

# Legal Justification and Legislative Path of Reverse Piercing in China

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**Abstract**—In practice, many shareholders fraudulently transfer their assets to companies to evade personal debts. However, existing remedies such as the right of rescission and equity enforcement are inherently flawed in protecting shareholder creditors' legitimate rights, which makes reverse piercing a necessary remedy. This paper elaborates on the asset partitioning theory as the theoretical foundation, combs through the global judicial practices of reverse piercing, and thus demonstrates its legal justification. It further analyzes the core dilemmas in China's judicial application, including the imbalance of interests among multiple subjects and the absence of clear normative provisions. Drawing on domestic and foreign research, the paper argues that reverse piercing shall be confined to single-member companies. Meanwhile, it clarifies the priority of repayment for different parties in liquidation and puts forward legislative proposals for the formal establishment of reverse piercing in China. By exploring the essence of reverse piercing, this study consolidates its theoretical basis and details its implementation guidance, which is of great significance for improving China's corporate legal system and safeguarding judicial certainty.

**Keywords**—Chinese law, reverse piercing, alter ego, assets partitioning

## I. INTRODUCTION

Reverse piercing is a special application of piercing the corporate veil. In practice, shareholders may transfer assets to the company for the purpose of evading their personal debts. Where this results in the commingling of personality, the creditors of the shareholder may pierce the corporate veil. Theoretically, the enforcement and disposition of equity could sufficiently protect the shareholder creditor. However, it is common for a shareholder to exercise their control over a company to transfer its assets, resulting in the depreciation of the equity. Meanwhile, as a supplementary remedy, the right of rescission also has substantial defects. In this context, reverse piercing becomes a practical remedy to protect the rights of the shareholder creditor.

However, within the Chinese legal framework, there is an absence of legislation that supports reverse piercing. Meanwhile, the judicial practice has produced contradictory outcomes, which undermine legal certainty. Besides, interest balance of the shareholder creditors and other stakeholders remains controversial. The justification of reverse piercing remains a theory gap to be filled.

This paper, firstly explores the origin, development and legal basis of reverse piercing, and proposes solutions to balance corporate stakeholders' interests and uphold judicial stability. Secondly, to ensure in-depth analysis, it draws on extensive domestic and international literature to examine the

rule's fundamental rationale, while focusing on Chinese courts' application considerations to identify practical implementation challenges. Thirdly, this research is expected to advance relevant theories, inform legislation in this area, and foster a sound commercial environment for future development.

## II. REVERSE PIERCING IN CHINESE LAW: THEORETICAL BASIS AND PRACTICE

### A. Development of Reverse Piercing

#### 1) Global development of reverse piercing

Reverse piercing was first applied by American courts. It could be traced back to a landmark case of *Kingston Dry Dock Co. v. Lake Champlain Transportation*, in which Judge Hand reversed the judgement in the trial court and held that it is too much to say that a subsidiary can never be liable for a transaction done in the name of a parent... such instances, if possible at all, must be extremely rare (*Kingston Dry Dock Co.*, 1929). Pursuant to this assertion, courts refused to hear cases of reverse piercing for nearly 30 years until *W.G. Platts, Inc. v. Platts*, in which the court held the corporation was an alter ego of the husband and applied reverse piercing (*W.G. Platts, Inc.*, 1956). Subsequently, reverse piercing was invoked by the government to pursue tax claims (*G.M. Leasing Corp.*, 1975). Over time, this rule has been increasingly adopted. In the present American judicial practice, there are two methods to apply reverse piercing, namely, the inverse method and the equitable result approach. The inverse method regards reverse piercing as a logical extension of traditional piercing due to the unchanged equitable purpose and applies the similar elements, whereas the equitable result approach aims to avoid the prejudice to innocent third parties and requires an examination of alternative remedies with less intrusion (Allen, 2011a).

