

Equity Transfer Modes in Limited Liability Companies under the New Company Law

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Abstract: As a key legal action in corporate operations, equity transfers significantly influence a company's governance structure, shareholders' rights, and market transaction security. With the enactment of the New Company Law (2023), limited liability companies will encounter new legal challenges regarding equity changes. This article aims to investigate the equity change models prescribed by the new law by analyzing legal provisions and academic perspectives. On the occasion of implementing the new law, the paper will justify the formalistic approach established by the New Company Law by comparing it with international equity change models and reviewing pre-law judicial practices. This analysis will assess the current law's adaptability and identify potential room for improvement, to provide theoretical and practical support for the equity changes in limited liability companies under the new legal framework.

1. The Equity Transfer Model Established by the New Company Law

1.1 Introduction

With the continuous development and improvement of the market economy, the issue of equity transfers in limited liability companies, a crucial element of market entities, has garnered increasing attention. The Company Law of the People's Republic of China (hereinafter referred to as the New Company Law) was revised and adopted at the 7th Session of the Standing Committee of the Fourteenth National People's Congress of the People's Republic of China on December 29, 2023, which provides vital legal guidance for fostering sustainable market growth, safeguarding stakeholder rights, and ensuring economic order. With the new Company Law set to take effect on July 1, 2024, limited liability companies will encounter a changing legal landscape and face new regulatory challenges concerning equity transfers. Therefore, it is of great theoretical and practical significance to discuss the mode of equity change of limited liability companies under the framework of the new Company Law (2023) for the protection of shareholders' interests, the reduction of transaction risks, and the maintenance of market order.

1.2 Pre-Implementation Issues

The equity transfer model, inspired by the changes in real property rights, aims to regulate the

normative model of the initiation, modification, and termination of equity.[1] Transferring equity in a limited liability company is multifaceted. Initially, the parties negotiate and reach an agreement, after which they seek the opinions of other shareholders (the new Law includes the right of first refusal). Subsequent steps encompass several time nodes such as signing a formal transfer contract, updating the shareholders' register, amending the articles of association, and updating the commercial registration. Scholars have noted that disputes over equity transfers have long been the most common type of corporate litigation. [2]A major source of these disputes is the question: "When does an equity transfer in a limited liability company take effect?" Specifically, this refers to the timing of when the original shareholder loses their status and when the new shareholder acquires the equity. On this issue, the legislative, judicial, and theoretical circles have not yet reached a consensus. Before the introduction of the new law, the Company Law (2018) and its relevant judicial interpretations have not yet made clear provisions on this issue, which has not only aroused widespread academic debate but also exists a variety of opposing views in judicial practice with the phenomenon of inconsistent judgments for similar cases.

1.3 Analysis based on Article 86 of the New Company Law

Article 86 of the New Company Law, a newly introduced provision, that establishes a more complete model for equity changes in limited liability companies, is based on Article 8 of the "Minutes from the National Court Civil and Commercial Trial Work Conference" (hereinafter referred to as the "Minutes of the Civil and Commercial Trial Work Conference") issued by the Supreme People's Court on November 14, 2019[3]. The following sections will delve into the legislative choices reflected in Article 86.

1.3.1 The New Company Law Adopts Recordation Formalism

According to Article 86 of the New Company Law, the transferee truly acquires the status of a shareholder when it is duly recorded in the shareholders' register and may claim the exercise of shareholders' rights from the company. It can be seen that the new law gives the register of shareholders the effect of granting rights, and only the contract of assignment itself cannot effectuate the change in equity, which needs to satisfy a specific form, i.e. to be recorded in the register of shareholders. The shareholder register is a legally mandated document that records key information such as the names of shareholders, their subscribed and paid-up capital contributions, and other relevant details. It serves as a definitive proof for identifying shareholders, verifying their shareholdings, and recognizing their rights within the company. The register carries presumptive legal authority, meaning its records are presumed accurate unless proven otherwise. Shareholders listed in the register have the right to engage in the company's decision-making processes, including attending shareholder meetings, voting, and receiving dividends. In the event of disputes over equity, the shareholder register can also serve as critical evidence for resolving conflicts and helping determine the ownership of shares.

1.3.2 New provisions on registration and remedies following a transfer of shareholdings

Article 86 also delineates the obligations of the transferor and the company during equity changes. Specifically, the transferor must notify the company and request the necessary updates to the shareholders' register and registration. In turn, the company must update the shareholders' register and registration accordingly. If the company fails to comply after receiving the transferor's notification and request, the new law empowers both the transferor and the transferee to initiate litigation to enforce the company's compliance through a court order. In a nutshell, the new law clearly outlines the obligations of the company and the transferor on the one hand and provides remedial

rights for both the old and new shareholders on the other.

