

What Foreign Investors Should Know about China's New Company Law By Lawrence An | Sol Zhang

On December 29, 2023, the National People's Congress promulgated the long-awaited amendment to the Company Law of the People's Republic of China (the "**New Company Law**"). After several rounds of public comments since 2021, the New Company Law contains certain significant changes that may alter many corporate activities.

Given that the Foreign Investment Law of the People's Republic of China requires foreign invested enterprises ("**FIE**") to adapt to the requirements under the Company Law within a transition period expiring at the end of 2024, the New Company Law, becoming effective from July 1, 2024, is remarkably meaningful and instructive to foreign investors, in particular in aspects as follows, whether they are considering the required changes to their investments in China, or planning and negotiating new joint venture or other deals.

1. Capital Contribution

1.1. The Five-Year Requirement

During the past decade, the Company Law allowed a subscription regime for registered capitals in limited liability companies ("**LLC**"), where the time for capital contribution is freely determined by shareholders. Under such regime the shareholders may choose to accomplish their contribution within the term of business of the company, which could be extended to an indefinite term.

The New Company Law reshapes the foregoing regime, where Shareholders of LLCs now must accomplish the entire capital contribution no later than five years from the incorporation, failing which, the defaulting shareholders will lose their rights and benefits attached to the unpaid capital.

For more Llinks publications,
please contact:

Publication@llinkslaw.com

In the meantime, the New Company Law requires companies already incorporated to adjust the deadline of capital contribution by their shareholders if it surpasses the foregoing five-year requirement. However, no clear time table is set for such adjustment.

In addition, the New Company Law adds an obligation on the directors to oversee the status of capital contribution by shareholders and call up the unpaid capital, failing which, the responsible director(s) will also become personally liable.

Links observation:

The existing subscription regime came into force in 2013, when China was promoting its Mass Entrepreneurship and Innovation Initiative, which invoked the need for flexibility on capital contribution for companies. The New Company Law signifies a shift at the policy level, where the legislators appear to require capital abundance and thus creditworthiness for companies when a certain level of flexibility is still retained.

However, the new regime caught wide attention immediately and sparked heavy discussion or even debates among the public. There are still question marks on when and how existing companies should comply with the five-year contribution requirement. In such case, it cannot be ruled out as a possibility that FIEs may be required by local company registration authority to accomplish the adjustment relating to the five-year requirement on capital contribution, especially when they apply for any registration concerning other corporate matters with the authority.

1.2. Joint and Several Liability among Shareholders for Capital Contribution upon Incorporation

Under the Company Law (with the latest amendment in 2018, the “**2018 Company Law**”), upon the incorporation of the company, a shareholder is liable to the company and other shareholders if it is in default of its capital contribution obligation.

Under the New Company Law, if, after the company is incorporated, any shareholder fails to make capital contribution required by the articles of association, or the value of its contribution in-kind is significantly lower than the amount of the registered capital it subscribed for, the other shareholders are jointly and severally liable to the company for the shortfall.

Links observation: This is a fundamental change in terms of capital contribution obligations. Now, for the foreign investor in joint venture deals, it is important to require in the relevant transaction documents an indemnity from the other shareholder(s) against losses the foreign investor may suffer for its joint and several liability (the foreign investor may have a claim against the other shareholder(s) by default under the Civil Code, but an explicit clause of indemnity would certainly help to eliminate any uncertainty).

2. Corporate Governance

2.1 Audit Committee vs. Board of Supervisors

LLCs are required to have a board of supervisors (or at least a supervisor) ever since the Company Law first came into force in 1993, which has the functions and powers to inspect the financial conditions of the company, and monitor and oversee the performance of directors and senior officers.

The New Company Law introduces the audit committee under the board of directors (the “**BoD**”) as an alternative to the board of supervisors, which has the same functions and powers as the board of supervisors.

Links observation: as mentioned above, the audit committee has the same functions and powers with the board of supervisors, which include the power to inspect the financial conditions of the company. But from cautious perspective this should not be read as automatically granting the power to such committee to conduct audits of the company, although it is interestingly called the “audit committee”.

2.2 Functions and Powers of Corporate Governing Bodies

The 2018 Company Law sets out a rigid regime for functions and powers among the shareholders, the BoD and the general manager, where certain operational matters, such as the operation strategy, investment plan and budget and settlement of account, require approvals from both the shareholders and the BoD. The functions and powers of the general manager are also prescribed by law, where these could be only amended by the articles of association of the Company.

The New Company Law allows more flexibility, as the matters requiring dual approvals above are now left for the BoD to decide only. As to the general manager, it is no longer a mandatory position prescribed by law. If the company still choose to have such position, its functions and powers could be determined by the authorizations from the board, no longer by the articles of association only.

Links observation: now the BoD will become the centerpiece for decision-making of the Company’s operational matters. If a foreign investor is the minority shareholder in the company and does not have any BoD seat, the right to appoint a BoD observer is increasingly meaningful if the foreign investor is seeking the access to more information regarding the business operation of the company.

2.3 Candidates of Legal Representative

A legal representative is the person that has the power to act on behalf of and thus bind the company by default. Under the 2018 Company Law, the legal representative is to be assumed by either the chairman of the BoD or the general manager.