Reverse piercing has also been adopted by other common law jurisdictions. Singapore has adopted the equitable result approach and rejected the doctrine of insider reverse piercing (Tjio & Tung, 2018). In addition, England keeps a conservative position on this issue, establishing strict standards for its application (Bhaita, 2023).

#### 2) Chinese judicial practices

In China, reverse piercing has been increasingly applied by courts based on different legal grounds. Some courts invoked the principle of good faith to interpret Article 23 Paragraph 3 of the Company Law of the People's Republic of China (2023 revision), and applied the reverse piercing through analogical construction (Intermediate People's Court of Anshan City,

2018; Higher People's Court of Beijing Municipality, 2024); others have resorted to an expansive interpretation of the term "enterprise" under the *Supreme People's Court Rules on the Trial of Civil Disputes Related to Enterprise Restructuring* (hereinafter: Enterprise Restructuring Rules), arguing that its Article 7 establishes a basis for reverse piercing for even private enterprises (People's Court of Beichen District, 2021); still other courts pierce the corporate veil pursuant to Article 23 of the Provisions of the *Supreme People's Court on Several Issues concerning the Application of Law in the Trial of Private Lending Cases* (hereinafter: Private Lending Provisions) (Intermediate People's Court of Zhongshan City, 2022).

However, many courts deny the application of reverse piercing due to the absence of legal basis (Intermediate People's Court of Hohhot, 2025; Higher People's Court of Hebei Province, 2020), and the Supreme Court of People strictly limits the reverse piercing to cases involving enterprise restructuring (Wu, 2010). These contradictory judicial decisions reveal the absence of clear authority for reverse piercing in the Chinese judicial system, which undermines the certainty of law. Considering such controversy, it is necessary to make an analysis of the justification for reverse piercing, thereby laying a theoretical foundation for its formal introduction.

## *B. Theoretical Justification for Reverse Piercing*

### *1) Affirmative partitioning*

The asset partitioning theory was developed by Henry Hansmann and Reinier Kraakman to reveal the essence of organizational law (Hansmann & Kraakman, 2000). The asset partitioning mechanism serves to determine which entities bond with which contracts, and which assets belong to which entities. There are two types of partitioning, namely the affirmative asset partitioning and the defensive asset partitioning. Defensive partitioning operates as limited liability, whereas affirmative partitioning embodies the separateness of corporate personality (Hansmann, Kraakman, & Squire, 2006). Reverse piercing, in its nature, constitutes an exception to affirmative partitioning rules. Therefore, the rationale for affirmative partitioning is crucial to determine the justification of reverse piercing.

Priority and liquidity protection constitute the essence of affirmative partitioning. Priority requires that the company's assets shall be prioritized to satisfy the company's creditors. In this way, by establishing a company, a shareholder can alter the priority of claims to certain amounts of his assets and accord company's creditors preferential treatment. Liquidity protection prevents shareholders from withdrawing capital, even when they go bankrupt, thereby maintaining the adequacy of the capital.

These two arrangements are of great social value and contribute to commercial development. First, they reduce the risk and monitoring cost for company creditors. Given the difficulties for company creditors to review shareholders' financial conditions, priority and liquidity protection ensure that the financial conditions of shareholders will not prejudice the liable assets in the company (Hansmann & Kraakman, 2000). This, in turn, eliminates the need for such a review and reduces the risk for creditors, thereby decreasing the average financing cost across society. Meanwhile, it also reduces the

information cost of other shareholders for the same reason, and hence stimulates investment vibrancy (Zeng, 2019).

