The Impact of the Registered Capital Requirement Reform in China

Yilun Zhou

Haitong Securities Co., Ltd, Shanghai 200001, China

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Abstract: The original purpose of the reform is to encourage entrepreneurship and innovation. However, there are many problems, for example, shareholders may increase their registered capital aimlessly, and file for bankruptcy or transfer their shares before the final investment deadline comes. Chinese society has formed a long-term requirement for registered capital, and it is generally believed that registered capital is an indicator of corporate credit. Even after the reform of the company law, many companies still estimate the risks of transactions by looking at the registered capital of counterparties, because the asset quality and/or reputation of counterparties cannot be easily assessed. It is unrealistic to rely on shareholders' self-discipline to protect creditors' interests before establishing a complete personal credit history system. On the contrary, the current regulatory framework should be revised. At the company level, first of all, if shareholders arrange a large amount of registered capital, they should provide guarantee for the unpaid part. Companies should disclose important information to creditors and creditors' committees in a timely manner. For creditors, they should also conduct due diligence on the information disclosed.

1. Introduction

Registered capital, also called “legal capital,” is the total amount of capital that is 1) prescribed in the company charter, and 2) contributed or to be contributed to the company. On a balance sheet, it is shown as the “common stock” and/or “capital in excess of par value” sections.

Before the new Chinese Company Law which took effect in 2014, to form a limited liability company, sole proprietorship or corporation in China, it was required that equityholder(s) should invest at least CNY 30,000, 100,000 or 5 million as registered capital in the new entity, respectively. Registered capital should be paid within 2 years of formation for a company (or 5 years for an investment company), and at the time of formation for a sole proprietorship. In addition, for LLCs and corporations, there used to be a minimum threshold of ownership of the controller. All three requirements (collectively, the “actual payment system”) were abolished in the 2013 “scheduled payment system” reform, which allows equityholders to decide among themselves and specify in the company charter the amount of capital, payment schedule and way of payment. Specifically, for LLCs, proposed registered capital and actual payment will not be registered or reported.

The original purpose of the reform was to encourage entrepreneurship and innovation. However, multiple problems were also created, such as equityholders might aimlessly increase scheduled registered capital, file bankruptcy or transfer equity before the final capital contribution deadline comes, etc. These issues will be discussed in the next section in detail.

2. Problems of the Reform

The long standing registered capital requirement formed in the Chinese society a prevailing belief that registered capital is *the* indicator of a company’s credit. Even after the Company Law reform, many companies still estimate a deal’s risk by looking at the counterparty’s amount of registered capital when its asset quality and/or creditworthiness cannot be readily assessed. Now that proposed registered capital and actual payment will not be registered, the cost of defrauding is significantly lowered. Even if the company registers its proposed capital, since the payment

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schedule is made by equityholders themselves, and no initial payment is required, the counterparty cannot determine the actual payment status. A trust problem is thus created.

2.1 Aimless Capital Increase

After the implementation of the 2013 Company Law, many equityholders increased proposed registered capital due to their baseless optimism or gambler's mentality. However, when the time of scheduled payment comes, many are not able to fulfill their duties. If an equityholder intentionally proposed a payment amount beyond his capabilities, he most likely will amend the company charter, postponing the deadline or reducing the amount payable. Once a company is insolvent, since the total capital transferred to the company account is less than scheduled, total assets might not be sufficient to pay off all debts, and thus creditors' rights are violated. Meanwhile, when the shareholders are unable to finance the rest of unpaid capital, which is very common, even if creditors win a judgment for them from the court, it is hard to execute in reality.

2.2 Bankruptcy Before Registered Capital Payment

Another problem arises if the company files bankruptcy before the scheduled deadline of capital contribution comes. Though some shareholders may not be willfully cheating the creditors, they might in fact face a financial failure which harmed creditors. According to *Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (II)*, Section 22,

When a company is dissolved, unpaid capital from equityholders should all be considered as liquidating assets of the company. Unpaid capital from equityholders include due but unpaid capital, and capital that is scheduled to be paid in installments but not due, according to Company Law Section 26 and Section 80.

In other words, when a company is being liquidated before the final deadline of capital contribution, capital scheduled to be paid by equityholders should also be considered as liquidating assets. However, since according to the schedule equityholders are not required to possess the full amount of total registered capital throughout the capital contribution period, in reality equityholders might not have enough assets to repay the creditors. For example, if a company has a proposed registered capital of CNY 4 million, which should be paid up in equal installments over four years. Only six months later, the company was insolvent. According to the Supreme People's Court, all of CNY 4 million should be considered as the company's liquidating assets, and equityholders should use their personal assets to make up for the unpaid part. Still, unintentionally, the equityholders might have to default, because their original plan was to collect enough money by, and only by, the end of the first year.

