review*, Vol. 32, No. 1, 2007, pp. 257-272.
- [2] John Armour ,Douglas J. Cumming, " Bankruptcy Law and Entrepreneurship",*American Law and Economics Review*, Vol. 10, No. 2, 2008, pp. 300-316.
- [3] Shawn M. Rohlin,Amanda Ross, " Does Bankruptcy Law Affect Business Turnover? Evidence From New and Existing Business",*Economic Inquiry*, Vol. 58, No. 6, 2015, pp.113-126.
- [4] Zacharias Sautner, Vladimir N. Vladimirov. " Indirect Costs of Financial Distress and Bankruptcy Law",*Business History*,Vol. 34, No. 4, 2015, pp. 56-66.

**Tiantian Liang** She received Master degree of Science of Law in Yanshan University. She worked in Northeast Petroleum University at Qinhuangdao as a teacher. Her research interests is Science of Law.