

Navigating the New PRC Company Law – Capital Adequacy

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Building upon our initial article in this series, “Navigating the New PRC Company Law – Overview of the Changes”, which outlined the background and key revisions in the New Company Law, this article delves into one of the most notable changes brought about by the New Company Law: capital contribution and capital adequacy, and the liabilities of relevant parties in connection therewith, hoping to offer some detailed guidance to investors in the PRC on the principle of capital adequacy.

I. Overview of Relevant Changes

Under the PRC Company law (revised in 2018) (*Current Company Law*), shareholders must make their subscribed capital contribution in full and within the specified timeframe, and are prohibited from withdrawing their capital contributions made to the company. The New Company Law upholds this principle of capital adequacy and reinforces it by introducing the following additional requirements to enhance shareholders' liability for capital contributions:

- Imposing a maximum time limit for the payment of capital for limited liability companies: while the *Current Company Law* grants limited liability companies the autonomy to determine the timeframe for capital payment, the New Company Law sets a maximum limit of five years from the subscription date for completing the capital payment.
- Mandating immediate payment of subscribed capital for joint-stock companies: the *Current Company Law* grants the same autonomy to joint-stock companies with respect to capital payment. The New Company Law mandates that capital must be paid-in when subscribed. On the other hand, the New Company Law introduces authorized capital system for joint-stock companies, offering them a degree of flexibility in capital increases.
- Defining accountability for shareholders who fail to pay in capital on time: the New Company Law provides that these shareholders must fulfill the outstanding capital contributions and compensate the company for any losses incurred. It also provides that other shareholders at the time of incorporation shall bear joint and several liabilities with the shareholders that are late in their contribution to the extent of the shortfall in the capital contributions.

- Implementing a mechanism for recovering outstanding capital: the New Company Law introduces a mechanism that mandates the board of directors to monitor shareholders' capital contributions and requires the company to request payments from shareholders who miss their contribution deadlines. Moreover, the law stipulates that shareholders who do not fulfill their capital obligations may forfeit certain rights associated with the outstanding capital.
- Acceleration of outstanding capital contribution: the New Company Law provides for the right of the company and its creditors to accelerate the shareholders' obligation to make capital contribution if the company is unable to discharge the debts when they become due.
- Defining the liability for unpaid capital in equity transfers: in relation to equity interests in limited liability companies being transferred, the New Company Law provides for the distribution of capital contribution liabilities between the transferor and transferee.
- Outlining directors, supervisors and senior management's liabilities for outstanding capital contribution: the New Company Law strengthens the liabilities of directors, supervisors and senior management to monitor and ensure full capital contribution by shareholders.

In the following sections, we will look at each of these changes in greater details.

II. Capital Paid-in Requirements

In its initial company law enacted in 1993, the PRC adopted a rigid paid-in capital system, requiring shareholders to fully contribute capital at the time of incorporation. Over the past three decades, the PRC gradually transitioned away from this system. It first introduced a moderate paid-in capital system in 2005, allowing shareholders to complete their capital contributions within two years from the time of incorporation. Subsequently, in 2013, the PRC fully embraced a subscription capital system, empowering companies (excluding those in specific regulated sectors) to determine their own timeline for the actual payment of the subscribed share capital. This framework remains unchanged in the Current Company Law.

While the full subscribed capital system facilitates the relaxed market access restrictions, boosts the efficiency of shareholders' capital utilization, and minimizes the transaction costs linked to capital registrations, it also presents challenges. The absence of constraints on the capital contribution timeline has led to prevalent misuse of the system, as seen in prolonged subscription periods and excessive subscribed capital amounts, which can be misleading to creditors and investors.

Acknowledging these challenges, the New Company Law replaces the full subscribed capital system for limited liability companies with a time-limited subscribed capital system. Shareholders are typically mandated to make capital contributions within five years of the company's establishment or follow-up capital increases, as the case may be. In addition, the law permits deviations from these timelines through laws, administrative regulations, and State Council directives.