According to Company Law Section 187, "after the liquidation work team check the company's assets and create a balance sheet as well as a list of assets, if it is found that the company does not have enough assets to repay its debt, the liquidation work team should declare bankruptcy to the People's Court." A paradox then emerges: while the company does not have enough assets to repay all debt right now, what if the company becomes solvent after considering scheduled registered capital from equityholders? If the equityholders refuse to contribute capital, arguing that they will stick to the schedule specified in the company charter, should the court declare bankruptcy or force the equityholders to bring forward capital contribution?

2.3 Equity Transfer Before Registered Capital Payment

In *Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (III)*, it is specified that, "when a limited liability company shareholder transfers his shares without fulfilling or fully fulfilling his obligation of capital contribution, and the transferee knows or should know about it, the People's Court should support the company's request for the shareholder's fulfillment of his capital contribution obligation, and the transferee will be jointly responsible for the liability." In the former actual payment system, there is no ambiguity in "fulfilling or fully fulfilling his obligation of capital contribution." After the reform, however, since the scheduled time has not yet come, as long as the shareholder follows the capital contribution plan as stated in the company charter, technically he might not be failing to "fulfill[] or fully fulfill[] his obligation of capital contribution." The new Company Law did not directly answer to whether and how shareholders can transfer their ownership in the company before the deadline of final capital contribution comes.

3. International Practice Regarding Capital Regulations: Lessons from Europe

Minimum capital requirement does not only exist in China. The *EU Second Company Law Directive*, which was enacted in 1976, prescribed that "[t]he laws of the Member States shall require that, in order that a company may be incorporated or obtain authorisation to commence business, a minimum capital shall be subscribed the amount of which shall be not less than EUR 25 000 [1]." Following the EU's Second Company Law Directive, the British government enacted the Companies Act 2006, where Section 761 requires that when a public company begins to trade it has a minimum of £50,000 promised to be paid up by the shareholders. Unlike PRC company law, the capital is not considered as a source of operating capital, but can be used for redemption or purchase of its own shares, though with certain constraints [2]. In the U.K., for private companies there is generally no minimum capital requirement. A company can be set up by issuing one £1 share per member [3].

Minimum capital requirements are more common in civil law countries. In France, a public company (*société anonyme*) must have a minimum capital of EUR 37,000. If the company is listed, the required amount rises to EUR 225,000 [4]. Following reforms in 2003, the minimum capital requirement for a private limited company (*société à responsabilité limitée*) was abolished from a previous minimum amount of EUR 7,500 [5]. In Germany, the minimum capital amount for a public company is EUR 50,000 [6] and for a private company is EUR 25,000 [7]. The application for registration may be made only after one quarter of the nominal value of each share has been deposited [8]. However, a kind of private company without minimum capital requirement was also allowed in Germany, though it must bear the designation "Unternehmergesellschaft (haftungsbeschränkt)" (entrepreneurial company (limited liability)) or "UG (haftungsbeschränkt)" for short [9].

Because of the different capital requirements among EU countries, there have been conflicts during cross-border registration of company branches. In *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, a private limited company formed in the U.K. was refused by the Danish government to register a branch in Denmark because the country is more restrictive as regards the paying up of a minimum share capital [10]. As mentioned above, British private companies are not restricted by a minimum capital requirement. Thus, the European Court of Justice found the Danish restrictions to be unlawful,

"Given that the right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment [11]."

The *Centros* ruling led a lot of French and German businesses to switch to the U.K. and form as a private limited company there. The abolishment of minimum capital requirement in France in 2003 and the new "UG" in Germany could as well be resulting from this case. Nevertheless, the *EU Second Company Law Directive* remained unchanged.

The court in *Centros* also provided some solutions to the problem of preventing or penalizing fraud, which might arise after the case. The local government could adopt less restrictive measures, such as enabling public creditors to obtain necessary guarantees, if necessary with the cooperation of another Member State [12]. Similar procedures could potentially be adopted in China, which will be discussed in detail in later sections.

4. Possible Solutions

4.1 Require Equityholders to Provide Security for Proposed Registered Capital Payment

Before the recent registered capital reform, the former minimum capital amount requirement and the 2-year across the board payment deadline were considered as obstacles for establishment of small and medium enterprises. Though the restrictions were lifted in the reform, new problems arose, most significant of which is that equityholders might set up an unrealistic registered capital contribution plan and fail to follow it. One possible solution to this problem is that the government can set up a flexible security system and require equityholders to provide security for proposed but unpaid capital.

Specifically, if equityholders schedule to pay a large amount of registered capital, they should provide security to the company. For example, equityholders may ask some third party to provide guaranty, or pledge their own assets. If guaranty is provided, once equityholders cannot fulfill their duties when capital contribution is due, the company can ask guarantors to take joint responsibility and make payment within the scope of liability prescribed in prior agreement. Even if guarantor's own assets are insufficient as well, creditors are still better protected since there is another source of repayment. Similarly, if equityholders try to transfer their ownership before scheduled capital payment, the new equityholder should also provide his own security methods.

