China Company Registered Capital Reform and its Implications on Your China Business

Description

It has been more than two years since China launched its reform on corporate registered capital (also termed as legal capital) regime with a view to reviving and boosting investment by the grassroots people. Apparently, it has been a successful reform so far. But in the meantime, this reform has its far-reaching bearing on the way companies are funded and on the way businesses in China are conducted.

I. Contents of the Reform in Respect of Registered Capital

Basically, the reform concerning registered capital is in the following aspects:

1. removing the minimum amount of registered capital requirements for setting up either a limited liability company or a company limited by share (or stock company). Before the reform, a limited liability company must have a minimum registered capital of RMB 30,000 and a stock company limited by shares RMB 5 million.
2. removing requirement on the time limits on contributing registered capital, leaving this to the discretion of corporate shareholders to be decided in the articles of association of the company. Before the reform, 20% of the registered capital of a company shall be contributed upon incorporation with the remainder to be paid up in full within two years, except for investment companies whose registered capital is allowed to be paid over five years.
3. removing the paid-in capital verification formality. Before this reform, whenever a part of registered capital is contributed by shareholders, this contribution must be verified by an accounting firm to make sure the contribution is correct and in accordance with laws and articles of associations. After this removal, the company shall disclose on the national company credit online system the contribution of registered capital when it is paid in by shareholders.

There are some other concrete reforms auxiliary to and supporting the registered capital reform.

II. Legal Implications on Business Formation and Conducting

There are many legal implications flowing out of the reforms which can be said to be fundamental in corporate practice in China.

(1) Business Formation

As you may have noticed, after the lifting of requirement on time limits on contributing company's registered capital, over night, there have been so many new companies set up. A conspicuous phenomenon is that the amounts of registered capital are very big. One of my personal friends set up a small trade company and put the registered capital at RMB 5 million, though he didn't really need such a big registered capital.

There are two reasons why people choose to have a big registered capital for their companies. (1) with this reform, China company registry authority no longer requires shareholders to lay out a clear time table for contributing the registered capital. Instead, in Shanghai so far as I know, many newly set up companies stipulate in their articles of association to the effect that the registered capital will be paid up over the whole life of the company which is often more than 20 years. So shareholders feel no pressure in paying up the capital any time soon. (2) the second reason is that many Chinese businessmen have the mistaken perception that companies with a great registered capital are often more credible than those companies with small ones, which is definitely wrong.

(2) Business Conducting

As a result of rampage of artificially inflated registered capital in the market, when you are entering into any business contract with a Chinese company, you have got to be careful of not gauging your Chinese counterpart's credibility only based on its registered capital, but more on its assets and cash flow.

The difficulty in practice is that you have no reliable way to know whether or how much of the registered capital is paid by the shareholders. Even though it is required by law that companies shall report its contribution of registered capital to the public, it remains to be seen how this can be enforced and how credible the information disclosed by companies.

Maybe it is worthwhile to ask your Chinese contract counterpart to make representation and/or undertaking in regard of its registered capital contribution, making sure its business is reasonably capitalized.

III. Implications on Judicial Practice Concerning Corporate Liability

So what if you are caught in a legal proceeding against your Chinese business partner company in China? For example, you sue the Chinese company to collect owed debts or you sue it for other pecuniary claims?

Though in real world, businessmen don't rely much on a company's registered capital but its asset and cash flow to assess the company's financial credibility, the concept of registered capital, as a basic element of corporate law, is still meaningful and important as it is nonetheless the first basis for any third party dealing with the company to gauge the company's financial credibility. So once set and published in corporate certificate, it is binding on the shareholders and the company. In certain circumstances, corporate creditors may benefit from artificially inflated big registered capital of their debtors.

(1) add the shareholders as co-defendants. According to Article 13 of the third judicial interpretation by China Supreme Court of China Company Law, if shareholders (or any of them) fail to contribute registered capital in part or in whole, the company's creditors shall have the right to demand the said shareholders to pay off the part of debts that the company is unable to pay, to the extent of the registered capital (and interests thereon) that is not paid. In the meantime, as per the third paragraph quoted below, the company's creditors can also demand other corporate promoters to assume the joint and several liability with the shareholders who have not paid up their subscribed registered capital. Further, corporate directors and other high-ranking officers (such as CEO or general managers) may

also be called to account for their respective liability if they are found to be delinquent in their duties prescribed in article of 147 of China Company Law.

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(2) the reform may have some obvious impact on the application of veil-piercing doctrine in China judicial practice. Piercing corporate veil is still kind of new but complicated cases in China. China Company Law embraces this cause of action with a very sketchy, rough and abstract provision, namely, Article 20:

> Shareholders of a company shall abide by the laws, administrative regulations and the articles of association of the company and exercise shareholders' rights according to law. Shareholders shall not abuse their rights as shareholders to impair the interests of the company or other shareholders, or abuse the independent legal person status of the company or the limited liability of shareholders to impair the interests of creditors of the company.
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> Where the shareholders of a company abuse their rights as shareholders and cause losses to the other shareholders, the shareholders shall be liable to compensate such losses according to law.
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> Where the shareholders of a company abuse the independent legal person status of the company or the limited liability status of shareholders, evade debts and seriously impair the interests of the creditors of the company, the shareholders shall bear joint and several liability for the debts of the company.

So far, China Supreme Court has not issued any guidance or interpretation to guide local courts to apply this provision in practice. Some local high courts at provincial levels have attempted to test the ground by issuing their own guidance to their respective lower courts. For example, Shanghai High People's Court has stepped up its opinions on how to apply the veil-piercing doctrine in its jurisdiction. In the Shanghai High People's Court's Opinions, it says in its Article 7:

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> Article 7 (obvious undercapitalization) where shareholders fail to contribute its share of registered capital, or covertly withdraw their capital contribution following formation of the company, resulting in the company's capital being lower than the statutory thresholds, the People's courts shall find obvious undercapitalization on the part of the company.

As is clear in the quoted provision, the old statutory minimum thresholds set for different kinds of limited liability companies serve as benchmarks for piercing corporate veils, which is highly called into question as to its practical efficacy on redressing justice in corporate practice.

Now with the removal of those statutory minimum thresholds in this reform, courts will be lost and find it more elusive and difficult in applying the veil-piercing doctrine in real cases.

The reforms on corporate registered capital have far-reaching impacts on China's corporate law practice which will roll out over time and is worthwhile to be observed closely.

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