Company Law Revision Draft of China: Major changes concerning company capital

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The “Revision Draft” of the Company Law was promulgated for public comments by the end of 2021. Significant changes to many aspects in the company capital regime are made in this new Revision Draft. What advantages and challenges does this bring to investors in a Chinese limited liability company?

There are three issues that investors most often consider regarding the capital of a company:

- Fairness and balance, i.e. how to treat all shareholders fairly and balance the interests between major and minor shareholders as well as between the company and its creditors;
- Efficiency, how to efficiently protect abovementioned fairness and balance; and the
- Overall viewpoint, how to give the company maximum flexibility, autonomy and profitability in strict accordance with the principles of lawfulness.

In the Revision Draft, we can see the consideration of legislator in improvement and innovation in these aspects.

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Expiry acceleration for contribution term of registered capital

When a new company shall be established in China, one of the first considerations of investors is usually how much registered capital should be invested. Under the current Company Law of the People's Republic of China ("Company Law"), shareholders can decide freely the amount, term and form of capital contribution, and the actual capital contribution is not required before the term expires. Taking advantage of these rules, it is not uncommon to see investors establishing small companies with a registered capital of hundreds of millions RMB and decades-long contribution term. They may even extend the contribution term when the expiry date is approaching in order to achieve the purpose of not actually paying the capital. Expiry acceleration for contribution term is only applicable in the event of bankruptcy, dissolution or liquidation of a company. On the one hand, however, case filing for bankruptcy is not easy and often the last option for creditors. On the other hand, for situations of non-bankruptcy and non-dissolution, if shareholders maliciously extend the capital contribution term before its deadline, expiry acceleration cannot be applied. Therefore, creditors may face difficulties in the execution even if they obtain a favorable judgement.

The Revision Draft may find a solution to this dilemma. It is stipulated in Article 48 "where a company is unable to pay off its due debts and is obviously insolvent, the company or the creditors thereof shall be entitled to require the shareholders who have subscribed for their capital contributions but whose term for capital payment has not expired to make the capital contributions in advance."

This provision would greatly change the previous problem of investors in determining the amount and term of the registered capital at will and further solve the difficulties in judgement execution. Investors should take the development and the actual needs of the company into account and determine a reasonable amount and term of the capital contribution by rigorous calculation.

Share deprivation of defaulting shareholders

Under the current law, shareholders are entitled to shareholders' equity even if they have not actually paid their capital contributions. Where a shareholder of a limited liability company has not performed capital contribution obligations or has withdrawn all capital contribution, and has not made payment or returned the capital contribution within a reasonable period after being urged by the company, the company is entitled to pass a resolution of shareholders' meeting to remove the shareholder status In the judicial practice, however, if a shareholder partially fulfils his contribution obligations, the court usually does not support the resolution of the shareholders' meeting to remove his shareholder status which undoubtedly leaves room for shareholders who "know the law" that they do not need to worry about being kicked out as long as they have paid part of their subscribed capital.

This Revision Draft creates a totally new solution for such situation. It stipulates that where a shareholder fails to make the capital contributions in full amount within the time limit, or the actual value of the non-monetary property used as capital contributions is obviously lower than the amount the shareholder has subscribed for, and even fails to make correction upon written call for capital contribution sent out by the company within the grace period, the shareholder loses the equity right for which the shareholder capital contribution has not been made. The procedure for share deprivation is as follows:

1. The company sends out a written call for capital contributions to the shareholder, which fails to fully fulfill its contribution, with a grace period of no less than 60 days;

2. Where the shareholder still fails to make the capital contributions, the company may send a written notice of share deprivation to the shareholder. Such notice is effective upon sending out; and

3. The company shall, within six months, transfer the deprived share, or reduce the registered capital by deregistering the said deprived share.

These provisions are more conducive to protect the interests of the company and other non-defaulting shareholders and acting as a deterrent to shareholders which fail to pay their capital contributions in full and on time.

However, these provisions still need to be improved in terms of operability. For example, under the current law as well as the Revision Draft, resolution of a shareholders' meeting on capital reduction shall be adopted by the shareholders representing two-third or more of the voting rights. If the proportion of the deprived share exceeds one-third, can a valid resolution be made? Or if the shareholder who fails to make a timely capital contribution in full is the absolute controlling majority shareholder, which results in delay or non-performance of the company in issuing such share deprivation notice, what procedure could the minority shareholder follow to complete the share deprivation. It is hoped that the subsequent

law and the relevant judicial interpretations will further refine those uncertainty.

Equity transfer to a non-shareholder

In accordance with the current Company Law, shareholder proposing to transfer equity interests to a non-shareholder shall obtain the consent of more than half of the other shareholders. The shareholder shall inform the other shareholders of the proposed equity transfer in writing and seek their consent. Failure to reply within 30 days from receipt of the written notice shall be deemed as consent to the proposed transfer. Where more than half of the other shareholders do not consent to the proposed transfer, the non-consenting shareholders shall acquire such equity interests. Otherwise they shall be deemed to have consented to the proposed transfer. Where the shareholders consent to the proposed transfer, the other shareholders shall have pre-emptive right to acquire such equity interests on similar terms.

