Case Report: Shareholder Not Liable for Company's Debts Prior to Expiry of Capital Contribution Time Limit

Description

In the past, we have written posts about going after shareholders for debts incurred by companies they invest so long as such shareholders still have outstanding subscribed capital to be paid.



Shareholder Liability for Corporate Debts

China Registered Capital Reform and Its Implications on Your China Businesses

Can Company's Creditors Go After Shareholders Who Have Not Paid up Subscribed Capital?

Registered capital, the greater, the better? Not really!

It has been long discussed on whether the shareholder of a limited company shall be jointly and severally liable for the debts of the company before the expiration of the capital contribution period. For a while immediately after the initial issuance of the Provisions (as defined below) in February of 2014, many courts in China have ordered shareholders to assume the debts of the companies they invest to the extent of unpaid capital subscribed by such shareholders despite that the paid-up deadline stipulated in the articles of association of such companies have not yet come.

Now things have changed. We singled out a civil ruling issued by the PRC Supreme People's Court on August 12, 2020 (Case No.: (2020) Supreme Court Minshen 2285) in which China Supreme Court took a different stance on the issue, marking a shift from previous practice.

Here we summarize the details of the case as below, for your kind reference.

1. **Facts of the Case**

Jiangbin Nie (hereinafter as "**Nie**"), a shareholder of Zhongyi Optical Communication Co. Ltd (hereinafter as "**Company**"), subscribe to RMB 10 million as capital contribution when establishing the Company on December 13, 2012. Nie paid RMB 2 million, and he promised to pay the remaining RMB 8 million before December 9, 2014, as stipulated in the Articles of Association of the Company. On January 21. 2013, Nie transferred all his shares to Aiwen Fu (hereinafter as "**Fu**") and completed the registration of transfer on January 29.

Zhongge Construction Co., Ltd (hereinafter as "**Creditor**") signed an agreement (hereinafter as "**Agreement**") with the Company on November 18, 2014, in which agreed that the Creditor contracted the "Optical Fiber Production Supporting Construction Project", and the project reservation fee was RMB 13 million. After the signature of the Agreement, the Creditor paid 13 million to the Company as agreed. However, the Company did not arrange the project to the Creditor for construction but used the amount of reservation fee for other purpose.

Thus, the Creditor claimed that the Company should return the reservation fee and take the liability for breach of contract, and also claimed that Nie and Fu should take the supplementary liability within the amount of unpaid capital contribution, RMB 8 million.

The Creditor is relying on the conventional wisdom of going after shareholders if they have outstanding capital contribution to be made, or in other words, such shareholders have not paid up all their subscribed registered capital.

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2. **Summary of the Ruling Part**

The court of first instance supported the claims of the Creditor. Then, Nie appealed to the High People's Court of Hunan Province. The court of second instance judged that Nie transferred his shares and his obligation of capital contribution to the transferee at the same time, so he did not constitute the circumstance stipulated in Article 13 of *the Provisions of the Supreme People's Court on the Application of the Company Law of the People's Republic of China III*. (hereinafter as "**Provisions**") Therefore, there is no supplementary liability should be taken by Nie.

> Article 13 Where a shareholder fails to perform or fully perform his capital contribution obligation, the people's court shall uphold the claim made by the company or other shareholders requiring the shareholder to fully perform his capital contribution obligation towards the company.
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> Where the creditor of the company claims that the shareholder who has failed to fulfill or to fully fulfill the obligation of capital contribution shall assume supplementary compensation liability for the debts of the company that cannot be cleared, to the extent of the principal

and interest on the capital not contributed, the people's court shall support such claim; and where the shareholder who failed to fulfill or failed to fully fulfill the obligation of capital contribution has assumed the aforesaid liabilities, if any other creditor makes the same claim, the people's court shall not support it.

Where a shareholder fails to fulfill or fails to fully fulfill the obligation of capital contribution at the time of establishment of the company, if the plaintiff who initiates a lawsuit according to paragraph 1 or 2 of this Article claims that the promoters of the company and the defendant shareholder shall bear joint and several liabilities, the people's court shall support such claim; and the promoters of the company may have recourse against the defendant shareholder after they have assumed the liabilities.
Article 13 of the Provisions

The Creditor applied for a retrial (for more information about retrial, please refer to our past blog explaining China judiciary systems) to the Supreme People's Court and claimed that Nie was the promotor of the Company whose legal status was different from that of other shareholders and should assume joint and several liability within the amount of his subscribed capital contribution. However, the Supreme People's Court upheld the judgment of the second instance and rejected the application for retrial.

