

Creation and Justification of the Parent Company's Liability in the Case of Apparent Bankruptcy

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Abstract:

Today, holding companies attract individuals as shareholders, leading to the establishment of companies with a legitimate nature, where subsidiary companies are controlled under them. However, these subsidiaries are often created with the intent of generating illicit profits. This formation, along with transactions involving third parties, profit attraction, and capital increase, allows the main company's structures to conceal fraudulent gain under the guise of corporate identity. By injecting immediate profits into its subsidiaries, the parent company may artificially present itself as bankrupt. The economic and managerial relationship between the parent company (at the top of the holding) and its subsidiaries enables control over the dependent companies, which, in turn, allows the parent company to assume liability and control. In cases where criminal elements emerge through the involvement of the subsidiary, the concept of agency theory can be invoked to eliminate the independent corporate entities, hold the primary parties accountable, and impose criminal liability for fraudulent activities. Every right that is exercised entails both positive and negative obligations. Consequently, when the true principal (the parent company) derives a benefit, it assumes responsibility and is barred from misusing that right. The unity of benefit and ownership between the parent and the subsidiary, along with the principle of preventing fraud and the requirement of good faith in the relative nature of contracts, leads to the obligation of the parent company or subsidiary to bear responsibility for any wrongdoing. This study examines the nature of this bankruptcy, the process of profit absorption and injection, and the potential liability of the companies' structures, particularly the directors, from both a theoretical and practical perspective.

Keywords: Fraud Prevention, Phantom Profit, Parent Company, Subsidiary Company, Fraudulent Bankruptcy, Lifting the Corporate Veil, Judicial Practice, Profit Injection, Unjust Enrichment, Full Compensation Principle.

Extended Abstract

This article investigates the creation and justification of civil and criminal liability of a parent company in cases of *apparent* or *fraudulent* bankruptcy engineered through its subsidiaries. In contemporary corporate practice, holding structures are widely used to organise economic activities and attract outside investors. While such structures may be legitimate, they can also be exploited to generate illicit profits and to shield real decision-makers from the reach of creditors and criminal law. The study focuses on situations in which the parent company, by channelling profits and assets to dependent subsidiaries, portrays itself as insolvent, thereby frustrating creditors' claims while preserving the real economic value within the corporate group.

The core research question is whether, and under what legal and doctrinal conditions, the liability for such *apparent bankruptcy* can be extended from the debtor company to its parent and to the

key organs of the group, especially directors and controlling shareholders. The paper further asks whether the separate legal personality of each company and the principle of limited liability necessarily preclude such an extension, or whether rules on anti-fraud, abuse of rights, unjust enrichment and representation—both in Iranian law and comparative systems—provide a solid basis for “lifting” or “piercing” the corporate veil of the parent company.

Methodologically, the article adopts a doctrinal, analytical and partly comparative approach. It systematically examines the Iranian Commercial Code (notably Articles 412, 424, 549 and 554), the Civil Code (Articles 196, 218, 301, 642–643), the 1347 Company Law (*Lāyehe-ye eslāhī*, including Articles 17, 90, 118, 142, 143, 150, 154, 157–158, 240, 258), the Law on Enforcement of Financial Convictions and relevant judicial precedents. These provisions are interpreted in light of Shi‘i jurisprudential principles such as *lā ḍarar* (no-harm), *(man lahu al-ghunm fa-‘alayhi al-ghurm* (whoever enjoys the gain must bear the loss) and the prohibition of *akl al-māl bi-l-bāṭil* (unlawful appropriation of property). Comparative references to French law (e.g. Code de commerce, art. L232-17) and US common law doctrines (alter ego and veil piercing) further inform the analysis.

The first part of the article clarifies the structure of holding and subsidiary companies in Iranian law and practice. A parent (holding) company acquires sufficient voting rights in a subsidiary to control its board and policies, creating a relationship of economic and managerial dependence. While each company enjoys a separate legal personality, the reality of control means that decisions formally taken by the subsidiary may in fact be dictated by the parent. The article then examines “fraudulent incorporation” and the formal steps of company formation, arguing that once the essential elements of incorporation are fulfilled and the company is validly registered, primary liability for bankruptcy lies with the company as such. However, where managers’ fault or fraud is established, their personal liability can and should be added without allowing registration defects to be misused as a technical escape from responsibility.

The second part analyses the mechanisms of profit attraction and phantom (illusory) profits. Relying on Article 118 of the Company Law, the article explains how directors are empowered to conduct business and distribute profits, but notes that fixed or guaranteed payments to certain shareholders in the absence of real profit constitute an unlawful distribution equivalent to a return of capital, which is a guarantee for creditors. Under Articles 90, 240 and 258 of the Company Law and Article 301 of the Civil Code, such distributions may create both civil liability (unjust enrichment) and criminal liability for the company and its directors. The parent company’s practice of transferring profits and capital, including funds obtained from third parties and through capital increases under Articles 157–158, to its subsidiaries in order to make itself appear insolvent is conceptualised as a form of fraudulent bankruptcy and *akl al-māl bi-l-bāṭil*.

