A Study on the Legal Validity of Capital Reduction of Limited Liability Companies

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Abstract. The Company Law amended the capital system, and the registered capital subscription system completely replaced the paid-up system in 2013. However, the revision of the capital system was only in the formation stage. There was no substantial change to the capital system during the maintenance stage, and the relevant provisions on capital reduction remained simple and rough, lacking maneuverability. This has also led to an increase in judicial practice in cases involving company capital reduction in recent years, seriously undermining the realization of creditors' claims. Therefore, the focus of this article is on improving China's capital reduction system and protecting the legitimate rights and interests of creditors under the subscription system.

Keywords: Subscribed capital system; Effectiveness of company capital reduction; Creditor protection

1 Introduction

Among the issues arising under the subscribed capital system, capital reduction has become one of the most controversial. Capital reduction directly affects the company's asset base and debt-paying capacity and may therefore undermine the legitimate interests of creditors. Although the newly revised Company Law of China has improved certain rules concerning capital reduction, the relevant provisions remain relatively general. In particular, the law lacks clear standards regarding the legal validity of defective capital reduction, the liability of shareholders, and the effective time of capital reduction. As a result, courts have adopted inconsistent approaches in judicial practice, leading to uncertainty in the protection of creditors and the maintenance of transaction security.

Against this background, this paper examines the legal validity of capital reduction under China's subscribed capital system. It first analyzes different scenarios of capital reduction and their legal consequences, including defective capital reduction, capital reduction before and after the expiration of the contribution period, and capital reduction after full payment of subscribed capital. It then identifies the major deficiencies in China's current capital reduction regime, particularly in relation to creditor notifica-

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tion procedures and the determination of effectiveness. Finally, drawing on comparative experience and the objectives of creditor protection, the paper proposes reforms aimed at improving the capital reduction system and achieving a better balance between corporate autonomy and creditor interests.

2 Legal Validity of Capital Reduction of Limited Liability Companies under China's Subscribed Capital System

Generally speaking, whether shareholders decide to reduce the company's registered capital falls within the scope of corporate commercial autonomy, and the law should grant sufficient autonomy[1]. However, because capital reduction weakens the company's ability to repay external debts, it inevitably affects the interests of external creditors. Therefore, the law imposes corresponding regulations on corporate capital reduction. Analyzing the legal validity of different types of capital reduction can further deepen the understanding of the capital reduction system.

2.1 Defective Capital Reduction with Full Satisfaction of Creditors

First scenario: The company conducts a defective capital reduction, but the creditors are fully satisfied. According to Article 226 of the new Company Law, it can be inferred that if the company fails to follow the statutory capital reduction procedure, even if creditors are fully satisfied, it still constitutes an illegal capital reduction, and the reduction is invalid, with shareholders having a statutory obligation to restore the original state[2]. However, such a provision presents certain difficulties in judicial practice. The author believes that for capital reductions that violate the statutory procedure but result in satisfaction of creditors, the people's court should recognize the validity of the reduction, and shareholders should not bear civil liability for the defective reduction. This is because: creditors have already been fully satisfied, and their interests have not been substantially harmed. Without a justiciable interest, shareholders naturally should not bear corresponding liability.

2.2 Capital Reduction When Shareholders' Capital Contributions Are Not Yet Due

Second scenario: When the subscription period for shareholders has not yet expired, the company reduces the subscribed portion of capital, resulting in its inability to repay creditors' debts. Before the enactment of the new Company Law, there was a main controversy in academia regarding such capital reductions. If the subscription period has not expired, should shareholders bear liability within the scope of paid or subscribed capital? One view holds that shareholders should not bear immediate liability for contributions not yet due. Creditors can learn about the company's actual asset status through publicly available annual reports, so they transact based on reliance on the company's actual assets. If the company fails to repay debts due to defective capital reduction, creditors cannot directly request shareholders to bear supplementary compensation liability for the portion of subscribed capital not yet due. The other view holds that the registered capital subscription information recorded in public registration allows creditors to anticipate future capital contributions by shareholders, enhancing the company's solvency. To protect creditors' reliance interests, when the company cannot repay its debts after improper capital reduction, the issue of debt repayment can be resolved by accelerating shareholders' contribution obligations[3].

This issue was highly controversial under the old law, but the new Law effectively addresses it. According to Article 54 of the new Company Law, the law permits capital reduction before the subscription period expires, but if the company cannot repay due debts after reduction, creditors may directly invoke Article 54 to require shareholders to pay their outstanding subscribed capital in advance to satisfy debts.

2.3 Capital Reduction After Expiration of the Contribution Period

Third scenario: The subscription period has expired, the company fails to reduce capital in accordance with the law, and the debtor's debts remain unsatisfied. If the company makes a capital reduction resolution when shareholders have not actually contributed after the subscription period has expired, such a reduction is invalid. Previously, in judicial practice, courts directly analogized Article 13(2) of the Judicial Interpretation (III) of the Company Law to rule that shareholders bear supplementary compensation liability for the company's debts within the scope of their subscribed capital[4]. Now, Article 226 of the new Company Law directly provides a procedural remedy for such illegal capital reduction—shareholders shall restore the original state and make up the contributions.