The New Company Law takes a more stringent approach concerning joint-stock companies, mandating immediate payment of all capital, whether issued during incorporation or in subsequent capital increases. Conversely, aligning with international practices and the requirements of listed companies, the law introduces the authorized capital system for joint-stock companies. This system enables companies to authorize their board of directors, through the articles of association or a shareholders' meeting, to approve the issuance of new shares up to 50% of the issued shares within a three-year period. Notably, in-kind capital contributions require a resolution from the shareholders' meeting.

The New Company Law allows existing companies with outstanding capital contributions to gradually align with the new requirements. Moreover, it authorizes the company registration authority to mandate adjustments if the capital contribution period or amount appears notably abnormal. On February 6, 2024, the State Administration for Market Regulation (together with its local counterparties, [SAMR](#)) released a consultation draft of the Provisions of the State Council on Implementing the Registered Capital Registration Administration System under the Company Law of the People's Republic of China ([Draft Implementation Provisions](#)), seeking to offer detailed guidelines tailored to assist existing companies with outstanding capital contributions to align with the requirements of the New Company Law:

- i. Transition period: the Draft Implementation Provisions establish a three-year transition period (from July 1, 2024 to June 30, 2027) for existing companies to adjust to the new capital contribution requirements. Specifically, existing limited liability companies with remaining capital contribution periods extending beyond July 1, 2032 must shorten them to no later than June 30, 2032. For existing joint-stock companies, payment for the subscribed share capital in full is required within the three-year transition period (i.e., no later than June 30, 2027), and no capital increase is permitted until the outstanding capital contribution has been fully paid.
- ii. Adjustment order by SAMR: for companies with a contribution period of more than 30 years and a contribution amount of more than 1 billion yuan, the local SAMR may determine whether the capital contribution schedule of the company appears to be abnormal based on its comprehensive assessment of such factors as shareholders' contribution capacity, main business and asset scale of the company; if yes, the local SAMR may, subject to the consent

by the SAMR at the provincial level, order the company to adjust the capital contribution period or the capital contribution amount within six months, and the adjusted capital contribution period shall not extend beyond June 30, 2032.

III. Liabilities for Default of Capital Paid-in Obligations

If a shareholder fails to pay for the subscribed capital in full and on time, or if the actual value of the in-kind capital contribution is significantly lower than the amount of the subscribed capital, such shareholder is in default of his/her capital contribution obligation (*Defaulting Shareholders*). In a broader sense, illegal capital withdrawal, illegal profit distribution, and illegal capital reduction also constitute a default in capital contribution.

The Current Company Law provides that the Defaulting Shareholders should make up the difference in capital contributions to the company, and that in the scenario of default at the time of incorporation, the other shareholders are also jointly liable for the shortfall. The New Company Law upholds and expands upon this requirement, and further provides that the Defaulting Shareholders should also be liable for compensating the company against any losses incurred. Notably, while the initial consultation draft extended this compensation liability to all shareholders at the time of incorporation, the final law omits this provision, limiting the joint liability of other shareholders to capital contribution shortfall only. In addition, with respect to the calculation of losses incurred by the company, while the first consultation draft proposed applying bank interest rate, this was also dropped in the final law, leaving such determinations to the discretion of the judicial bodies overseeing relevant disputes based on the circumstances of each particular case. In light of this, we suggest the relevant parties provide for this matter in their investment contracts.

The Current Company Law provides that Defaulting Shareholders should be liable to the other shareholders for “breach of contract”, which was taken out in the New Company Law. Despite this change, the other shareholders can still claim breach of contract based on the Civil Code and the shareholders’ agreements, even in the absence of a specific provision in the New Company Law.

