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On the Offset of Capital Contribution Obligation by the Shareholders of a Limited Liability Company Against Their Claims Against the Company

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Abstract. Following the implementation of the new Company Law, debt-based capital contributions have been legally recognized as a valid investment method. However, the legal framework remains unclear regarding whether shareholders can directly offset capital obligations with their own corporate claims. Prior to the law's enactment, domestic and international scholars held divergent views on this practice. While the new legislation provides explicit legal basis for debt contributions, the feasibility of such offsetting mechanisms warrants further exploration. This study employs a review methodology to examine academic perspectives on corporate debt contributions, specifically analyzing the legal implications of shareholders offsetting capital obligations with corporate claims during routine operations of limited liability companies. The research concludes that conditional authorization of debt-based contributions within legal frameworks can balance the interests of shareholders, corporations, and creditors. Helps maintain an honest and trustworthy market transaction order, ensures social stability, clarifies boundaries between corporate autonomy and judicial intervention properly, and provide a strong guarantee for the operation of the company.

Keywords: Shareholder Debt, Obligation of Contribution, Debt Contribution, Third-party Creditor's Claims

1. Introduction

Article 48 of the New Company Law stipulates that shareholders may contribute capital in the form of creditor's claims, though it does not specify the sources, timelines for formation, or procedures for such contributions. There are two forms in which shareholders contribute their company-related creditor's claims to the company: First, creditors of a company contribute their claims against the company as shares, thereby transitioning from creditors to shareholders. Second, shareholders offset their capital contribution obligations with corporate creditor's claims. Except for explicit prohibitions in bankruptcy proceedings, current laws and regulations do not explicitly prohibit this practice [1]. Regarding whether a shareholder's creditor's claims against the company can offset their capital contribution obligations, legal scholars hold different views. Some argue that mutual offsetting is permissible due to mutual monetary obligations between shareholders and the company.

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Others contend that since paid-in capital constitutes a statutory obligation, such offsets are invalid. A third perspective suggests shareholders should first modify their capital contribution obligations—converting monetary contributions into creditor's claims—and then transfer these rights to the company to fulfill their obligations [2].

Given the current imperfections in relevant legal provisions, granting shareholders this right could potentially create obstacles and shackles for other creditors to protect their rights. Based on the new Company Law provisions and potential issues arising from judicial practice, this paper employs a literature review methodology to categorically discuss whether shareholders of limited liability companies can offset capital contributions with corporate debts before bankruptcy proceedings commence. The study aims to provide insights and recommendations for addressing the issue of shareholders offsetting capital contributions with prudently corporate debts.

2. Legal analysis on offsetting capital contribution obligations with claims against the company by different shareholders

2.1. Conceptual interpretation and distinction

First, this paper defines shareholder creditor's claims as the claims that shareholders, in their capacity as creditors, hold against company assets during the company’s existence. Second, the debt contribution mentioned here specifically refers to shareholders transferring their legitimate claims against the company to the company as non-monetary assets for the registered capital they have subscribed to the company, which essentially constitutes a transfer of property rights. Third, the offsetting of capital contributions by shareholder creditor's claims described herein means that during the establishment or capital increase of a company, shareholders directly offset their monetary capital contribution obligations with legally valid claims against the company through statutory and contractual procedures. This fundamentally represents a way debts are extinguished.

2.2. Offset of monetary contribution obligations by promoter shareholders with claims against the company

During the company's establishment phase, the contribution methods, dates, subscribed capital contributions, and actual paid-in amounts of founding shareholders must be recorded in the articles of association in accordance with legal provisions and shareholder agreements, then registered and publicly disclosed. These disclosure materials form the core basis for transaction counterparts to assess corporate creditworthiness and transaction risks. The fulfillment of shareholders' capital contribution obligations constitutes the company's liability assets for external debt repayment, which serve as financial safeguards for maintaining transaction security [3]. Therefore, when founding shareholders offset their capital contributions with creditor claims, it essentially eliminates the capital contribution obligation through debt offset, which must comply with the capital maintenance principle. This paper analyzes the offset of capital contribution obligations by different types of shareholders’ claims.