2.4 Capital Reduction After Full Payment of Subscribed Capital

Fourth scenario: When the subscription period has expired, and shareholders have fully paid their subscribed capital, the company reduces its capital. In a formal capital reduction, there is generally no substantial harm to creditors' rights and interests. Even if creditors are not directly notified or publicly announced, the impact on creditors' interests is minimal, so the law usually does not impose extensive regulations on formal capital reduction. In substantive capital reduction, the company's solvency and security capacity decline[5]. If capital reduction harms creditors' interests, it is significantly unfair to creditors. Therefore, the company shall bear compensation liability to creditors within the scope of the capital reduction, and shareholders shall bear supplementary compensation liability within the scope of the reduction for the portion of the company's debts that cannot be satisfied.

3 Problems in China's Capital Reduction System

Under the subscribed capital registration system, the Company Law's provisions on capital reduction are too brief[6], such as inadequate rules on the company's notification obligations and the lack of provisions on the effectiveness of capital reduction.

3.1 Oversimplification of Capital Reduction Notification

China's Company Law provisions on capital reduction notification are too simple to adapt well to the subscribed capital system reform. This is mainly reflected in: First, in judicial practice, most companies merely publish a capital reduction announcement in a local newspaper, and such announcements are generally not rigorous. This indirect notification of creditors about capital reduction has become the most common defect in capital reduction procedures in recent years[7]. Second, the Company Law does not provide detailed rules on how capital reduction announcements should be published. Third, in practice, companies usually only notify creditors of capital reduction by newspaper announcement, but the Company Law clearly requires that both notification and announcement obligations be fulfilled simultaneously.

3.2 Lack of Provisions on the Effective Time of Capital Reduction

The new Company Law still lacks clear provisions on when a capital reduction becomes effective. In judicial practice, people's courts generally use the formulation "the capital reduction shall not be effective against pre-reduction creditors" as the basis for ordering that shareholders bear supplementary compensation liability. This wording indicates that the court considers the capital reduction to have become effective, but it remains undetermined whether the capital reduction becomes effective upon completion of creditor protection procedures, upon adoption of the reduction resolution, or upon registration of the change with the Industry and Commerce Authority.

4 Suggestions for Improving the Capital Reduction System for Limited Liability Companies in China

As capital constraints gradually loosen, the Company Law must improve its shortcomings to adapt to new challenges faced by corporate capital reduction under different circumstances[8].

4.1 Improving the Methods of Notifying Creditors and Publishing Announcements

This article suggests that the Supreme People's Court may issue judicial interpretations to refine the provisions on notification and announcement procedures in the Company Law. First, refine notification methods. With the development of the internet, the influence of print media has gradually declined. The new Company Law also recognizes the limitations of print media in circulation and influence, and therefore includes the unified enterprise information disclosure system as a medium for announcements[9]. With convenient internet communication today, in addition to traditional written, telephone, and email notifications, specific creditors may also be notified via methods such as WeChat group messaging, allowing creditors to be directly informed. Second, capital reduction announcements should be published in provincial or higher-level newspapers, television stations, and influential local websites.

4.2 Clarifying the Effective Time of Capital Reduction

First, capital reduction can be divided into ordinary capital reduction and simplified capital reduction. For ordinary capital reduction, a distinction is made based on the company's solvency. For companies without solvency, capital reduction is naturally invalid. For solvent limited liability companies, the UK Companies Act approach may be followed, using a solvency declaration or complying with creditor protection procedures[10]. For simplified capital reduction, the above procedures need not be followed. In cases of mandatory capital reduction or loss compensation as provided by law, the effective condition is the registration of the capital reduction with the industrial and commercial authority.

5 Conclusion

Through an analysis of different forms of capital reduction, this paper argues that the validity of capital reduction should not be determined solely by procedural compliance. Instead, courts should take into account whether creditors' substantive interests have been harmed. Where creditors have been fully satisfied, defective procedures should not necessarily invalidate the reduction. Conversely, where capital reduction impairs the company's ability to repay debts, shareholders should bear corresponding legal responsibilities, including restoring capital contributions or assuming supplementary compensation liability.

The paper further identifies two major shortcomings in China's current capital reduction regime: the oversimplified rules on creditor notification and the absence of clear provisions regarding the effective time of capital reduction. These deficiencies create uncertainty in judicial practice and weaken the effectiveness of creditor protection. To address these problems, this paper proposes improving notification and announcement mechanisms through diversified communication methods and clarifying the effectiveness of capital reduction by distinguishing between ordinary and simplified capital reduction procedures and introducing solvency-based standards.

In conclusion, the capital reduction system under the subscribed capital regime should seek an appropriate balance between corporate autonomy and creditor protection. Future legislative and judicial developments should further refine the relevant rules to ensure legal certainty, safeguard transaction security, and promote the healthy development of the modern corporate system in China.

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