With respect to Defaulting Shareholder’s liabilities towards the creditors of the company, while the Current Company Law is silent, the People’s Supreme Court has made certain supplemental provisions in its judicial interpretations. For example, the *Provisions on Several Issues Relating to Application of the Company Law of the People’s Republic of China (III)* (*Company Law Judicial Interpretation (III)*) provides that, the company’s creditors have the right to demand that the Defaulting Shareholders bear the supplementary compensation liability for the

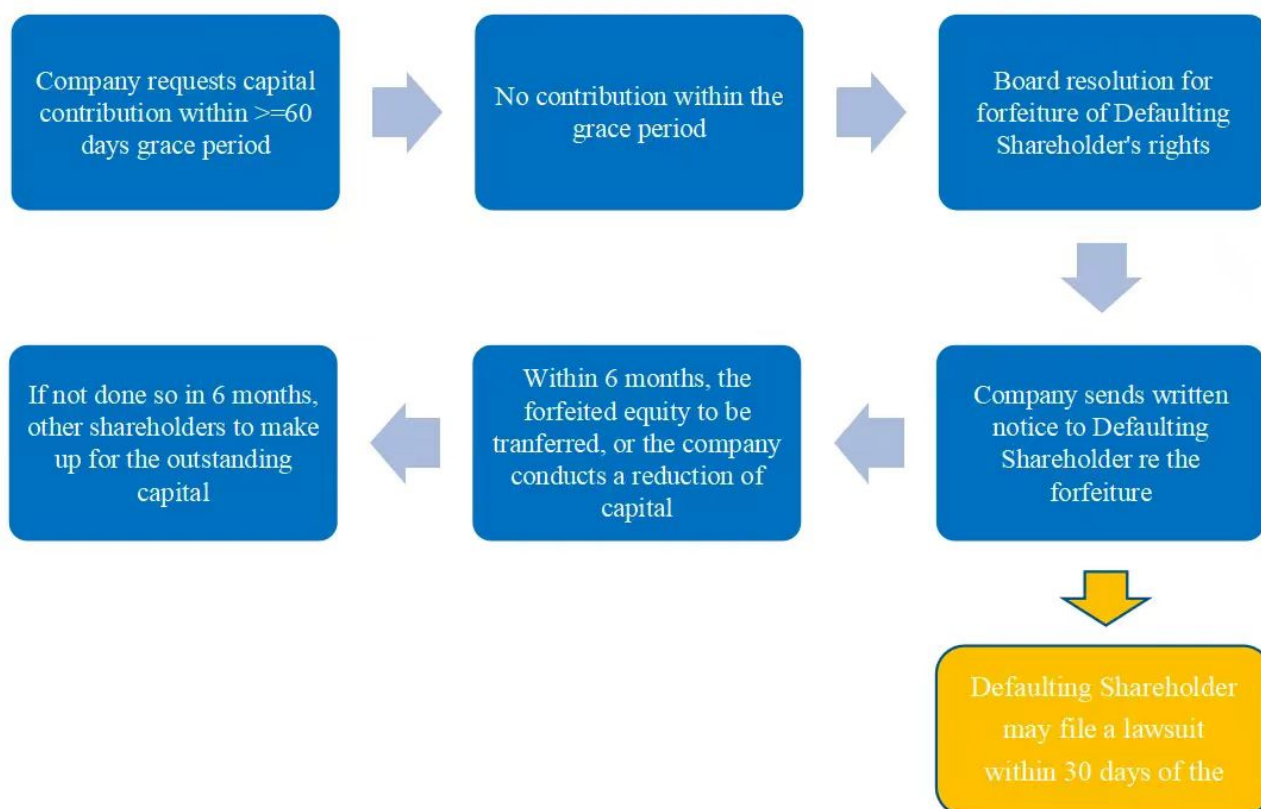
company's outstanding debts to the extent of its shortfall in capital contribution or illegal withdrawal capital contribution plus interest. In addition, according to the *Regulations on Several Issues Concerning Changing and Adding Parties during Enforcement of Civil Cases*, if the company's assets are insufficient to repay its debts, its creditors can seek to include Defaulting Shareholders in enforcement proceedings, holding them liable to the extent of the shortfall in capital contribution and illegal withdrawal of capital contribution. Notably these provisions however have not been incorporated into the New Company Law, and whether Defaulting Shareholders should be liable to the company's creditors is subject to further observations in subsequent judicial interpretations and practices.