2.2.1. Shareholder's capital contribution obligation

Shareholders' capital contribution obligations refer to their duties under corporate articles of association and legal provisions to deliver assets or fulfill other capital-enrichment requirements. The good faith fulfillment of these obligations forms the foundation for ensuring normal company operations and timely debt repayment. The contractual and legal nature of shareholders' capital

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contribution obligations coexist. The internal agreement where shareholders offset their capital contribution obligations with their claims must serve the company's capital replenishment and the legitimate demands of the company's creditors [3]. The legal nature of shareholders' capital obligations reflects legislative purposes aimed at ensuring stable capital formation. When creditors offset contributions, they must adhere to this principle to prevent inflated registered capital, maintain public trust in corporate governance and legal compliance, and safeguard market transaction security. Therefore, within the framework permitting creditor offsetting, how to reasonably define and allocate responsibilities among shareholders has become one of the core issues requiring clarification.

2.2.2. Assumption of liability by shareholders

The logical starting point of shareholders' capital contribution liability is that shareholders have the obligation to contribute capital. Failure to fully and properly fulfill the capital contribution obligation will lead to corresponding civil liability or other legal consequences, as follows [4].

First is the liability assumption of founding shareholders. When founding shareholders fail to contribute capital through originally agreed methods, resulting in scenarios like fraudulent debt contributions that adversely affect corporate operations and cause economic losses, the relevant shareholders shall bear compensation liability according to law. After equity transfers, based on the principle of register appearance, only transfers bear capital contribution responsibilities, allowing shareholders to evade obligations through equity transfers [5]. To ensure corporate capital adequacy and prevent shareholders from avoiding capital obligations by seeking "buyers," the new Company Law Article 88 stipulates that transferring shareholders shall assume supplementary liability.

Next is the assumption of responsibility for other shareholders of the company. According to the current status of China's corporate establishment, the human nature of limited liability companies weakens while their capital-based nature strengthens. To encourage mutual supervision and trust among shareholders, the new Company Law stipulates that during the establishment process, when some founding shareholders fail to fulfill their capital contributions as agreed, other founders shall bear joint and several liability for the insufficient amount.

2.2.3. Analysis of the mechanism and effects of offset by promoter shareholders

First, the founding shareholders may offset their monetary capital contribution obligations with advance payments. These advance payments refer to necessary expenses incurred by shareholders in good faith before a company's establishment to facilitate its formation, including but not limited to company registration fees and office rental costs. Regarding the nature of such payments, any prior agreement shall prevail. In the absence of such agreement, these payments shall be deemed as shareholder claims under this article, which do not automatically offset capital contributions. However, shareholders may fulfill statutory procedures to conditionally offset their obligations. On the one hand, these payments reflect shareholders' good-faith commitment to promoting corporate development. Offsetting these obligations helps reduce corporate debt while ensuring sufficient initial working capital, without harming the company or future creditors. On the other hand, these payments reflect shareholders 'good faith commitment to promoting corporate development. The recognition of their offsetting effect serves as positive reinforcement for shareholders' diligent fulfillment of fiduciary duties.

Second, the initiating shareholders offset their monetary capital contribution obligations with loans. As internal parties of the company, shareholders often become convenient lenders for the