### *2) Justification for reverse piercing*

However, abuse of affirmative partitioning rules will bring social costs as well. That is because it provides an incentive for the debtor to pursue improper profit by transferring assets. One of the good examples is the parent-subsidary strategy. The parent company could incorporate a finance subsidiary. Where it sells products on credit and generates accounts receivable, it could transfer them to it and distribute the payment to its shareholders. The subsidiary, in turn, pays for the account by borrowing unsecured funds from a bank. Consequently, the operating company maintains minimal assets. In this way, where the parent company incurs huge liabilities caused by defective products, the bank and shareholders could secure their interests, while parent company creditors would be left with no effective remedy (LoPucki, 1996). Another example is the transfer of assets by a shareholder to the company for the purpose of evading liability. This, in turn, prejudices the rights of the shareholder creditors and increases the financing cost across society because creditors are required to incur additional expenses to conduct reviews of debtors' financial conditions. In order to counter such abuse of rights, certain remedies for shareholder creditors are of great importance.

In Chinese law, there are several rules that could be invoked to protect the rights of the shareholder creditors. However, current remedies are not sufficient. First one is sharing enforcement, which has two major defects. The liquidity of shares in a limited liability company is weak, which makes disposition hard. Online auctions often fail to sell because third parties are reluctant to participate in the operation of an unfamiliar company and doubt the value of its shares. More importantly, it is easy for shareholders in small companies that lack supervision to transfer company assets again, thereby further decreasing the value of shares. Generally speaking, the right of rescission is a practical method to prevent such unreasonable transfers. However, this right can only be exercised against the immediate debtor. Therefore, shareholder creditors cannot claim directly against the company on this ground. This remedy is justified only in the context of reverse piercing, where the company and shareholder are deemed a single legal entity, thus enabling the shareholder creditors to rescind contracts between the company and third parties (Ding & Song, 2020).

Meanwhile, the fraudulent transfer to the company can be disguised in the form of investment. For instance, shareholders could establish a new company and transfer their assets. At the same time, it is difficult for shareholder creditors to discover all those carefully obscured unlawful asset transactions. Taken together, reverse piercing is a practical mechanism to protect the right of a creditor when the company is an alter ego of the shareholder.

## III. CONTROVERSIES OF REVERSE PIERCING IN CHINESE LAW: INTEREST IMBALANCE AND NORMATIVE ABSENCE

### *A. Protection Dilemma of Other Shareholders and Company Creditors*

The interest balancing problem is a major controversy for applying reverse piercing. First, other shareholders may

suffer damages from reverse piercing because it prejudices the company's property, which will in turn undermine the company's normal operations and the equity value. Some scholars hold that the reverse piercing should apply to one-person companies only (Spitz, 2021). More significantly, the rights of company creditors are seriously threatened due to the reduction of liable assets. In this context, the creditors' expectations based on the financial conditions of the company will be unreasonably prejudiced.

However, in the present practice, Chinese courts haven't given due considerations to such problems. For example, in a civil judgment of the Lease Contract Dispute, the court of people pierced the corporate veil without considering the interests of either the creditors or the innocent shareholders (People's Court of Fushan District, 2019). This embodies a lack of awareness of interest balance in Chinese courts.

#### *B. Normative Absence that Undermines Judicial Stability*

The absence of norms is another problem for current judicial practice. As mentioned above, courts have based their reasoning on three distinct provisions. Some of them analogically interpret Article 23 Paragraph 3 of the Chinese company law and construe this provision to encompass reverse piercing. However, the Notice by the *Supreme People's Court of Issuing the Minutes of the National Courts' Civil and Commercial Trial Work Conference* (hereinafter, 2019 SPC Civil & Commercial Trial Minutes) emphasizes that the doctrine of piercing shall be applied in a prudent way. However, the wording of Article 23 indicates that it only protects the rights of company creditors. In these circumstances, analogical interpretation is not reasonable.

Other courts resort to Article 7 of the Enterprise Restructuring Rules, which stipulates the principle of Debt Following Assets. Although this provision embodies the rationale of reverse piercing, its subject is strictly limited to state-owned companies (Wang, 2024). Meanwhile, this rule serves to protect the rights of the creditors in special social circumstances (Peng, 2008). Taken together, this rule should be treated as a strictly limited exception. The expansive interpretation is not reasonable.