IV. Recovering Mechanism for Outstanding Capital and Forfeiture of Defaulting Shareholders' Rights

The New Company Law introduces a mechanism obliging the board of directors to oversee the capital contribution of shareholders and requiring the company to formally demand payments in writing for any outstanding shortfalls. Under this mechanism, the board of directors should verify the capital contributor status. If a shareholder is identified as failing to pay the capital contribution in full and on time, the company must issue a written letter to the shareholder to call the capital contribution. Failure to do so may lead to personal liability for the directors responsible for the oversight.

The Current Company Law does not include provisions for the forfeiture of Defaulting Shareholders' rights, a gap addressed by the Company Law Judicial Interpretation (III). According to this interpretation, if a shareholder defaults on its capital contribution obligations by either not making the required payment or withdrawing its contribution, the company is required to request the capital contribution or the return of the withdrawn capital. If the shareholder fails to adhere to this request, a shareholders' meeting can be convened to revoke the specific rights of the Defaulting Shareholder.

Building upon the provisions of the Company Law Judicial Interpretation (III), the New Company Law provides for a more detailed procedure of forfeiture of rights of Defaulting Shareholders, which runs as follows:



The Company Law Judicial Interpretation (III) mandates the convening of a shareholders' meeting to forfeit the rights of Defaulting Shareholders, but in practice without the cooperation of the Defaulting Shareholders, it may be challenging to hold a shareholders' meeting or pass a resolution. The New Company Law simplifies this process by enabling the forfeiture of rights through the issuance of a notice following a board meeting.

In addition, the New Company Law mandates the board of directors to monitor and urge shareholders' capital contributions, and provides for personal liabilities in connection therewith. We recommend that the board and the company be diligent in monitoring and maintaining good records of all requests and notifications sent to safeguard against potential liabilities.

V. Acceleration of Outstanding Capital Contribution

The Current Company Law does not include any provision regarding the acceleration of payment for the outstanding capital contributions. The Minutes of the National Court Work Conference for Civil and Commercial Trials (*Minutes*), issued by the Supreme Court in 2019, establishes that, under the subscription capital system, shareholders typically have the entire period specified in the articles of association to fulfill their capital contribution obligations and shall not be compelled to pay before the designated schedule. However, in order to maintain a balance between the interests of shareholders and creditors, the Minutes sets out two exceptions where creditors can request shareholders, whose capital contribution obligation has not yet become due, to assume supplementary compensation liabilities for the company's debts. These exceptions include where: (i) the court is unable to locate any assets for enforcement against the company's debts, indicating a de facto state of bankruptcy without any bankruptcy proceedings initiated; or (ii) the company extends the capital contribution period following the incurrence of debts through a shareholders' resolution or other means.

The New Company Law incorporates the above spirit from the Minutes into Article 54, which provides that where a company is unable to pay off debts when due, both the company and the creditors are entitled to request the shareholders to pay their capital contributions before the expiration of their pay-in period.

VI. Capital Contribution Obligations Related to Transfers of Unpaid-in Equity

Under the subscription capital system, it is possible that equity interests can be transferred before the corresponding capital has been paid in, and the Current Company Law does not stipulate who shall bear the obligation of paying the capital to the company. This gap was filled by the Company Law Judicial Interpretation (III), according to which where a shareholder of a limited liability company transfers its equity before the capital contribution has been fully paid in, the company may request the transferring shareholder to pay the capital contribution, and the creditors of the company may request such shareholder to assume supplementary liability for outstanding debts of the company to the extent of the outstanding capital contribution and interests thereon. It also provides that if the transferee is aware or should have been aware of the circumstances, then it should bear joint and several liability together with the transferor.

In judicial practice, most case precedents take the stance that the above provisions only apply to Defaulting Shareholders but not the shareholder whose capital contribution period has not yet expired, although some precedents take the opposite view, holding that the transferring shareholder remains obligated to fulfill the capital contribution even if the paid-in period has not elapsed at the time of transfer.