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company when it is in financial distress [6]. At this point, shareholders hold the dual status of creditor and shareholder with respect to the company. When a company has the ability to repay its debts, the offsetting behavior of shareholders meeting certain conditions has certain feasibility. However, when a company's debt-paying ability is lacking, this move is tantamount to the shareholders' claims being given priority for repayment, violating the rule of subordination of equity: in terms of the dividend distribution stage, to meet the demands of creditors, the company must make up for losses before distributing dividends to shareholders; in terms of the company's existence stage, it is also necessary to regulate the opaque and prohibited related-party transactions between shareholders and the company [7]. Obviously, in order to achieve the goal of the subordinated repayment rule, preventing shareholders from evading or transferring operational risks, breaking through the formal equality of creditor's claims, and to punish the malicious behavior between shareholders and the company, it is not allowed for the initiating shareholders to offset their monetary capital contribution obligations with loans [8]. In conclusion, given the information gap between shareholders and the outside world of the company, and the difficulty in guessing whether shareholders have the intention to evade their capital contribution responsibilities, if shareholders want to exercise this right, they need to bear the responsibility of information disclosure. In particular, the controlling shareholder should bear the burden of proof. Only when they provide sufficient evidence to prove that the creditor's claims are legal and that there is no intent to evade capital contribution obligations will their offsetting behavior be recognized [4].

2.3. Legal analysis of the offset of shareholders' monetary contribution obligations by their claims against the company

The term "capital contribution liability of equity transferees" refers to the obligation where a shareholder transfers equity while still having outstanding capital contribution obligations. In such cases, the equity transfer must fulfill these obligations or assume corresponding liabilities [9]. During equity transfer, the transfer pays consideration for the equity transfer and acquires corresponding shareholder rights and obligations. However, this process does not alter the original capital contribution methods stipulated in the company's articles of association. Additionally, the nature and claims that the transfer holds against the company remain unrelated to the equity transfer. Therefore, in principle, the transfer cannot directly offset capital contributions with existing claims against the company.

2.4. Legal analysis of offset of shareholders' monetary contribution obligations by claims against the company during capital increase

Article 227 of the Company Law stipulates that when a company increases its capital, shareholders may subscribe to capital contributions in accordance with the articles of association and applicable laws. Non-shareholders can also become corporate shareholders through capital subscription upon meeting statutory requirements. If new subscribed capital contributions are offset by corporate debts, this essentially disrupts the sequence of creditor realization and give priority to the realization of claims and carries risks of harming the interests of other creditors. This article argues against recognizing such practice.

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3. The balance of interests in the offset of shareholders' monetary contribution obligations with company claims

The offsetting shareholders 'claims against capital contributions is a double-edged sword, with both advantages and disadvantages that require case-by-case analysis. The legal validity of such offsetting should be conditionally recognized on the premise of complying with the company's articles of association and applicable laws. Specifically, shareholders' claims must first meet statutory basic requirements, followed by special criteria for such claims as unique creditor rights, with all conditions being thoroughly evaluated [10].

3.1. General requirements for the offset of shareholders claims

3.1.1. Validity and authenticity of claims

The source of creditor's claims shall be legal, genuine, and valid. The act of offsetting false claims created by shareholders and the company through malicious collusion and related-party transactions is invalid. Article 48, Paragraph 2 of the new Company Law explicitly stipulates that non-monetary property contributions shall be appraised and valued, with asset verification conducted to prevent overvaluation or undervaluation. The actual value of creditor's claims is not solely reflected by book value; thus, the appraisal value should serve as the basis for determining the amount of capital contributions. China's Company Law adopts a mandatory appraisal model for non-monetary contributions, ensuring the fairness of such contributions through independent professional institutions [2]. This paper argues that companies and shareholders may negotiate to select state-approved professional appraisal institutions, or have appraisal institutions designated by the People's Court in accordance with the law.

3.1.2. Procedural legality

Existing reference cases indicate that shareholders offsetting capital contribution obligations with maturing corporate claims must meet the following conditions: First, amend the articles of association through a shareholders 'resolution to change the capital contribution method to debt contribution, and confirm paid-in capital; Second, the company must demonstrate sufficient solvency when the shareholders' resolution is made; Third, the amended articles of association shall be filed with the company registration authority. For cases failing to meet these requirements, if creditors request that shareholders who have not fulfilled or fully fulfilled their capital contribution obligations bear supplementary liability for the company's unrepayable debts within the scope of unpaid principal and interest, the People's Court shall support such claims [10].