Still other courts pierce the corporate veil pursuant to Article 23 of the Private Lending Provisions. However, it only applies to loans borrowed by the *de facto* controller for the company operation, and therefore, it cannot provide sufficient normative supply for reverse piercing.

As mentioned above, the absence of norms has undermined the certainty of law. Taken together, to establish the reverse piercing rule in China, the legislative branch must enact specific norms to clarify its applicability.

### IV. GOVERNING RATIONALE FOR PROTECTION OF SHAREHOLDERS

#### *A. Application to Single-member Companies as a Principle*

##### *1) Current views and their inherent flaws*

Scholars have formulated many remedies for innocent shareholders. One of them is to limit the company's liability to the amount the shareholder fraudulently transferred (Fan, 2025). However, this approach is untenable. Reverse piercing is based on personality commingling. In this context,

ascertaining the amount of assets fraudulently transferred is impracticable and the allocation of the burden of proof presents additional challenges.

Another view is to permit a capital exemption for innocent shareholders when enforcement would liquidate the company (Allen, 2011b). However, this arrangement grants innocent shareholders preferential treatment in enforcement, which conflicts with the priority of claim for the company's creditors. Meanwhile, compared with the shareholders, the company's creditors do not participate in the company's operation. As a result, they often have limited insight into the company's actual financial health. Given this factor, company creditors shall be granted more protection compared with innocent shareholders. Consequently, this view lacks sufficient legal justification.

##### *2) Confining to single-member company*

Confining the application of reverse piercing to single-member companies is justified. In the first place, it aligns with the rationale underlying the asset partitioning theory. According to the assets partitioning theory, the more investors there are, the stronger the effect of affirmative partitioning in reducing information costs that stem from financial review. Meanwhile, where a company has a large number of investors, their incentive to avoid their personal debts by transferring assets into the company will be weakened. The investment is thus more likely to represent a normal investment activity. Therefore, as an exception to affirmative partitioning, reverse piercing is more appropriately applied for companies with a small number of shareholders (LoPucki, 1996).

Some other scholars are of the same view. Ma Gengxin and Wang Huanwu argue that, considering the uncertainty standard for identifying innocent shareholders, the application of reverse piercing should be limited to the *de facto* one-person companies (Ma & Wang, 2023). This view points out the certainty and consistency advantage of above method.

Meanwhile, Laura Spitz stated that courts must balance the equities before granting reverse piercing, which requires an assessment of its impact on other innocent shareholders and an evaluation of other potentially available remedies (Spitz, 2021). This argument emphasizes the protection of innocent shareholders, thereby supporting the restrictive application of this remedy.

Practice also upholds this point of view. In *Floyd v. Internal Revenue Serv.*, the court held that "the problems associated with reverse-piercing may be viewed as less serious in cases where a corporation is controlled by a single shareholder (Floyd, 1998)." Meanwhile, Colorado courts require that reverse piercing achieve a result such that no innocent shareholders will be prejudiced (Allen, 2011c). In practice, only those companies wholly owned by a single member would be reverse pierced (Shem, LLC, 2008).

Taken together, confining the application of reverse piercing to single-member companies is a justified approach. However, in order to secure the rights of shareholders, some exceptions for specific circumstances are also necessary.

#### *B. Exceptions for Specific Circumstances*

##### *1) De facto single-member company*

*A De facto* single-member company consists of multiple

shareholders, whereas only one of them is the actual shareholder. The capital contribution, operation and management, profits, and risks of the company are actually enjoyed and borne by a single entity (Sun & Wang, 2021). In this scenario, nominee shareholders will not suffer from any actual damages where reverse piercing is applied. Meanwhile, expanding the application of reverse piercing to cover single-member companies could provide more comprehensive protection for the shareholder creditors. Therefore, such an exception is a necessary supplement to the above-mentioned approach.

The identification of nominee shareholders poses additional challenges. In the first place, a nominee agreement is the most crucial evidence (Fan & Wang, 2023). Meanwhile, the actual capital contribution and the right to claim dividends are also factors for consideration as they reveal shareholders' interests in the company.

