

Certain Issues Concerning Verification of Registered Capital

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According to the PRC Company Law (Company Law), the investors of a limited liability company shall specify the registered capital of the company in the shareholders' agreement and the company's articles of association. The registered capital shall be contributed by the shareholders pursuant to the shareholders' agreement and the company's articles of association. In addition, a CPA registered in China shall verify the contribution of registered capital so that the company can apply for a business license at the State Administration of Industry and Commerce (SAIC) or its branches. The purpose of verification of registered capital is to assure the equity investment into the company from the investors and to protect legal rights of the potential creditors the company may have.

The Company Law has no specific stipulations on the verification of registered capital in an equity transfer transaction of a limited liability company. According to the context, it is implied that no verification of registered capital is required in an equity transfer transaction. Under the Company Law, shareholders of a limited liability company have an obligation to contribute their respective proportion to registered capital and hold equity of the company once completing contribution of registered capital. Before the transferring shareholder transfers equity deriving from its contribution of registered capital to a third party, the transferor shall have already contributed its proportion of the registered capital to the company. Therefore, neither party has an obligation to contribute the registered capital to the company again.

However, in some equity transfer transactions, the transferees are required to contribute the registered capital into the company, at the same time, the company shall refund the original investment to the transferor. This causes confusion as to the nature of equity transfer and has negative effects on the rights and obligations of relevant parties.

On November 10 2000, SAIC publicized its Questions Relevant to Transfer of Equity Reply (Reply), which states "..... According to the Company Law, a shareholder may transfer its equity to other shareholder(s) after the incorporation of a limited liability company has been duly registered; subject to an approval by the shareholders' meeting, a shareholder may transfer its equity to a third party other than the shareholders. In an equity transfer transaction, after the transferor and the transferee sign the equity transfer agreement, the transferee shall make payment of the contribution of registered capital to the transferor directly, and consequently has no obligation to re-contribute the registered capital into the company. Once the company registration authority approves and registers relevant alteration (items), the transferee becomes the shareholder of the company in question.". The Reply clarifies the issue on verification of registered capital in equity transfer transactions, and it is expected that SAIC will follow the Reply in handling with the equity transfer transactions involving companies with domestic investment.

Since China's adoption of the open-door policy, numerous laws and regulations have been promulgated to regulate foreign investment enterprises. These may differ from those enterprises with domestic investment. China's foreign exchange control system is playing an active role in foreign direct investment also, which makes equity transfer of an enterprise with foreign

investment a little more complicated than a transaction involving only domestic companies. The Reply states that specific provisions will apply to the equity transfer of limited liability companies with foreign investment.

A foreign investor is required to contribute its proportion to registered capital in foreign currency, based on the assumption that a foreign investor will not have income in renminbi (except re-investment with income deriving within the territory of China). On the other hand, renminbi cannot be freely converted into any foreign currency. Further, in practice, the foreign investor is usually required to make payment in foreign currency when acquiring equity of a company with foreign investment and the company shall change its form to an enterprise with foreign investment. As a result, the foreign exchange system makes it difficult for foreigners to acquire equity held by the local investors and especially for local investors to acquire equity held by foreign investors pursuant to the Reply. In practice, the State Administration of Foreign Exchange (SAFE) or its branches will require a domestic entity to present the following documents when applying for foreign currency in an equity transfer transaction where the domestic entity is the transferee:

- a) an application letter stating background company information and modification of equity structure;
- b) a letter of approval issued by the examination and approval authority (the Ministry of Foreign Trade and Economic Cooperation or its branches);
- c) the equity transfer agreement;
- d) the business licenses and certificates of approval prior to and after equity transfer;
- e) the latest verification report on the company's registered capital;
- f) the annual auditing report on foreign exchange of the company;
- g) the statement of settlement and utilization of the capital account in foreign exchange;
- h) revised shareholders' agreement and articles of association;
- i) the foreign exchange registration certificate of the company;
- j) other documents SAFE considers necessary.

The latest verification report on registered capital shall reveal how the transferor obtained the equity and whether the transferor has completely contributed its proportion to the registered capital. It is particularly important when a domestic entity intends to purchase foreign currency for the purposes of acquiring equity in a foreign investment enterprise held by a foreign investor who is not an original equity investor of that enterprise.

Obviously, according to the Company Law and other pertaining laws and regulations, a transferee shall effect payment directly to the transferor under an equity transfer transaction. However, due to China's foreign exchange control system, it seems that this well-established practice needs time to be adopted in the equity transfer transactions involving foreign investment enterprises.