The article then examines in detail the roles and potential liabilities of directors, auditors and “shadow directors.” Once the founding meeting appoints directors and auditors and they accept their positions in writing (Article 17), they assume responsibility for their acts and omissions, including the obligation to provide security shares to protect the company’s assets. Auditors, under Articles 150 and 154, must report irregularities and financial misconduct. If they acquiesce in schemes whereby the parent’s funds are systematically diverted to subsidiaries to create apparent insolvency, they may incur fault-based liability. The concept of a shadow director—someone who

effectively controls corporate decisions without formal appointment—is also considered, but the paper argues that where there is a formally appointed director who chooses to follow such a person’s instructions, the causal link for liability remains with the formal organ.

A further section is devoted to the legal concept of bankruptcy and its fraudulent variant. Under Article 412 of the Commercial Code, bankruptcy is tied to “cessation of payments,” a factual state whose existence and timing must be established through expert financial evidence. Where a company, after attracting capital and profits, transfers its assets to subsidiaries but continues to have the real capacity to pay, it cannot be regarded as truly bankrupt. Article 424 allows rescission of transactions effected before cessation of payments if carried out with intent to evade debts or harm creditors and involving a significant undervaluation. The article reconciles this provision with Article 218 of the Civil Code (which invalidates transactions concluded with the intention of evading debt) and with Article 21 of the Law on Enforcement of Financial Convictions, arguing for a nuanced division between absolute nullity in cases of sham transactions and relative avoidance where the other party lacked awareness of the debtor’s intent.

On this basis, fraudulent bankruptcy under Articles 549 and 554 of the Commercial Code is distinguished from ordinary fraud: in fraud, deceptive acts precede acquisition of the property; in fraudulent bankruptcy, deceptive acts occur after acquisition, at the stage of non-payment or evasion of debt. Nevertheless, the paper emphasises that fraudulent bankruptcy is functionally a specific form of fraud, and that the parent company’s coordinated transfer of assets to subsidiaries to simulate insolvency falls squarely within its ambit.

The central theoretical contribution of the article is its elaboration of *piercing the corporate veil* (kharq-e hijāb-e shakhṣīyat ḥoqūqī) as a legitimate and necessary corrective to the misuse of separate legal personality. The author identifies three core principles normally associated with corporate personality—limited liability of shareholders, independence of corporate assets from shareholders’ assets, and non-restrictability of directors’ powers vis-à-vis third parties—and argues that veil piercing should operate as an exception where these principles are abused to the detriment of creditors and third parties. The article draws parallels with US alter ego doctrine and French theories of *levée du voile social* and *représentation apparente*, under which courts attribute liability to the real principal when a company is used merely as a façade.

In Iranian law, this corrective is grounded in fiqh-based doctrines such as *lā ḍarar* and the prohibition of abuse of rights, as well as in explicit statutory developments. The draft 1403 Commercial Code (Article 600) and the corporate governance guidelines in the securities markets define control as the ability to direct the financial and operational policies of another entity to obtain economic benefits, and treat control as an indicator of responsibility. Similarly, Article 132 of the Industrial Property Law implicitly endorses veil piercing in cases of abusive conduct. Articles 142 and 143 of the Company Law provide frameworks for directors’ liability that can be interpreted in light of these principles to reach the parent company and its controlling organs when they orchestrate fraudulent use of subsidiaries.

The article further develops a representation-based justification for parent liability by interpreting Article 196(2) of the Civil Code: the parent company can be seen as the true principal and the subsidiary as its agent, particularly where the parent legally dominates the subsidiary’s will, enjoys

the substantive benefits of the contracts concluded and provides the consideration or capital used in the transactions. Once this “real principal” relationship is established and the corporate veil is pierced, creditors may claim directly against the parent as the main obligor. Criminally, the piece argues that Article 526 of the Islamic Penal Code has effectively superseded Article 332 of the Civil Code in cases of causation of harm, allowing the same principles of liability to be applied in both civil and criminal domains where the parent’s control over the subsidiary amounts to culpable causation.

In conclusion, the article contends that Iranian law, read in light of its fiqh foundations and informed by comparative doctrines, already contains sufficient normative tools to impose liability on parent companies that engineer apparent bankruptcy through their subsidiaries. Piercing the corporate veil and invoking the real-principal theory enable courts to bypass formal separateness when it has become a vehicle of fraud, ensuring full compensation of creditors in line with the fundamental principle of *complete reparation*. Rather than undermining corporate law, this approach restores its integrity by denying legal protection to abusive structures. The study therefore recommends that Iranian judges consciously employ these doctrines—supported by statutory provisions, jurisprudential principles and emerging legislative trends—to allocate responsibility to the real economic actors behind fraudulent bankruptcies and to deter future misuse of complex corporate groups.

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