#### *2) Non-innocent shareholders*

Non-innocent shareholders refer to shareholders who actively contribute to or participate in the abuse of a corporation's independent personality. In its essence, such abuse is a special type of tort (Qu, 2026). In this context, the conduct of non-innocent shareholders may constitute a joint tort, and thus their interests shall not be protected.

It has been argued that non-innocent shareholders encompass disregarding shareholders (Du, 2016). This point of view lacks a legal basis. First, disregarding shareholders do not directly contribute to the tortious conduct and thus cannot be regarded as joint tortfeasors. Meanwhile, they bear no duty to assist. Therefore, no additional obligation shall be accorded to them.

Besides, shareholders who have a marital relationship with the abusing shareholders shall be presumed to be non-innocent. That is because they usually share common interests with the abusing shareholders and thus are more likely to participate in the fraudulent transfer. Meanwhile, those in marriage tend to form a community of conduct because the abusing shareholder could exert influence over such shareholders, leading them to assist their unlawful conduct (Dagan, 2004).

### V. INTEREST BALANCE ON COMPANY CREDITOR AND STOCKHOLDER CREDITOR

#### *A. Subject of Liability for Company Creditor*

According to the privity of contract, the subjects of liability for company's creditors shall be confined to the company itself. However, in Chapter II, Section 4 of the 2019 SPC Civil & Commercial Trial Minutes, piercing does not permanently disregard the independence of a company. Therefore, there is a problem with whether company creditors could claim their rights directly against the abusing shareholders in the context of reverse piercing.

The answer is yes. A company creditor has expected interests derived from reliance on the corporate financial appearance. However, such interests are prejudiced where fraudulent transfer happens. In order to maintain a well-established commercial environment and provide remedies for company creditors, the shareholders shall bear a joint and several liability for the company's debt. What's more, the company and shareholder shall be treated as a

single entity in the context of reverse piercing, which provides an additional basis for this arrangement.

#### *B. Priority of Repayment in Enforcement*

##### *1) Balance between company and shareholder creditor*

As a principle, in the context of reverse piercing, priority in enforcement should be consistent with existing creditor-priority laws (Allen, 2011d). However, it has been argued that claims of the company's creditors shall be satisfied in priority to the shareholder creditors' claims, so as to protect the commercial environment and safeguard the company's financing capacity (Liao, 2007).

However, the second view is untenable under current company law. In the context of personality commingling, the company and the shareholder shall be deemed a single entity. This, in turn, negates the priority of claim for the company's creditors. Meanwhile, as mentioned above, the shareholder becomes a subject of liability for the company creditor. Its priority of claims would get unreasonably extended in the context of such a view. Therefore, shareholder creditors and company creditors shall enjoy the same priority in the enforcement proceeding.

##### *2) Critical analysis of the priority of involuntary creditors*

American practices classify creditors into voluntary and involuntary ones. Voluntary creditors refer to those who voluntarily extend credit to a debtor, whereas involuntary ones become creditors by operation of law. It is argued that involuntary creditors shall enjoy priority because they could not conduct prior review or require security like voluntary ones (Dagan, 2004). A similar idea has been introduced to the context of reverse piercing (Floyd, 1998).

However, such a view is not justified. Abuse of company independence is a type of tort. For shareholder creditors, their expected interests are prejudiced by the fraudulent transfer. Therefore, they actually become involuntary creditors. Meanwhile, although they could make prior reviews, it is impossible for them to conduct consistent monitoring of the transaction between the company and its shareholder, thereby preventing fraudulent transfer. Therefore, involuntary and original voluntary creditors shall enjoy equal priority in the enforcement proceedings (Dagan, 2004).

