

# Legal Commentary

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## Reform of Capital Contribution Rules in the 2023 Company Law – What Companies and Shareholders Need to Know

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China's Company Law was enacted in 1993 and underwent certain amendments in 1999, 2004, 2005, 2013 and 2018. In response to the latest trends and demands in economic development, China adopted a comprehensive amendment to the Company Law on December 29, 2023 (the "2023 Company Law"), which will take effect on July 1, 2024.

The rules concerning capital contribution are of great importance to companies and their shareholders and creditors. This article will focus on the amendments related to the capital contribution rules with respect to limited liability companies in the 2023 Company Law, and will try to provide some insights and practical advice in relation to such amendments.

### Capital contribution timeline

#### Paragraph 1 of Article 47 of the 2023 Company Law

The registered capital of a limited liability company is the total amount of capital contributions subscribed by all shareholders as registered with the company registration authority. The subscribed capital shall be fully paid by the shareholders within five years from the date of the company's establishment as stipulated in the company's articles of association.

#### I. Evolution of capital contribution timeline requirement for limited liability companies

The capital contribution timeline requirement for limited liability companies has undergone numerous discussions and amendments in light of the changing economic and social development since the first enactment of the Company Law in 1993 (as illustrated in the following table).

	Company Law of 1993	Amendment to Company Law in 2005	Amendment to Company Law in 2013	2023 Company Law
<b>Capital contribution timeline for limited liability companies</b>	One-time paid-in capital	The registered capital is required to be fully paid within 2 years (5 years for investment companies)	No specific requirement	The registered capital contributions are required to be fully paid within 5 years

The amendment to Company Law in 2013 removed the statutory time limit for making capital contributions and lifted the minimum registered capital requirements. This amendment raised considerable concerns, as shareholders can indefinitely postpone the capital contribution deadline, and the registered capital amount of a company may not accurately reflect such company's financial strength.

Article 47 of the 2023 Company Law provides that the capital contribution of a limited liability company shall be fully paid within five years of its incorporation, which will strengthen shareholders' commitments on capital contribution, better protect creditors' interests, and encourage a more rational approach in determining the registered capital amounts of limited liability companies.

## II. Commentary on Article 47 of the 2023 Company Law

What impacts will Article 47 of the 2023 Company Law have on existing companies and their shareholders, and what are the key takeaways for companies to be incorporated and shareholders who may subscribe for increased registered capital in the future?

### 1. Impact on existing companies

#### ■ Transition period

Existing companies and their shareholders may be concerned about the application of capital contribution timeline under the 2023 Company Law, including whether they are supposed to reduce the registered capital amounts or make capital contributions as soon as possible, and whether the company's article of association needs to be amended to adjust the timeline to make capital contributions. To clarify these points, paragraph 2 of Article 266 of the 2023 Company Law provides that *"For companies incorporated before this law comes into force, if their capital contribution timeline exceeds the timeline stipulated herein, they shall gradually adjust to meet the timeline provided herein, unless otherwise provided by any laws, administrative regulations, or the State Council; in the scenario where the capital contribution timeline or amounts are clearly abnormal, the company registration authority may require timely adjustments in accordance with the law. The specific implementation measures shall be prescribed by the State Council."* The representative of the Legislative Affairs Commission of the Standing Committee of the National People's Congress also stated in the response to media inquiries on the 2023 Company Law that: *"The State Council is tasked to issue implementation measures for the 2023 Company Law, including setting a transition period for companies incorporated prior to the effectiveness of this law with capital contribution timeline exceeding the required timeline under this law, and such companies will be required to gradually adjust their capital contribution periods to be in line with this law."*

The above regulations and statements have dispelled the previous speculation of "existing rules for existing companies, and new rules for new companies". In other words, there is no grandfathering for existing companies in this respect. The five-year capital contribution timeline will apply to all companies, including those incorporated before the promulgation and implementation of the 2023 Company Law. Therefore, it is suggested that the existing companies and their shareholders keep a close eye on the implementation measures to be promulgated by the State Council.