On the one hand, requiring equityholders to provide security for proposed registered capital is similar, but more practical than setting a minimum registered capital threshold and a rigid 2-year deadline of payment, as in the old "actual payment system." Previously, once registered capital is paid up, theoretically the money must remain on the company account for operational needs, but in reality equityholders would always want to make better use of the money and pull it out of the company account, which has significant legal risk. By requiring only security, equityholders are allowed the flexibility of making their own capital contribution plans, and thus they would have less incentive to break the law and pull the money back.

On the other hand, with the security requirement, equityholders will be more prudent in proposing total registered capital. Concerning the safety of their own personal assets, people will be less inclined to use the company as a gambling tool. Moreover, guarantors will act as another safety net in the process, since a competent guarantor will not make a promise for an amount which is unrealistic and/or unreasonable.

It is, admittedly, impractical to demand all equityholders to provide security for their promised capital contribution. Even if security is uniformly provided, such a practice would be contradicting to the goal of this recent Company Law reform, which is to streamline the process of setting up small and medium enterprises and thus encourage entrepreneurship. The concerns in Section II of this article were raised from the standpoint of creditors, so the solutions should also be rooting in protecting creditors as well. Consequently, security should be required only from equityholders who promised a number big enough to induce concerns. Such a scheme would produce positive incentives to financially competent entrepreneurs. The more personal assets an entrepreneur has, the easier it is for him to provide security (especially in terms of pledge or mortgage of assets), the more likely that he would pay the registered capital as scheduled. Similarly, the less financially competent an equityholder is, the more likely that he will have a gambler's mentality and cheat on his duty of registered capital payment. As a result, with the security requirement, entrepreneurs who are truly dedicated to the business and acting reasonably will be able to differentiate themselves. Thus, few people would be able to take advantage of the limited liability system and transfer undue risks to creditors.

4.2 Enhance Disclosure of Company Operations Information to Creditors

Creditors should be aware that, the basis of a company's ability to take civil liability is its own operating assets, rather than registered capital. Registered capital only delimited the bottom line of equityholders' personal liabilities. If the company encounters significant or continuous operating loss, even if equityholders faithfully fulfilled their responsibilities of capital contribution, the company may still become insolvent. In fact, when a Chinese company engages in business dealings with a foreign company, it will not consider the other side's amount of equity as the most significant factor. Why shouldn't the same reasoning apply in the PRC domestic market? For creditors to better assess debtors' financial status, it is essential to establish a disclosure and transparency framework.

The English Companies Act 1862 established basic guidelines of information disclosure [13]. The *G20/OECD Principles of Corporate Governance* listed "Disclosure and Transparency" as one of the important corporate governance principles. Specifically, "the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company [14]." In the case of private companies, disclosure on an annual basis would suffice, though "some countries require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company [15]."

With public disclosure of company affairs, potential creditors would be able to use this information to analyze the company's assets, credit and operations. They could also hire a third-party credit analyst to decide whether they should engage in a lending and/or business relationship, basing their decision on the counterparty's cash flow, net assets, security and other credit factors. At the very least, potential creditors could make risk-sharing arrangements to their advantage. Meanwhile, if the creditor himself did not conduct due diligence with readily available information, or insisted on initiating business dealings with a company whose riskiness was fully exposed, then he has walked out of the scope of legal protection.

Promoting the principle of Disclosure and Transparency would significantly help with protecting creditors' access to information and other related rights. The quality of disclosure, undoubtedly, would still mostly rely on the integrity of potential debtors and their equityholders. Nevertheless, a variety of corresponding schemes and procedures could be established to ensure adherence to the principle. For example, in companies of a certain size and up, creditors could set up a committee, which would have the right to require the company to disclose events that could result in material changes to the company's capital. Such a creditors' committee should only include those creditors who have a relatively large loan value, so that a balance could be reached between the costs and benefits of maintaining the committee.

4.3 Uphold the "Three Principles of Corporate Capital"

The "Three Principles of Corporate Capital" is a notion widely recognized among Chinese corporate law scholars. Specifically, the three principles require a company's registered capital to be confirmed, maintained, and fixed, which are considered to be universally present in civil law countries. The Three Principles together can ensure the reliability and security of corporate capital during the whole process of the company's establishment, operation and management. The Confirmed Capital Principle means that when a company is being set up, the total amount of registered capital should be specified in the charter and be paid up or scheduled to be paid up in the future. Otherwise, the company cannot be set up. The Maintained Capital Principle means that during the existence of the company, it should keep a number of assets which equal to that of its registered capital, so as to turn "capital" from a number to real assets and prevent equityholders or officers from encroaching the company's capital. Lastly, the Fixed Capital Principle refers to the requirement that once the total amount of capital is ascertained, it cannot be changed without certain procedures prescribed by law [16].