The New Company Law resolves this ambiguity by outlining rules regarding capital contribution obligations and the distribution of liabilities after the transfer of unpaid-in equity between the transferor and the transferee as follows:

- If, at the time of transfer, the outstanding capital contribution is not yet due, the transferee assumes responsibility for the outstanding capital contribution. In case the transferee fails to meet this obligation by the due date, the transferor becomes the secondary obligor to cover the outstanding capital contribution.
- If, at the time of transfer, the outstanding capital contribution is already overdue or the actual value of the in-kind contribution made by the transferor significantly falls short of the subscribed capital amount, the transferor bears the liability for the outstanding capital contribution. The transferee is jointly and severally liable unless deemed a bona fide transferee, meaning it was unaware and could not have reasonably become aware of the deficient capital contribution status.

Given the provisions in the New Company Law, it is advisable for both parties involved in the transfer of unpaid-in equities to engage in comprehensive due diligence regarding each other's capital contribution status and payment capacity to avoid unforeseen responsibilities.

VII. Directors, Supervisors and Senior Management's Compensatory Liabilities

The New Company Law strengthens the liabilities of directors, supervisors and senior management to ensure the security of the company's capital. According to the New Company Law,

- Where the directors fail to monitor the capital contribution status of shareholders or urge them to make contributions on time, the **responsible directors** should compensate the company for any losses incurred;
- Where shareholders withdraw their capital contributions and cause damages to the company, the **responsible directors, supervisors and senior management** should bear joint compensation liabilities to the company with the relevant shareholders;
- Where the company distributes dividends to shareholders in violation of the laws and articles of association, causing damages to the company, the relevant shareholders and **responsible directors, supervisors and senior management** should bear compensation liabilities to the company;
- Where the company provides financial assistance to others to assist them in acquiring shares in the company or the company's parent company in violation of laws, the **responsible directors, supervisors and senior management** should compensate the company for any losses incurred.

It is important to highlight that in three of the aforementioned scenarios, the New Company Law expands the scope of liabilities to include supervisors in addition to directors and/or senior management. Regarding the determination of who should be considered “responsible” among directors, supervisors, and senior management, the New Company Law does not provide explicit guidance. However, it is worth noting that the initial consultation draft stipulated that directors, supervisors, and senior management “who were aware or should have been aware” of a shareholder’s failure to complete the full capital contribution and “did not take necessary actions” should bear liabilities for compensation. This specific provision was not included in the final law, leaving the decision to the discretion of judicial bodies. It is understood that being “responsible” should encompass situations where directors, supervisors, and senior management are actively involved in illicit activities or fail to fulfill their legal duties as outlined in laws and articles of association.

VIII. Other Changes

In addition to the significant amendments highlighted earlier, the New Company Law introduces several other changes concerning the company’s capital:

- The law specifies that any capital reduction must be carried out proportionally, unless otherwise mandated by law, agreed upon by all shareholders, or stipulated in the articles of association. This differs from the Current Company Law, which allows capital reduction by designated shareholders, a practice that has often been utilized as a means for shareholders to exit.
- A new provision prohibits joint-stock companies from providing financial assistance for the purchase of their own shares, with two exceptions: (i) when the financial support is intended for implementing an employee stock ownership plan, or (ii) when the financial support benefits the company and is approved either by the shareholders’ meeting or by the board of directors as per the authorization granted in the articles of association or shareholders’ meeting. In such cases, the maximum amount of financial support allowed is 10% of the issued share capital.
- The New Company Law imposes restrictions on cross-shareholding between listed companies and their controlling subsidiaries. Controlled subsidiaries of a listed company are prohibited from acquiring shares of the listed company. Any shares acquired for specific reasons must be promptly divested, and voting rights associated with these shares cannot be exercised until the disposal is completed.

Conclusion:

The New Company Law, while largely retaining the principles of capital adequacy from the Current Company Law, tightens the deadline for payment of registered capital. It incorporates judicial interpretations and judicial practices regarding shareholder contribution responsibilities, optimizing and enhancing these rules. Overall, it places greater emphasis on protecting companies and their creditors, and sets higher requirements for shareholders and company directors and senior management in fulfilling capital contribution obligations and maintaining the company's capital adequacy.

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