## ■ Registered capital reduction

Although the State Council has not promulgated implementation measures for the 2023 Company Law, it is anticipated that some companies may need to reduce their registered capital to lower capital contribution requirements to mitigate the potential impact on the cash flow of their shareholders.

Article 225 of the 2023 Company Law introduces a simplified capital reduction procedure, which applies to companies that have incurred losses and whose asset value is significantly lower than their registered capital. Under this simplified procedure, such companies may reduce their registered capital and announce capital reduction through the National Enterprise Credit Information Publicity System, without the need to notify creditors or publish an announcement in newspapers, which are typically required for normal capital reduction procedures. Such simplified capital reduction procedure aims to ensure such companies' registered capital aligns with their actual operational and financial strength, while keeping such companies' solvency and avoiding the companies' assets flowing back to their shareholders.

## 2. Key takeaways for companies to be incorporated

Article 50 of the 2023 Company Law generally follows the current Company Law on the capital contribution obligations of founding shareholders, and provides that: *“When a limited liability company is incorporated, if a shareholder fails to make an actual payment of capital contributions as stipulated in the company’s articles of association, or if the actual value of non-monetary assets contributed falls significantly below the subscribed capital amount, the other shareholders at the time of establishment shall bear joint and several liability with that shareholder for such shortfall in capital contributions.”* However, compared with the current Company Law, the 2023 Company Law provides that founding shareholders shall bear joint and several liability only for the shortfall in capital contributions of the defaulting shareholder.

Therefore, for companies to be incorporated, it is suggested that founding shareholders set the amount of registered capital properly, monitor the progress of capital contributions made by other founding shareholders, conduct necessary due diligence and understand the financial strength of other founding shareholders.

## 3. Key takeaways for shareholders subscribing for increased share capital

Article 228 of the 2023 Company Law says that *“When a limited liability company increases its registered capital, the contribution of its shareholders to the new capital shall be made in accordance with the relevant provisions of this Law regarding the payment of capital contributions for the establishment of a limited liability company”*, which means that the five-year capital contribution timeline also applies to capital increases. Consequently, shareholders subscribing for increased capital shall pay the increased registered capital within five years (or a shorter period provided for in the articles of association).

## Written payment demand and forfeiture of shares

<b>Article 51 of the 2023 Company Law</b>
<p>After the establishment of a limited liability company, the board of directors shall verify the shareholders' capital contributions. If it is found that a shareholder has not timely and fully made capital contributions as stipulated in the articles of association, the company shall serve a written notice to the shareholder to demand payment of capital contributions.</p> <p>Directors who fail to fulfill the obligations stipulated in the preceding paragraph in a timely manner, resulting in losses to the company, shall be liable for compensation.</p>
<b>Article 52 of the 2023 Company Law</b>
<p>If a shareholder fails to make capital contributions by the date specified in the company's articles of association, and the company issues a written payment demand in accordance with the first paragraph of the preceding article, the company may specify a grace period for the capital contribution in the written payment demand, which grace period shall not be less than 60 days from the date the company issues the payment demand. If, upon the expiration of the grace period, the shareholder still fails to fulfill the capital contribution obligation, the company may, with a resolution of the board of directors, issue a notice of forfeiture to the shareholder, and such notice shall be in writing. From the date of the notice, the shareholder loses the rights to the unpaid share capital.</p> <p>The shares forfeited according to the preceding paragraph shall be transferred in accordance with the law or the registered capital shall be reduced accordingly with the cancellation of those shares; if the transfer or cancellation is not completed within six months, other shareholders of the company shall make corresponding capital contributions in full in proportion to their respective contributions.</p> <p>If the shareholder has objections to the forfeiture, it shall file a lawsuit with the people's court within 30 days of the receipt of the notice of forfeiture.</p>

### I. Comparison between Articles 51 and 52 of the 2023 Company Law and Article 17 of Judicial Interpretation III of the Company Law

Before the 2023 Company Law, Article 17 of the *Provisions of the Supreme People's Court on Several Issues Relating to Application of Company Law of the People's Republic of China (III)* (“**Judicial Interpretation III of the Company Law**”) already provided mechanisms similar to the written payment demand and share forfeiture. The 2023 Company Law goes one step further and allows both the company and its shareholders to seek remedies against capital contribution defaults of other shareholders.