1.4 Comparison of the differences between the old and the new law in terms of legal provisions

The Company Law (2018) contained ambiguous provisions regarding equity changes, leading to numerous disputes in practice. For instance, although Article 32, Clause 3 of the Company Law (2018) clarified the opposability of commercial registration, it did not provide detailed provisions on the specific model of equity changes. There is a general academic consensus that commercial registration was merely declaratory and incapable of effecting equity changes, serving only to oppose third parties.[4] Article 8 of the "Minutes of the Civil and Commercial Trial Work Conference" recognized the change in the shareholders' register as the effective time point for equity changes and stated that equity changes should take effect upon their recordation in the shareholders' register (a formalist perspective). This emphasized the company's recognition of the new shareholder status and the expression of its intention in the equity transfer process, at that time, neither the transferor nor the transferee was entitled to the right of recourse, leaving the transferee in a particularly weak position with no proper basis to compel the company to cooperate in the change or to claim breach of contract against the transferor. In addition, some scholars noted that while this provision helped unify judicial thinking at the trial level, its reasonableness was still open to debate.[5] Compared with the Company Law (2018), the new law adopts an equity change model that "the change in the shareholders' register is the validity requirement, and the change in commercial registration is the opposability requirement." [6] This aligns with the view of Recordation Formalism. Unlike the views in the "Minutes of the Civil and Commercial Trial Work Conference", the new model stipulates that assisting the transferee in obtaining the company's recognition is the main contractual obligation of the transferor. It also grants the transferee the right to sue, thus improving the transferee's position and allowing for a better balancing of the interests of the company and the transferring parties.

2. Theoretical debates on modes of equity change

The academic community is divided over the mode of equity transfer, with the debate primarily centered on the intent-based approach versus formalism. The crux of the distinction between these two perspectives is whether the equity transfer, in addition to the legality and validity of the contract, necessitates compliance with a particular formality.

2.1 The pure intentionalism model

Proponents of this theory argue that once the equity transfer contract is formed and becomes effective, the transfer of equity is triggered and the transferor recognizes the transferee as a new shareholder of the company. [7] Similar statements include that a change in equity does not require publicity as an element of effectiveness, and a change in equity occurs when the parties agree on the meaning of the contract of transfer, i.e., when the contract of transfer is formed and becomes effective.[8] According to these views, the so-called the pure intentionalism model asserts that equity changes require only the consent of the parties involved, without the need for additional formalities.

However, the author contends that while the pure intentionalism model aligns with the efficiency and convenience sought in commercial transactions, limited liability companies, due to their inherent insularity and human association, often conduct share transfers under contracts that obscure the legal facts from third parties. If the transferor deliberately conceals the change, it becomes even more difficult for third parties to become aware of the legal fact of the equity change. Therefore, the pure intentionalism model not only fails to protect the legitimate rights and interests of third parties but also, by disregarding the proprietary nature of equity as a property right, risks arbitrariness in

regulating equity changes.[9] Potentially this can increase the litigation burden on judicial authorities and is not a sound approach.

2.2 Formalism model

This model emphasizes that equity changes must meet certain formal requirements, such as commercial registration and the shareholders' register. It can thus be divided into registration formalism and recordation formalism.

Registration formalism advocates that commercial registration should be the condition for the effectiveness of equity changes. Proponents of this view emphasize, that commercial registration gets private subjects and public authorities of a high degree of trust because of its publicity effect. This model aligns with China's legal traditions and practices in equity transactions and provides a clear and unified standard for adjudicating disputes involving equity changes.[10] However, critics argue that the effectiveness of commercial registration should be separate from the civil legal acts between the parties in an equity transfer. They believe that this model excessively interferes with private rights and autonomy, potentially hindering transaction safety and efficiency.[11] Additionally, a literal interpretation of the Company Law (2018) indicates that commercial registration only has an opposability effect against third parties and does not confer rights. Therefore, whether the registration is changed does not affect the acquisition of equity.

Recordation formalism, on the other hand, argues that changes in the shareholders' register should be the condition for the effectiveness of equity changes. Some scholars further point out that the shareholders' register serves as presumptive proof of shareholder qualification, allowing registered shareholders to exercise their rights within the company, while the change in shareholder registration has an opposability effect.[12] Unlike registration formalism, recordation formalism treats commercial registration as a condition for opposability rather than effectiveness. Internally, within the company, the new shareholder's qualification is confirmed by updating the shareholders' register; externally, commercial registration discloses equity change information to the public, thereby creating opposability effects.

2.3 Modified intentionalism model

In this model, the equity transfer contract takes effect and triggers the equity change; however, the transferee must first notify the company and obtain its approval (recorded in the shareholders' register) before exercising shareholder rights within the company. Additionally, only after completing the commercial registration change can the transferee assert rights against third parties.[13] In essence, while retaining the core of pure intention, this model adds company approval as a necessary condition for the equity change to be effective within the company. Nevertheless, some scholars criticize the modified intentionalism model for violating the principle of "non-separation of membership rights and membership qualifications," falling back into the interpretative path of "incomplete property rights," and contradicting the in rem nature of equity as property rights.[14] The author also believes that although the modified intentionalism model represents progress, it still lacks logical consistency and practical operability. The modification of Purely intentionalism is insufficient, and it is necessary to explore a more comprehensive and optimized model.