4.4 Confirmed Capital Principle

Despite the fact that the current Chinese Company Law allows equityholders to pay up the legal capital within a specified span of time, equityholders should not be allowed no limitations regarding their behavior. Before the due date stated in the company charter, equityholders must faithfully fulfill their capital contribution obligations, no denial in obligation or extension of deadline should be granted. Such restrictions rooted not only in equityholders' personal creditworthiness, but also in the credibility of law.

In addition, the capital contribution plan prepared by equityholders should be reasonable, with detailed milestones. The greater the proposed registered capital is compared to equityholders' own financial status, the more information they should provide in the charter. Take an extreme example, if equityholders set the planned registered capital to be $1 billion, to be paid in 100 years, then they should at least make some payment each year, for example, $10 million a year.

The recent registered capital reform, though aimed at providing equityholders with more freedom in terms of making their own plans, does not mean that the "Confirmed Capital Principle" was abandoned. If equityholders are allowed absolute freedom as to when to pay and how much to pay, then it could be that the company will be short in funds in early stages, or when the company had operational problems, equityholders will just abandon the company at the cost of creditors' interests. In fact, equityholders have the duty to make reasonable plans and implement them, which correspondingly will help equityholders rationally evaluate their own financial abilities.

4.5 Fixed Capital Principle

One key element of the Fixed Capital Principle is that before a company decides to reduce its registered capital, it must make arrangements regarding its current debt and acquire consent from creditors. If some debts are due, they must be paid first; other debts must be guaranteed in escrow or by additional security.

These requirements are essential because reducing registered capital in fact poses more risk on creditors by cutting down the scope of equityholders' responsibilities and lowering the company's liquidity and solvency. One may argue that, even if an equityholder amends the company charter to reduce his scheduled capital contribution, as long as the post-reduction amount is greater than the capital already paid up, the company's assets available will not change. However, it should also be taken into account that, if one equityholder is not able to fulfill his capital contribution obligations, the other equityholders are jointly responsible for his breach of duty. Though the company's assets currently available does not change, in the long term creditors' interests are harmed.

Moreover, to better uphold the Fixed Capital Principle, equityholders should be prohibited from prolonging the term of capital contribution in the name of increasing the amount of registered capital. At first glance, increasing capital amount is in the interest of creditors, but some equityholders might take advantage of this scheme and delay payment. As a result, if the term of capital contribution has already expired, no equityholders should be allowed to increase registered capital without first paying up the original proposed amount. Specifically, the amount past due should not be deferred in any way.

4.6 Maintained Capital Principle

The "Maintained Capital Principle" usually requires that: 1) equityholders may not return the shares to the company or pull back capital; 2) no dividend is allowed when the company incurs losses or has no profit; and 3) a company may not freely repurchase its own shares. These principles require authorities to issue corresponding rules and regulations.

To prevent companies from losing its own capital, for companies that are in normal operations its capital status should be monitored. Equityholders may not directly or indirectly pull back capital or transfer company assets. Besides, equityholders cannot ask for a refund of capital that is already paid up to the company under the excuse that the final due date has not passes. Such behavior will significantly reduce the company's ability to repay debt and jeopardize creditors' interests.

The company should also be restricted in terms of dividends. If an equityholder breaches his duty of capital contribution, his share of dividends should be withheld by the company to make up for unpaid capital, so as to ensure that the company's registered capital is maintained. However, if creditors are not allowed a cause of action in the case of unlawful dividend distribution, the Maintained Capital Principle will be vacated in effect. According to Company Law Section 149 and 150, if officers caused undue losses to the company, in certain circumstances equityholders can request Board of Supervisors and/or a Supervisor to bring a lawsuit. If such request is rejected, equityholders can file a derivative action in the name of the company. Also, in *Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's*

Republic of China (III), creditors may claim in court and ask equityholders who failed to fulfill or fully fulfill their duties of capital contribution to repay the part of debt that the company is unable to clear. But if equityholders first pay up their scheduled registered capital, and then collude with officers in illegal transfer of the company's assets, according to the Provisions creditors' claims may not be supported. Legislators may consider in these cases allowing creditors a separate cause of action.

5. Conclusion

Though the 2013 Company Law reform created more favorable conditions for setting up new companies, it also shifted risks to creditors. Before a full personal credit history system is established, it is unrealistic to rely on equityholders' self-discipline in protecting creditors' interests. Instead, the current regulatory framework should be amended.

On the company level, first, if equityholders schedule a large amount of registered capital, they should provide security to the unpaid part. Second, companies should disclose material information in time to creditors and the creditors committee. Third, the three principles of capital should be upheld. For creditors, they should also conduct due diligence with the information disclosed.

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