	<b>Judicial interpretation III of the Company Law</b>	<b>2023 Company Law</b>
<b>Applicable scenarios</b>	Failure to fulfil capital contribution obligations or withdrawal of all capital contributions, and such failure is not cured within a reasonable period after being demanded by the company.	Failure to pay capital contributions by the date specified in the company's articles of association, and still failure to fulfill the capital contribution obligations within the grace period.
	<i>Comments: The share forfeiture mechanism stipulated in Judicial Interpretation III of the Company Law is not applicable if the shareholders have partially paid capital contributions or only partially withdrawn capital contributions, which makes it</i>	

	<i>challenging to effectively achieve the intended purposes.</i>	
<b>Legal effect</b>	The forfeited shareholder is disqualified from being a shareholder.	From the date of the demand, the defaulting shareholder loses the rights to the unpaid registered capital.
	<i>Comments: The application of the Judicial Interpretation III of the Company Law will result in the defaulting shareholder losing the entire share capital and their shareholder status, although in practice judicial authorities have already started to support partial forfeiture of share capital in some cases. The 2023 Company Law has paved the way to overcome such a predicament.</i>	
<b>Procedural requirements</b>	<ul style="list-style-type: none"> <li>■ Failure to make the payment or return the withdrawn capital contribution within a reasonable period after being demanded by the company.</li> <li>■ The company passes a shareholders' resolution to disqualify the shareholder.</li> </ul>	<ul style="list-style-type: none"> <li>■ Failure to pay the capital contribution within the grace period after being demanded by the company.</li> <li>■ Issuance of a notice of forfeiture to the shareholder pursuant to a resolution of the board of directors.</li> </ul>
	<i>Comments: According to the 2023 Company Law, the right to confirm the issuance of a notice of forfeiture shifts from shareholders to directors, which is in line with the board of directors' duties to supervise capital contributions.</i>	
<b>Subsequent process</b>	Prompt completion of capital reduction procedures, or other shareholders or a third party paying such capital contribution.	Reduction or transfer of share capital within six months.
	<i>Comments: The 2023 Company Law specifies the timeframe for the disposal of the forfeited share capital, which enhances the stability and clarity of the company's capital structure.</i>	

## II. Commentary on Articles 51 and 52 of the 2023 Company Law

### 1. Verification of capital contributions and issuance of written payment demand

Article 51 of the 2023 Company Law provides that the board of directors shall verify the capital contribution, and if a director fails to perform such obligations in a timely manner and causes losses to the company, such responsible director shall be liable for the compensation.

#### ■ Board of directors' right to verify capital contributions

The 2023 Company Law tends to give the board of directors more supervisory rights, given that the supervisors/board of supervisors have not been proven to be very effective in supervising corporate governance in practice. For example, the 2023 Company Law introduces the concept of an audit committee (consisting of directors), which is expected to exercise the powers and functions of the supervisors/board of supervisors.

Although the 2023 Company Law provides that the board of directors shall verify and supervise the payment of capital contributions, it does not expressly grant the directors access to the company's accounting books or other materials. It is advisable for companies to specify in the articles of

association or other corporate documents the rights and authorities of directors to review the register of shareholders, capital contribution certificates and necessary accounting records. This will help the board of directors exercise their rights to verify capital contributions, especially in light of the 2023 Company Law's emphasis on the supervisory functions of the board of directors. On the other hand, for confidentiality considerations, some companies may wish to limit directors' access to information that is necessary to perform their duties.

#### ■ Compensation liability of directors

The 2023 Company Law imposes compensation obligations on directors who fail to fulfill the obligations to verify capital contributions and cause the company to demand payment. Therefore, it is advisable for directors to keep records of their efforts to verify shareholders' capital contributions and cause the company to demand payment of capital contributions from the defaulting shareholders, which could help directors defend against compensation claims.

Meanwhile, for investors in private equity and venture capital deals that are entitled to appoint directors, it is suggested that the transaction documents contain clauses granting the appointed directors the specific rights of verification and supervision. This will help the directors perform their statutory duties of verification and demanding payment of capital contributions. Director liability insurance is also a good option to protect the appointed directors.