3. Justification for choosing the recordation formalism model

By reviewing different theoretical models of equity changes, it can be concluded that the new Company Law adopts the recordation formalism model with the register of shareholders as the effective element and the specific moment the transferee acquires the equity is when they are recorded

in the shareholder register. Compared with the intentionalism model, the equity change model established by the new law introduces the act of corporate recognition, which is conducive to protecting the interests of the company and other shareholders. Unlike “Minutes of the Civil and Commercial Trial Work Conference”, the new model explicitly stipulates that the transferor must assist the transferee in obtaining the company's approval and grants the transferee the right to sue. This improvement strengthens the transferee's overly disadvantaged position and better balances the interests of the company and the transfer parties. In the author's opinion, the legislative choice of the new Company Law is well-founded and the subsequent discussion will justify two perspectives: the reference from foreign models of equity transfer and the embodiment of the domestic judicial practice.

3.1 Reference to Foreign Models

In the era of globalization, the mutual referencing and integration of corporate laws internationally have become a trend. This paper selects and examines relevant legislative examples from Germany , the United Kingdom, and the United States to underpin the legislative choices of the new Company Law.

The limited liability company (GmbH) under German law closely resembles the limited liability company in China. According to Articles 15 and 16 of the German Limited Liability Companies Act, shares are alienable, and an agreement establishing a shareholder's obligation to transfer a share likewise requires a notarial form. Following the transfer, the transferee does not formally become a shareholder, nor do their legal actions take effect against the company, until they are registered in the company's shareholder list within the commercial registry. This implies that, although a share transfer agreement may be reached between the parties, it only acquires legal validity at the company level after the transferee's registration. Under German law, equity transfers require a formal public registration process, thereby excluding the mode where the transfer becomes effective merely upon mutual agreement between the parties.

Private companies under the UK Companies Act 2006 share analogous characteristics with our limited liability companies.[15] According to Article 112 of the UK Companies Act 2006, to become a company member requires two conditions: consent to membership and being recorded in the register of members. Scholars further clarify that in the UK, shares exist in registered form, and shareholders are not considered complete shareholders until they are recorded in the register of members. This underscores the significant emphasis the law places on managing and maintaining the register of members.[16]

In the United States, company law varies by state, with Delaware General Corporation Law highly regarded for its advanced legislation and implementation. The register of shareholders occupies a pivotal role in Delaware corporate law. According to Section 219(c) of the Delaware General Corporation Law, the register of shareholders is the sole evidence for determining shareholder rights and accessing company records. An integrated analysis of the equity transfer models in both the UK and the US reveals that both countries have clear legal frameworks to regulate equity transfers and the overall process, key points, effectiveness and other issues of the transfer of equity are stipulated. Additionally, neither country considers commercial registration as a condition for the effectiveness of equity transfers. Instead, they use records like the register of members or shareholders as key documents for shareholder rights. China's new Company Law, by explicitly stipulating the modalities of equity transfer in legal provisions and designating the registration in the shareholder register as the point of effectiveness, aligns with international legislative norms both formally and substantively.

3.2 Embodiment of domestic judicial practice

Scholars have researched and affirmed the legitimacy of a company's involvement in equity changes, and the author also supports this view. The judgments of the Supreme People's Court highlight the importance of the company's intent in shareholder changes. For instance, "if the equity transfer agreement and the company's internal registration procedures are completed, the transfer obtains the equity even without commercial registration"; "whether Fushun Bank completes the change registration with the commercial administration does not affect the validity of the equity transfer in question."

Analyzing these judgments, the author believes that China's judicial practice emphasizes the fulfillment of the equity transfer agreement and the update of the shareholder register in determining the validity of equity transfers and shareholder identity. Although commercial registration changes are routine procedures, they are not decisive for the effectiveness of equity transfers. This underscores the importance of the shareholder register and the non-essential nature of commercial registration changes. As previously mentioned, using the shareholder register change as a decisive factor for the effectiveness of equity transfers is already reflected in judicial practice. This lays a practical foundation for the new legal model and facilitates the harmonization and alignment of legal principles with judicial practices.

4. Conclusion

The newly added provision in Article 86 of the new Company Law establishes a recordation formalism model, offering a clearer and more practical legal framework for equity changes in limited liability companies. This provision not only responded to the controversy on the doctrine but also incorporated useful experience and beneficial practices from foreign legislation and aligned with the development of domestic judicial practices. Although this does not signify that current legal stipulations are flawless, nor does it indicate that an academic consensus or prevailing doctrine has been established, the significance of clear legal provisions cannot be understated. It is undeniable that the lack of clarity of the legal provisions will bring about the key point of time of the change of equity is ambiguous, and the confirmation of the qualification of shareholders is complex and difficult to understand. This not only destabilizes corporate governance but also increases the cost of shareholders exercising their rights, reduces equity liquidity and dampens investor enthusiasm. Admittedly, each model of equity change has its advantages and disadvantages, and no flawless model exists that can perfectly balance all interests and resolve all risks involved in equity changes. However, clear rules enhance reasonable expectations and predictability of transaction risks for the parties involved. The enactment of the new law is just the first step; its effectiveness in practice requires continuous observation and evaluation. Paying close attention to judicial interpretations and practical applications following the implementation of the new law is crucial to ensure legal norms are correctly understood and applied, achieving a balance between stability and adaptability.

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