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New Chinese regulations clarify rules on contributions with shares

by Ingo Vinck

On January 14, 2009, the State Administration for Industry and Commerce (SAIC) announced the *Measures on the Administration of Registration of Capital Contributions Made with Shares* (Measures) which took effect on March 1, 2009.

Scope of Application

The *Measures* apply to cases where an investor uses equity which he holds in a limited liability company or shares he holds in a company limited by shares established within China (jointly "Contributed Company") as investment in another domestic limited liability company or in a company limited by shares (jointly "Invested Company").

Since the *Measures* address limited liability companies and companies limited by shares "*established within China*" they should also apply to foreign invested enterprises (FIEs). Officials of the Ministry of Commerce and of SAIC, competent for approval and registration of FIEs, orally confirmed this understanding and stated that a FIE can be the Contributed Company or the Invested Company.

Background

According to Article 27 of the revised *Company Law* (2006), a shareholder (of a limited liability company) may make his capital contribution in cash or in the form of non-monetary property (physical objects, intellectual property, land use rights etc.) the monetary value of which can be appraised and that may be transferred.

Equity interests or shares fulfil these requirements because they are both generally transferable and have a monetary value which can be assessed. But non-monetary contributions in kind need to be appraised and valued.

In contrast to this wording of the *Company Law*, it was in practice not widely accepted to use equity interests or shares as a capital contribution in the past (apart from some local regulations in Shanghai, Jiangsu, Zhejiang, Chongqing, Chengdu, Shandong and Guangdong etc.). Only very few precedents are known, where equity was used as capital contribution, e.g. in some infrastructure projects.

Therefore, it is for the first time that the new *Measures* generally confirm contributions in kind made with equity interests or shares, which is a welcome clarification.

The *Measures* are also aimed as a means to address the current financial crisis. In an official statement issued by the SAIC on February 2, 2009, answering questions of journalists regarding the *Measures*, an SAIC official pointed out that the *Measures* were part of the economic stimulus package published by the State Council. The official stated that the *Measures* could boost investment in China, because capital contributions made with equity interests or shares increased their marketability.

Requirements

The *Measures* require that equity interest or shares which serve as a capital contribution shall be clearly attributable, comprise of complete shareholder rights and functions and shall be legally transferable.

According to Article 3 of the *Measures*, equity interest or shares may not serve as a capital contribution in any of the following situations:

- the registered capital of the Contributed Company has not yet been paid up
- the equity interest or shares have been pledged
- the equity interest or shares are legally frozen
- the articles of association of the Contributed Company prescribe that the equity interest or shares may not be transferred
- laws, administrative regulations, or decisions of the State Council provide for approval requirements, but such approval has not been obtained yet
- laws, administrative regulations, or decisions of the State Council stipulate other situations in which an equity interest or shares may not be transferred.

Limits to Contributions in Kind

Article 4 of the *Measures* clarifies that the amount of capital contributions made by all shareholders with equity interests or shares plus the amount of other non-monetary contributions in kind must not exceed 70 percent of the registered capital of the Invested Company. This limitation of contributions in kind is in accordance with the regulations of the *Company Law* for limited liability companies. Cash contributions of all shareholders may not be less than 30 percent of the registered capital.

The *Measures* also require that the equity interest or shares which serve as a capital contribution shall be appraised by a legally established appraisal organisation.

If during the establishment of a company the investor makes a contribution in kind with an equity interest or shares, such contribution must be completed within one year as of establishment, i.e. issuance of the business licence, of the Invested Company (Article 6 para. 1 of the *Measures*). The *Measures* thereby

provide for sufficient time to complete any required approval and registration processes involving the Invested Company.

Capital Increase

The *Measures* also expressly address capital increases by means of contributing an equity interest or shares. It is therefore not only possible to use equity as an in kind contribution during the establishment of companies but also for capital increases of existing companies.

Registration

Finally, the *Measures* set forth details of the relevant SAIC registration procedures as well as regarding the documents which need to be prepared for such registration.

Conclusion

The *Measures* close a previously existing gap under the *Company Law*. The possibility of contributions with equity interests or shares considerably expands the available scope of legal structures for domestic and foreign investment in China. The *Measures* offer new opportunities regarding capitalisation of companies (including FIEs) and can be useful for setting up new companies as well as with respect to the restructuring of corporate groups.

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