## 2. Forfeiture of share capital

According to Article 52 of the 2023 Company Law, the company shall dispose of the forfeited share capital within 6 months by transferring such share capital or canceling such share capital through registered capital reduction. If the forfeited share capital is not transferred or canceled within such 6 months, the other shareholders shall pay such outstanding capital contributions in proportion to their respective shareholding ratio.

Given the time limit for the disposal of the forfeited share capital, the company may wish to start to find a transferee or start to prepare for capital reduction concurrently with or shortly after issuing the notice of forfeiture. Furthermore, to streamline the disposal process, it is advisable to specify in the articles of association and other corporate documents (such as the shareholders' agreement) that the shareholders whose share capital has been forfeited are obligated to cooperate with the disposal process, including the possible share transfer and registered capital reduction.

Additionally, since the 2023 Company Law imposes obligations on other shareholders to make capital contributions in proportion to their shareholding percentages for forfeited share capital not disposed of within the 6-month timeline, it is suggested that shareholders monitor the capital contribution progress of other shareholders and the register of members, and cause the directors and the company to promptly demand the relevant shareholders to rectify any default in capital contributions, thereby avoiding the risks of being asked to make capital contributions for forfeited share capital of other shareholders.

Meanwhile, companies may consider to address in the articles of association and other corporate documents (such as the shareholders' agreement) issues not specifically addressed in the 2023

Company Law, such as revoking the voting rights of directors appointed by the defaulting shareholders and/or allowing defaulting shareholders or their representatives to attend board meetings and present their cases.

### Acceleration of capital contribution timeline

**Article 54 of the 2023 Company Law**

If a company is unable to pay off the due debts, the company or the creditors of the due debts shall have the right to demand early capital contributions from shareholders whose subscribed capital contributions are not yet due for payment.

The rationale behind the capital contribution acceleration rules is that, under certain circumstances, the interests of shareholders with respect to the capital contribution timeline shall give way to the interests of creditors, and the company’s registered capital shall be used to facilitate the enforcement of creditors’ rights.

Under the current rules, if a company is unable to pay its due debts, the creditors are generally unable to demand the shareholders of the company to pay capital contributions not due for payment, unless under limited circumstances such as the company already in the bankruptcy or dissolution process or intentional extension of capital contribution timeline to avoid debts.

Article 54 of the 2023 Company Law aims to expand the scenarios where acceleration of capital contribution timeline is applicable, pursuant to which, as long as a company is unable to pay off its due debts, the creditors may require early capital contributions from shareholders, even if such shareholders’ subscribed capital contributions are not yet due for payment. This provision also shows that the 2023 Company Law puts more weight on creditor protection.

Meanwhile, further guidance is needed on how to determine whether a company “is unable to pay off its due debts” under Article 54 of the 2023 Company Law. For instance, it remains unclear whether creditors can demand to accelerate capital contributions when a company has sufficient assets or funds but refuses to pay off its due debts.

In addition, Article 54 of the Company Law does not elaborate on the nature and extent of shareholders’ liability. Shareholders may want to specify in the articles of association and/or shareholders’ agreement that the shareholders who are required to expedite their capital contributions only need to contribute an amount necessary to settle the company’s outstanding due debts, and the timeline for the remaining capital contributions shall be unaffected, although such provisions (as an agreement between the shareholders and the company) may not be used as a defense against creditors. Some shareholders may want to go one step further to require to state in the articles of association and/or shareholders’ agreement that the company shall, after paying off the creditors, reimburse the shareholders for any losses (such as the loss of benefits of the original capital contribution timeline) caused by such capital contribution acceleration.

**Conclusion**

Capital contribution rules form the bedrock of a company's financial strength and play a vital role in companies' operations. The 2023 Company Law introduces a series of reformative measures, including the capital contribution timeline, written payment demand and share capital forfeiture. It is advisable for shareholders, directors and management of limited liability companies to pay close attention to these new rules related to capital contribution, and implement appropriate measures to protect the companies' and their shareholders' interests.



## ***Important Announcement***

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