3.2. Circumstances warranting special restrictions

3.2.1. In the absence of other creditors

The statement that "there are no other creditors" refers specifically to the absence of non-shareholder creditors. For debts incurred by shareholders during company establishment and other operation of the company, provided the company demonstrates sufficient solvency, shareholders may amend the articles of association through a resolution, by changing the capital contribution method to "debt contribution", to reconfirm the status of paid-in capital, complete legal registration, and make public disclosures, thereby recognizing their offsetting effect under relevant regulations.

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3.2.2. Coexistence of shareholder claims and third-party creditor rights

First, when a company is operating normally and possesses sufficient debt repayment capacity, even if the shareholder debt offset complies with the aforementioned procedural legality and public disclosure requirements, given the special status of shareholders and the hidden nature of capital withdrawal methods, it is essential to establish a risk firewall. This ensures third-party creditors are not harmed by shareholders' debt offsetting capital contributions. Therefore, this article argues that before fulfilling the obligation of debt offsetting capital contributions, shareholders should provide detailed written notification to creditors and commit to assuming joint liability within the offset amount if the company fails to repay third-party debts. Second, in the circumstances where an enterprise's debt-paying ability is lost or absent due to abnormal operation, considering the subordination of shareholders' claims, the bankruptcy rules should be referred to, this paper does not support such offsetting behavior.

To sum up, this paper holds that based on differences in the origin, timing, and operating status of shareholders' creditor's claims, allowing shareholders to offset their capital contribution obligations with creditor's claims under the condition of law is not only consistent with the legislative spirit of Article 48 of the new Company Law, but also can balance the interests among shareholders, companies and creditors.

4. The role and impact of shareholders offset of capital contribution obligations with company claims

4.1. Positive effects of shareholders offset

First, when a company is operating normally and has sufficient debt repayment capacity, shareholders offsetting their capital contribution obligations with creditor claims not only reduces financial pressure but also enables the realization of shareholder claims through offsetting. Second, this practice eliminates corporate debts to shareholders while avoiding cash expenditure pressures from debt repayment, which facilitates capital turnover and activate shareholders' funds. Finally, it mitigates legal risks arising from insufficient economic payment capabilities when shareholders' subscribed capital contributions mature.

4.2. Negative effects and legal risks of shareholders offset of capital contribution obligations

First, such practices may undermine the adequacy of a company's registered capital. Shareholder contributions serve as the primary source of corporate assets and a crucial safeguard for creditors' interests. Allowing shareholders to offset capital obligations with potentially unenforceable creditor's claims when the company is insolvent would severely erode corporate capital, violating the principle of capital maintenance. Second, given the diverse and often ambiguous nature of shareholder debt claims, the absence of strict restrictions could enable this offsetting mechanism to become a legal facade for illegal capital withdrawal. Shareholders and companies might fabricate creditor-debtor relationships to evade capital commitments through debt offsets, thereby harming creditors 'rights and disrupting market order [11]. Finally, even if a company hasn't entered bankruptcy proceedings yet, such offsetting actions effectively grant priority repayment to specific creditors when bankruptcy conditions are met, contradicting the bankruptcy law's fundamental purpose of ensuring fair creditor compensation.

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5. Conclusions

Shareholders offset their capital contribution obligations with corporate claims, which has both advantages and disadvantages. Currently, there are no unified standards for this practice domestically or internationally, but the core trend is to strictly restrict shareholders from offsetting capital obligations with their claims against the company. In China, there is only one strongly relevant case available for reference. When addressing this issue, it is necessary to consider the actual circumstances of the company, balance the need to stimulate market vitality and optimize the business environment with adherence to the capital adequacy principle and legislative spirit of corporate law, thereby legally and reasonably balancing the interests among shareholders, the company, and creditors.

Based on the amendments to the new Company Law, this paper focuses on whether shareholders can offset their capital contribution obligations with corporate claims in various situations. This study has certain limitations due to insufficient reference to judicial cases. In the future, with the enrichment of judicial practice, we will further explore the practical operation of companies and markets to draw more comprehensive conclusions.

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