##### *3) Priority of special creditors*

Besides, for special purposes, certain types of creditors shall enjoy priority. In American practice, reverse piercing has been introduced to tax collection for a long period of time and gained universal support from courts (Liao, 2007). The tax claim represents public interests. In enterprise bankruptcy, tax claims are prior to common claims without guarantee (Standing Committee of the National People's Congress, 2006). Therefore, in the context of reverse piercing, taxation creditors shall also be prioritized.

It has been argued that claims arising from personal injury shall be paid in priority (Dagan, 2004). This view is well-founded. First, such claims serve to maintain the basic life of the victim. The priority of repayment accorded to such claims safeguards special social value and embodies respect for basic human rights (Yang, 2010). Besides, the amount of personal injury claims is small compared with commercial activities. In empirical research regarding the application of

inadequate capitalization, among 212 cases, only three of them involve personal injury. The minimum claim amount is 50,648 yuan, and even the maximum is only 347,040 yuan (Zhun & Liang, 2021). Therefore, granting personal injury claims priority would not prejudice the rights of other creditors significantly.

In addition, labor claims should be prioritized. As the disadvantaged party, the majority of employees rely heavily on their salaries for their livelihoods. Meanwhile, they shall not bear the risks deriving from company operation. Therefore, in order to preserve related social value, their claims should be satisfied in priority.

## VI. LEGISLATIVE PROPOSAL AND CONCLUSION

### A. Regulatory Approach

In order to safeguard legal certainty and foster an ideal commercial environment, this paper highly recommends that the Chinese legislature add a paragraph to Article 23 of the company law, so as to include reverse piercing. Such a paragraph should include the expression of “without prejudice to the interests of third parties” to maintain the interest balance among different parties.

Meanwhile, compared with forward piercing, reverse piercing may give rise to greater controversy. Therefore, adequate normative supply is of great importance to ensure its sound operation. In this context, related secondary law should be introduced to clarify the details of the rules (Chen, 2012). The Supreme People’s Court could issue judicial interpretations and guiding cases to address how to protect the interests of company creditors and other shareholders.

### B. Coordination with Forward Piercing

As a special application, reverse piercing should also satisfy the elements of forward piercing as well. As a matter of fact, abuse of the shareholder’s right is a special type of tort liability. Accordingly, the shareholder creditors must prove the intention (Zhong, 2022). However, such an intention is presumed. That is, if a shareholder causes personality commingling, which would reduce the liable assets of the company, the burden of proof shall shift to the shareholder himself.

Meanwhile, the inadequate capitalization cannot establish a claim for reverse piercing. Inadequate capitalization refers to a significant mismatch between capital and risk in the course of operation, which would unfairly pass the risk on to the company’s creditors. In this scenario, the creditors could pierce the corporate veil and claim directly against the shareholders. However, such a rule only targets the abuse of limited liability and thus cannot be reversely applied.

### C. Conclusion

Affirmative partitioning of a company reduces the costs of financing but provides an implement for shareholders to evade personal liability. In the face of dilemmas in equity enforcement, reverse piercing has proven to be a practical alternative remedy to counter fraudulent transfer, thereby safeguarding the rights of shareholder creditors. However, it may also prejudice the rights of the company’s creditors as well as other shareholders. In order to minimize such negative impact, it should apply to single-member companies, and only be extended to other circumstances on special occasions.

Meanwhile, the company’s creditors shall be entitled to claim rights directly against the shareholders and enjoy equal priority with shareholder creditors in the enforcement proceedings.

This paper still has some limitations. Firstly, the reasoning on the justification of reverse piercing is based on the asset partitioning theory, but lacks empirical analysis. Meanwhile, proposals for the protection of stakeholders mainly focus on substantive matters, which undermines the comprehensiveness of the study. Further research could focus on the procedural arrangements for stakeholders to safeguard their rights and other potential reasons that prevent the Chinese legislature from introducing reverse piercing. Furthermore, an empirical study on the impact of reverse piercing on SME financing may lend additional persuasive weight to the justification of reverse piercing.

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