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Limitations on the Liability of Defective Capital Contribution Shareholders for Compensation to Third Parties in Enforcement Proceedings

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Abstract: In current judicial practice, the liability of defective shareholders towards third parties typically involves both the accelerated maturity rule and the illegal allocation liability system, which often collide or become confused with each other. This article mainly discusses the issue of compensation liability of defective capital shareholders to third-party creditors, combined with legal norm analysis and empirical research of judicial cases. By examining execution objection lawsuits related to the liability of defective capital shareholders on the China Judgments Online, the conflict and coordination path between the accelerated maturity rule and illegal distribution liability in judicial practice are analyzed. Research has shown that although both the accelerated maturity rule and the illegal allocation liability system aim to protect the interests of creditors, differences in their application conditions can easily lead to confusion in practice. This article proposes to improve judicial efficiency and fairness by establishing an audit platform and improving accountability procedures.

Keywords: Defective capital contribution shareholders, execution procedures, liability for compensation, accelerated maturity rules

1. Introduction

The company capital system requires shareholders to fulfill their capital contribution obligations and bear limited liability to the company, meaning shareholders is capped at the amount of their subscribed capital contributions. According to Article 47 of the Company Law, the registered capital of a limited liability company is the total amount of capital subscribed by all shareholders, who must fully pay their subscribed capital contributions within five years after the company's establishment, as stipulated in the company's articles of association. However, in practice, diverse methods of capital contribution often lead to defective capital contributions. This situation not only affects the interests of the company but also complicates debts recovery for creditors.

In enforcement proceedings, creditors may apply to add defective capital contribution shareholders as persons subject to enforcement under the Supreme People's Court’s provisions. This allows creditors to demand supplementary compensation for the company's debts within the limits of the defective capital contributions. However, judicial decisions vary regarding the scope of liability

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for these shareholders. In individual cases, creditors often advocate for piercing the principle of limited shareholder liability, while shareholders attempt to defend themselves by citing share transfer or unexpired contribution deadline. Despite different opinions within the judicial practice community, defective capital contribution constitutes a violation of the requirements concerning shareholders' capital contribution obligations under the Company Law. In a market economy, it exacerbates the risks to company capital and has a detrimental impact on company operations and solvency.

This paper explores the specific scope of the supplementary compensation liability for defective capital contribution shareholders, particularly focusing on reconciling the conflict between the acceleration rule and liability for unlawful profit distribution. It provides a reference for resolving divergences in judicial decisions and unifying the standards for applying the law.

2. Theoretical basis for the liability of defective capital contribution shareholders

2.1. Definition of defective capital contribution shareholders

Defective capital contribution occurs when a shareholder fails to fully or adequately fulfill their capital contribution obligations during a company's establishment or capital increase, as mandated by laws, regulations, or the company's articles of association. Common situations include shareholders not contributing at all, contributing insufficiently, providing non-conforming assets, or withdrawing their contribution [1]. Under the subscribed capital system, the company's articles of association specify the required paid-in capital. Given the binding nature of these articles and the public record of company registration, the registered capital and promised contribution amounts become unalterable commitments. Therefore, a shareholder's commitment to contribute capital represents a promise made by the company to society and its creditors.

Although the newly revised Company Law of 2024 mandates that shareholders fully pay their capital contributions within five years from the company's establishment, there were previously no practical restrictions on the contribution period. This led to issues such as inflated registered capital, prolonged payment periods, and low actual capital contribution rates, significantly increasing risks for both creditors and company capital [2]. Even after the amendment, some shareholders who did not fully meet their obligations during that earlier period will be classified as defective capital contribution shareholders.

2.2. Legal liability of defective capital contribution shareholders

The act of defective capital contribution by shareholders can significantly harm multiple parties. Such acts compromises the company's capital adequacy, damage its creditworthiness and lead to losses for creditors and external third parties, ultimately impacting market transaction order [3]. Therefore, defective capital contribution shareholders face several legal liabilities under company law: the obligation to make up the contribution, breach of contract liability, and compensation liability. As shareholder rights derive from shares, based on the concept of corporate autonomy, the company's articles of association may impose certain restrictions on the rights of defective capital contribution shareholders [4]. Beyond restricting rights, the purpose of pursuing liability is to ensure adequate company capital, maintain normal company operations, protect the lawful rights and interests of company creditors, and safeguard transaction security beyond the company itself. Consequently, the legal accountability for defective capital contribution is also significant for broader market stability.

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First, the primary liability is the obligation to rectify the contribution. If a shareholder fails to meet the capital requirements outlined in the articles of association, other shareholders or the company can demand that the shareholder cover the shortfall [5]. This liability serves to perfect and supplement the capital adequacy responsibility borne by other shareholders at the time of the company's establishment [6]. It not only ensures that shareholders fulfill their basic obligations but also safeguards the integrity of the company's capital and its debt repayment capacity. Liquidated damages or interest may accrue when making up the contribution.