However, in practice, the most common situation is that the other shareholders do not agree to the transfer and do not exercise their pre-emptive rights, which complicates the transaction and delays it.

The Revision Draft amends the above provisions so that the consent of a majority of the shareholders is not required for the external equity transfer. Upon the expiry of the notice period, other shareholders shall only have the option to purchase or renounce the purchase. The renunciation or failure to make a timely statement is deemed to be a waiver of the pre-emptive right. In addition, the Revision Draft further stipulates main factors for the equivalent conditions under pre-emptive rights, namely the quantity, price and method of payment and time limit of the equity transfer. These factors are currently not directly mentioned in the Company Law, but are stated in Article 18 of the Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China (IV).

Moreover, Article 87 of the Revision Draft further provides that the company shall cooperate to modify the register of shareholders and complete registration formalities with the local Administration for Market Regulation and may not refuse to do so without justifiable reasons. Both the new shareholder and the selling shareholder may file a lawsuit against the company if it refuses or fails to cooperate within a reasonable time limit.

The above changes simplify the antecedent processes in the execution of pre-emptive rights, increase the efficiency of equity transfer and the speed of capital flow. The convenience of equity transfer has however at the same time impact on the stability of the company, which may further affect company's corporate structure, business policy and investment direction. It requires more caution of investors when choosing a cooperation partner.

Binary procedural structure of capital reduction

Under the current Company Law, a capital reduction can be done by repurchasing the company's shares from shareholders, returning the already existing share capital or releasing the shareholders from their payment obligations.. In such processes, company's assets flow back to shareholders and company's solvency is thus impaired, which may affect the interests of creditors. For this reason, the company shall strictly comply with the procedures of capital reduction as stipulated in Article 177 of the current Company Law, notifying its creditors and publishing an announcement in the relevant newspaper (e.g. China Market Supervision Newspaper etc.). The creditors may demand the company to settle the debts or provide the corresponding security.

The simplified capital reduction as introduced in the Revision Draft refers to the procedure that where a company incurs a loss that cannot be covered by the company's reserves, the company may eliminate the loss by merely an adjustment between the "statutory capital reserve" and "profit distribution" accounts in the accounting books. With such abstract transaction, shareholders do not actually get their investment back from the company, and the net assets of the company will not be reduced.

Therefore, the procedure of the simplified capital reduction is simpler than the general capital reduction. It is not required to notify creditors, provide security to creditors or pay off debts in advance, but an announcement thereon shall be made in the relevant newspaper or the official company database (National Enterprise Credit Information Publicity System).

After a company reduces its capital in such manner, no profit may be distributed before the accumulated amount of the statutory reserve exceeds the registered capital of the company, nor shall the shareholders be exempted from the obligation to pay for shares. While giving flexibility to the shareholders, the solvency of the company is ensured.

Legal consequence for surreptitious capital withdrawal

The current Company Law only provides in general terms that shareholders shall not withdraw its capital contributions surreptitiously. In Article 14 Provisions of Supreme People's Court on Several Issues Relating to Application of the Company Law of the People's Republic of China (III) ("Provisions III"), it is further stipulated that in case of capital withdrawal, the shareholder shall repay the principal and interest of the capital contribution to the company and that the other shareholders, the directors, the senior executives or the actual controlling party who assist(s) withdrawal of capital contribution bear(s) joint and several liability.

In order to fight against capital withdrawal and protect the stability of the legal personality of company, the Revision Draft specifies that the interest thereof shall be calculated at the bank deposit rate for the same period of time, and if any loss is caused to the company, the shareholder shall be liable for compensation.

Considering the fact that normally a shareholder cannot conduct capital withdrawal without colluding with the company management, the Revision Draft also emphasizes the responsibility of directors, supervisors, and senior management personnel or the actual controlling party. In accordance with Provisions III, only by conducting assistance, said personnel shall bear joint and several liability. In Revision Draft, those who know or shall know the shareholder's said act but fail to take any necessary measure, thus causing any loss to the company, shall be liable for compensation. With such new provisions, the company's management should fulfill its duties scrupulously and the interest of company as well as creditors will be better protected.

Outlook

The Revision Draft does make a breakthrough in protecting shareholders' and creditors' rights and interests, enhancing corporate autonomy and ensuring its flexibility. However, its implementation may still encounter various challenges. We expect that further improvement can be made by supporting regulations and interpretations. In any case, the Revision Draft is still in the process of solicitation of public comments and we expect additional revisions to the Revision Draft before its finalization.

FROM THE NEWSLETTER

Newsletter China

CONTACT

Xiaolan Zhao

T +86 10 8573 1345

Send inquiry

Christina Gigler, LL.M.

Senior Associate

T +86 10 8573 1300

Send inquiry