Under the New Company Law, a director that manages the affairs of the Company (instead of the chairman of the BoD) or the general manager is eligible to assume the role of the legal representative.

Links observation: it is a common practice for FIEs, especially those established by multinational companies, to appoint a senior officer from the headquarter as the chairman of the BoD and the legal representative, while such person is not involved in the business operation of the company. If this is the case, such FIEs may need to consider changing their legal representative to be fully compliant with the New Company Law.

3. Duty of Loyalty and Duty of Care

3.1. Duty of Loyalty and Duty of Care

The duty of loyalty was stipulated in the Company Law when it was first made in 1993. The duty of care was later added in the amendment in 2005. As until the 2018 Company Law, events that constitute violations of the duty of loyalty are expressly prescribed by law, but the standard of duty of care is still absent (in practice courts usually adopt a reasonable care standard when adjudicating duty of care cases).

Under the New Company Law:

- For the duty of loyalty, on top of the events already stipulated as violations of law, the New Company Law further prescribes the followings:
 - (i) restrictions on related party transactions, which require BoD and/or shareholders approval for dealings between directors, senior officers or supervisors, their immediate relatives, enterprises directly or indirectly controlled by the foregoing persons, on one hand, and the Company on the other hand; and
 - (ii) prohibition on usurpation by directors, senior officers or supervisors of the company's business opportunities.
- For the duty of care, it now expressly stipulates reasonable care to the best interest of company as the standard.

It is noteworthy that the scope of obligors has also been extended under the New Company Law, where the controlling shareholder and ultimate beneficial owner who is not a director but manages the affairs of the company is also on the hook for the foregoing duties.

3.2. Director Insurance

While the New Company Law places substantial duties on directors, it also provides for a right of the company to purchase insurance for directors. This is a common practice in foreign jurisdictions but is

only adopted by a few public companies in China so far. Now after this is written into the law for the first time, more companies may choose to adopt the practice to offset potential risks for their directors.

Links observation: directors, officers, and even shareholder now must act with diligence and prudence. To limit their exposure to the duty of care, FIEs may consider indemnification by the company, the directors insurance mentioned above, and waivers of liability.

4. Proportionate Capital Reduction

As to capital reduction of the company, the New Company Law now requires that, unless otherwise agreed by all the shareholders (for LLCs), they shall reduce their capital contributions in proportion to their shareholding.

Links observation: company redemption or the valuation adjustment mechanism, which are commonly seen in mergers and acquisitions, joint venture or fund investments, are mostly achieved by means of capital reduction. However, in such cases unproportionate capital reduction by one or a few shareholder(s) is needed, but not the proportionate capital reduction by all the shareholders mentioned above. Therefore, to ensure the enforceability of the foregoing mechanisms, agreement among all the shareholder is a “must-have” in the said deals.

5. A New Trigger Event for Company Redemption

The 2018 Company Law stipulates a duty to compensate if a shareholder abuses its shareholder’s rights and thus causes loss to the company or other shareholders.

In addition to the foregoing protection, the New Company Law further provides the right to minority shareholders to require redemption by the company at a fair price, when the majority shareholders abuse their shareholder’s right and materially impair the interest of the company or other shareholders.

Links observation: the intention behind the above change is quite straightforward, while legislators seem to allow the exit from company as another protective measures to the minority shareholders. However, so far the New Company Law only provides for a principle. Without further guidelines or judicial interpretation rules, the standards for abuse of shareholder’s rights and material impairment of company’s or other shareholders’ interest remain vague. In such case, the redemption right may be intentionally used by the minority shareholders as the leverage when they dissent from the majority shareholders.

Please note that the above only contains a few notable points in the latest amendment to the Company Law. Please do not hesitate to contact Lawrence An at Lawrence.an@linkslaw.com and Sol Zhang at Sol.zhang@linkslaw.com if you have any questions.

If you wish to learn more about the SCCs or our cybersecurity and data compliance services, please contact:



Lawrence An

+86 21 3135 8761

lawrence.an@llinkslaw.com

SHANGHAI

19F, ONE LUJIAZUI
68 Yin Cheng Road Middle
Shanghai 200120 P.R.China
T: +86 21 3135 8666
F: +86 21 3135 8600

BEIJING

30F, Central Tower, China Overseas
Plaza, 8 Guanghuanongli,
Chaoyang District
Beijing 100020 P.R.China
T: +86 10 5081 3888
F: +86 10 5081 3866

SHENZHEN

18F, China Resources Tower
2666 Keyuan South Road,
Nanshan District
Shenzhen 518063 P.R.China
T: +86 755 3391 7666
F: +86 755 3391 7668

HONG KONG

Room 3201, 32/F, Alexandra House
18 Chater Road
Central, Hong Kong
T: +852 2592 1978
F: +852 2868 0883

LONDON

1/F, 3 More London Riverside
London SE1 2RE
United Kingdom
T: +44 (0)20 3283 4337
D: +44 (0)20 3283 4323



www.llinkslaw.com



Wechat: LlinksLaw

WE LINK LOCAL LEGAL INTELLIGENCE WITH THE WORLD

This publication represents only the opinions of the authors and should not in any way be considered as legal opinions or advice given by Llinks. We expressly disclaim any liability for the consequences of action or non-action based on this publication. All rights reserved.

© Llinks Law Offices 2024