

# Proposed Changes to China's Company Law Capital Contribution System: Implications for Businesses



CHINA

## **BACKGROUND**

On December 30, 2022, the National People's Congress released the second draft of amendments to China's Company Law (the "Company Law") (the "Second Draft Amendments"), inviting public feedback on the proposed changes.

The Second Draft Amendments are aimed at enhancing the country's business environment, promoting market vitality and strengthening investor protections.

In the following sections, we highlight some of the significant proposed changes to the capital contribution system in the Second Draft Amendments and analyze their potential impact on businesses operating in China.

## **PROPOSED CHANGES TO THE CAPITAL CONTRIBUTION SYSTEM**

### **1. Explicit Recognition Of Equity Interests and Creditors' Rights as Forms Of Capital Contribution Under The Law**

Under the current Company Law, investors can contribute capital in the form of cash, in-kind assets, intellectual property rights, land use rights, or other non-monetary assets that have a measurable value and are transferable. Although the law does not prohibit the use of equity interests or creditors' rights as a means of capital contribution, it also does not explicitly recognize these forms of contribution.

The Second Draft Amendments represent the first time that equity interests and creditors' rights have been officially recognized as valid forms of capital contribution under the law, providing a more solid legal foundation for utilizing equity swaps and debt-equity conversions.

However, it is worth noting that the use of equity interests and creditors' rights as a form of capital contribution must adhere to the same assessment requirements as non-monetary assets. Additionally, governmental registration will also be required for equity interests and creditors' rights utilized in this manner.

### **2. Accelerated Maturity For Registered Capital Contribution Term**

One of the primary considerations for investors when establishing a company in China is determining the appropriate amount of registered capital to invest. Under the current Company Law, investors are free to decide both the amount and term of registered capital contribution. Additionally, the law does not require actual capital contribution to be made prior to the expiration of the specified term.

In practice, some investors may establish companies with a significant registered capital amount and lengthy contribution period, which they may then extend as the expiration date approaches to avoid making the actual capital injection. Under current laws, accelerated maturity for the registered capital contribution term only applies in the event of bankruptcy, dissolution, or liquidation of a company. If shareholders deliberately extend the contribution term without facing bankruptcy or dissolution, accelerated maturity cannot be applied. As a result, even if creditors obtain a favorable judgment, enforcing it may prove to be challenging.

To address this issue, the Second Draft Amendments stipulate that «if a company is unable to repay its debts, the company or its creditors may require shareholders who have subscribed to their capital contributions, but whose term for capital payment has not expired, to make the capital contributions in advance.»<sup>1</sup>With this potential legal development, investors should calculate the appropriate registered capital amount and contribution period with extreme care and based on the actual needs of the company.

### 3. Deprivation Of Shareholder Rights for Failure to Pay Capital Contribution

Under current law, shareholders are entitled to shareholder equity even if they have not yet made their capital contributions. However, if a shareholder has not fulfilled their capital contribution obligations and has not made payment within a reasonable period after being urged by the company, the company can remove the shareholder status. This means that shareholder rights are only deprived if a shareholder completely fails to fulfill their capital contribution obligations. As a result, this leaves room for shareholders who are aware of the law to avoid being removed as long as they have partially paid their subscribed capital.

The Second Draft Amendments aim to close a loophole that has been exploited by some shareholders. It states that if a shareholder fails to make the full amount of their capital contributions within the given time limit, they will lose the shareholder rights corresponding to the amount of capital contribution that they have not made. This means that partial payment of capital contributions will no longer be sufficient to maintain shareholder rights.

The provisions will discourage shareholders from failing to fulfill their capital contribution obligations in full and on time as they will risk losing corresponding shareholder rights.

### 4. Simplified Process for Capital Reduction

The Second Draft Amendments introduce a simplified capital reduction procedure that can be used by companies facing operating losses that cannot be recovered from their capital reserves. This procedure allows the company to eliminate the loss by adjusting its «capital reserve» and «profit distribution» accounts, without requiring the shareholders to return their investments. As a result, the net assets of the company will not be reduced.

From the procedural perspective, the simplified capital reduction procedure introduced in the Second Draft Amendments allows companies to reduce their capital without notifying their creditors or providing security to them, or paying off debts in advance. Instead, a simple announcement in a relevant newspaper or on the official company platform (such as the National Enterprise Credit Information Publicity System) is sufficient. Thus, this procedure can significantly reduce the time required for the company to complete the entire capital reduction process by 45 days or more, compared to traditional methods.

## **CONCLUSION**

It's important to note that the current version of the draft legislation is still open for public comments, and the final content of the law remains uncertain. However, if the draft legislation is enacted in its current form, it would lead to some significant changes to the capital contribution system compared to the Current PRC Company Law.

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1. Article 53



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Some of these changes may be viewed as improvements, such as the clarification on the possibility of making capital contributions with equity interests and creditors' rights, as well as the introduction of simplified capital reduction procedures. However, other changes may have a negative impact on investor interests, such as the accelerated maturity for registered capital contribution terms and the deprivation of shareholder rights for failure to contribute capital.

Given the potential impact of these changes, it's essential for companies to closely monitor the development of this legislation and seek professional advice to ensure compliance with any changes that may be introduced. By staying informed and taking proactive steps, companies can navigate these changes effectively and minimize any potential disruptions to their operations.



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