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3. The Law and Legal Reasoning

1) The Registered Subscribed Capital System under China Company Law

Since the *Company Law of People's Republic of China* was revised on December 28, 2013, the previous paid-in system of registered capital was replaced by the current system of subscribed registered capital. In this case, the legal basis for Nie to assume the supplementary liability is Paragraph 1 of Article 13 of the Provisions, as quoted above. Based on the current Company Law, the subscribed system of capital contribution allows the shareholders to perform their obligation of capital contribution in installments within the period they registered in the Article of Association of the Company. Many have taken advantage of this provision by extending the period of capital contribution to tens of years or even till the end of the corporate operation life span. In other words, as long as the period of capital contribution is not expired, there is no circumstance that the shareholders fail to perform their capital contribution obligations or fail to perform them in full.

Therefore, Nie shall not be liable for the debt according to the above-mentioned paragraph of the Provisions.

2?The Obligation of Capital Contribution shall be Transferred to the Transferees

In addition, the High People's Court of Hunan Province held that, "if the share is transferred to others before the expiration of the subscribed period, the obligation of capital contribution shall be transferred to the transferees of the share accordingly."

The legal consequences of the transaction include the change of shareholders, the transfer of shareholders' rights as well as the obligations. In this case, Nie's status in the Company is replaced by the transferees and they completed the registration procedures, which take the effect of constructive

notice. As the Creditor claimed that, in accordance with Article 18 of the Provisions?

> Article 18 Where a shareholder of a limited liability company fails to fulfill or fails to fully fulfill the obligation of capital contribution and transfers his equity shares to someone else, and the transferee knows or should have known this, if the company claims that the shareholder shall fulfill the obligation of capital contribution and the transferee shall assume joint and several liabilities for the transfer, the people's court shall support such claim; and if the creditor of the company initiates a lawsuit against the shareholder according to paragraph 2 of Article 13 of these Provisions, and simultaneously claims that the aforesaid transferee shall assume joint and several liabilities for this, the people's court shall support such claim.
> *Article 18 of The Provisions*

the transferees shall assume joint and several liabilities where a shareholder of a limited liability company fails to fulfill the obligation of capital contribution and transfers his shares to others who knows or should have known about this. However, as we discussed above, Nie's transaction does not constitute the circumstance of escaping from the capital contribution. The current shareholders of the Company are the transferees so that the liability shall be assumed by them.

3) The Specific Obligation of the Company Promotors

In the proceeding of retrial, the Creditor claimed that Nie was one of the promotors establishing the Company at the outset, according to Paragraph 3 of Article 13, he still has to assume the liability. The Supreme People's Court rejected the claim based on the fact that the Creditor did not explicitly claim that Nie should assume the liability of the promotor for breach of capital contribution when the Creditor sued in previous proceedings. Corporate promoters assume greater responsibilities than other non-promoter shareholders who join the company after corporate setup. We will discuss promoter shareholder responsibilities in future posts.

From the above, it is pretty clear that China courts are proactively protecting corporate shareholders from being caught by corporate creditors (people dealing with the company in general course of businesses) by upholding such shareholders' time interests in contributing their subscribed capital. While this is a shareholder-friendly shift, it is hostile against corporate creditors, who are now compelled to do more due diligence when dealing with any limited liability company in China, increasing their costs of conducting businesses.

Conclusion

From all above, the Supreme People's Court emphasized that the registered subscribed capital system in current China Company Law. The application of Article 13 of the Provisions shall be conditional on the expiration of the period of capital contribution.

Lastly, in light of such development of China judicial practice, as we have always emphasized that parties dealing with Chinese companies shall pay attention to the performance of capital contribution of the companies' shareholders before entering into transactions, and it is necessary to take feasible measures to lower the risks, for example, a basic due diligence on the capitalization of your China business partners.

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