Secondly, defective capital contribution shareholders are liable for breach of contract. Since the establishment or capital increase of many companies is based on shareholders' capital contribution promises to contribute, failure to fulfill this commitment constitutes a breach. Other shareholders or the company can seek damages for breach. Creditors may exercise subrogation rights regarding "matured creditor's rights," though this only applies if the capital contribution deadline has not yet expired [7]. In summary, the demands on the defaulting shareholder at this stage include not only making up the capital contribution but also paying for losses suffered by the company due to the breach, contract liquidated damages, litigation costs, attorney fees, and all other costs and expenses incurred to protect their own interests [8].

Finally, in situations where the company faces bankruptcy or is unable to repay debts, creditors and the company have the right to demand compensation from shareholders with defective contributions. This includes not only making up the defective contribution but also covering losses stemming from actions like withdrawing funds or making false contributions.

In conclusion, the primary legal liability of defective capital contribution shareholders protect the company's capital integrity, the lawful rights and interests of company creditors, and the rights of non-defaulting shareholders. This liability framework aims to ensure the company's normal operation, eliminate systemic operational risks, and maintain transaction security and market order stability.

3. Accelerated maturity rules and liability for unlawful profit distribution

3.1. Connotation and applicable conditions of the accelerated rule

The acceleration rule is one of the important systems established in the new Company Law for corporate capital governance. Based on accelerating the fulfillment time of shareholders' capital contributions, it serves not only as a crucial tool for implementing the company capital adequacy system but also provides creditors with a significant legal means to protect their own interests. Specifically, it allows creditors to demand early payment of capital contributions from shareholders who have subscribed but whose contribution deadlines have not yet expired, when the company is unable to repay debts as scheduled [9].

The application of the acceleration rule mainly involves three conditions. For a creditor to claim acceleration, three prerequisites must be met: the subscribed capital contribution must be recorded in the articles of association; the company establishment or change registration must be completed; and the claim is limited to the subscribed amount that is both unpaid and not yet due [10]. Therefore, the conditions under which creditors can assert acceleration are relatively strict, primarily to avoid shareholders bearing excessive liability at the time of subscription and to protect shareholders' limited liability within the legal framework.

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3.2. Elements constituting liability for unlawful profit distribution

Unlike the acceleration rule, liability for unlawful profit distribution primarily addresses situations where a company improperly distributes profits to shareholders, diminishing its assets available to satisfy debts. According to Article 211 of the new Company Law, it stipulates that the shareholders return the profits distributed in violation of the provisions to the company. Specifically, it states that when a company distributes funds that should have been retained for the company's development, the shareholders are required to return the unlawfully distributed profits to the company.

The main elements of liability for unlawful distribution include the illegality of the company's profit or asset distribution act and the shareholder's knowledge (or constructive knowledge) that the distribution violated legal provisions. This rule aims to curb shareholders appropriating company resources through illegal means, thereby protecting the lawful rights and interests of the company and its creditors. For shareholders, liability for unlawful distribution is not limited solely to the amount unlawfully distributed; it also encompasses the act of accepting an improper distribution while knowing it is unlawful. When pursuing shareholder liability under the new Company Law, shareholders' obligations are not confined solely to the scope of their capital contribution and also required to exercise supervision over the company's operational conduct and financial condition.

3.3. Dilemmas and challenges in coordination

Although the primary purpose of both the acceleration rule and the liability for unlawful profit distribution system is to protect creditor interests, in the practical operation of company law, due to their differing constitutive elements, coordination becomes difficult in complex situations.

Firstly, the acceleration rule primarily targets situations of overdue shareholder contributions, while liability for unlawful distribution more often refers to situations where the company illegally distributes benefits to shareholders without meeting certain conditions. While their common goal is to protect creditor interests, their differing legal bases and applicable scenarios may lead to overlap or conflict during practical application. Furthermore, the acceleration rule and liability for unlawful profit distribution differ in their applicable conditions and procedures, making it difficult to determine the scope of liability for defective capital contribution shareholders. The acceleration rule causes the subscription deadline to accelerate prematurely when the company faces operational difficulties, forcing shareholders to fulfill their contribution obligations ahead of schedule. In contrast, liability for unlawful profit distribution requires shareholders to return profits that were unlawfully distributed by the company. Since shareholders may face both situations concurrently during corporate governance, the issue of attributing liability should be judged based on whether the shareholder truly upheld the independent legal personality status of the company during its operational activities.

3.4. Construction of coordination mechanism

To resolve the conflict between the acceleration rule and liability for unlawful distribution, a reasonable coordination mechanism should be established to allow the two to coexist harmoniously. On one hand, the law should clearly define the scope and procedures applicable to both acceleration and liability for unlawful distribution, avoiding conflicts between them. On the other hand, judicial practice must strictly scrutinize these two types of liability. When the financial situation of shareholders and the company is complex, it is necessary to examine whether the consequences arose from shareholder abuse of rights or failure to exercise reasonable duty of care. If so, priority

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should be given to addressing this, enabling creditors to obtain relief more quickly. Finally, a coordination mechanism should be built on the foundation of establishing a sound corporate governance model, improving internal management, reducing instances of defective capital contribution at the source, promoting healthy financial management of companies, and safeguarding the interests of all parties.

4. Integrating procedures to achieve efficiency and fairness

4.1. Shortcomings and problems in the current procedures

Currently, the determination of liability for defective capital contribution shareholders faces multiple problems, mainly manifested as procedural imperfections causing obstacles in enforcement. Although the Company Law and relevant judicial interpretations have provided regulations, considering the complexity of practical application, the delineation of liability for such shareholders remains relatively vague. Furthermore, existing legal provisions concerning litigation related to adding shareholders who have not reached their subscription deadline and have not fully paid their contributions as persons subject to enforcement are complex, involving multiple overlapping and sometimes contradictory judicial interpretations [11]. Vague procedural regulations lead to different practices among courts regarding adding shareholders whose capital contribution deadlines have not expired as persons subject to enforcement during the enforcement process, severely affecting judicial efficiency. From the perspective of protecting the rights and interests of all parties, the existing procedures also exhibit significant deficiencies, with insufficient attention paid to protecting third-party interests. As third parties are often at a disadvantage due to information asymmetry, they may encounter obstacles during the recovery process due to difficulties in obtaining the true situation, affecting judicial fairness.

4.2. Goals and principles of procedural integration

The main goal of procedural integration is to enhance the efficiency and fairness of liability pursuit, ensuring the protection of all parties' interests. Specifically, it can be divided into the following aspects: First, improving judicial efficiency by ensuring that the procedures for pursuing liability against defective capital contribution shareholders are simple and efficient, avoiding unnecessary delays. Second, guaranteeing fairness. Even in the addition procedure, the lawful rights and interests of defective capital contribution shareholders should be protected. The specific conditions for adding persons subject to enforcement should be clarified, and connections with other legal systems strengthened to unify enforcement procedures [12]. Third, ensuring clarity and transparency of information throughout all process stages, accessible for all parties to know, reference, and supervise, thereby minimizing information asymmetry that leads to erroneous liability pursuit. Fourth, enhancing the strength and breadth of laws and regulations concerning the pursuit of liability against defective capital contribution shareholders, providing more detailed regulations on such liability to better exert legal effectiveness.

4.3. Specific paths and methods for integration

Specifically, a unified review platform can be established to collect information, data, and materials, avoiding unnecessary duplication of work and improving efficiency. The procedure for pursuing shareholder liability can be optimized by structurally linking company law with personal damage compensation relationships, eliminating procedural complexities. Cooperation between judicial and

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administrative organs should be strengthened to achieve rapid and comprehensive determination of shareholder liability through information sharing. Third, mechanisms to safeguard third-party interests should be established, including creating guarantee funds to compensate losses suffered by private enterprises after harm occurs, and protecting victims' rights such as the right to know and participate.

5. Conclusion

This paper primarily studies the issue of pursuing third-party liability against defective capital contribution shareholders, particularly focusing on the conflict between the acceleration rule and liability for unlawful profit distribution. Although the application of these two legal provisions does not inherently affect or exclude each other, in practice, they are highly susceptible to conflation. When a shareholder has both failed to fulfill their capital contribution obligation and participated in unlawful distribution, grasping the boundary between the two, and how the relevant legal provisions should connect to avoid overlapping liability, are aspects prone to confusion in practice.

Faced with these problems, this paper advocates improving existing legislation to perfect the pathways for fulfilling the liability of defective capital contribution shareholders. First, establishing a unified review platform; second, supplementing and improving judicial and administrative procedures for pursuing shareholder liability, promoting cooperation between judicial and administrative organs, eliminating duplication and disorder, increasing work efficiency, and enhancing judicial fairness. Simultaneously, attention must be paid to protecting the lawful rights and interests of third parties, ensuring they enjoy equal status during the liability pursuit process.

During the research process, this paper explores coordination mechanisms between the acceleration rule and liability for unlawful distribution, but some shortcomings remain. Firstly, the depth of analysis for some literature was insufficient; future research could incorporate more practical cases for deeper exploration. Secondly, although some ideas for specific paths and methods of procedural integration were proposed, the details on practical implementation were insufficient. Additionally, this study on the liability of defective capital contribution shareholders was confined to domestic law; future research could attempt to introduce an international comparative perspective to enable a more comprehensive analysis and discussion of this issue.

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