Navigating the New Company Law-New Era for Key Company Personnel

Author: LAN, Jie XIAO, Yi PAN, Bing YANG, Chunyan YAN, Zhuofei *Guo Huarong (intern) also contributed to this article.

On December 29, 2023, the Standing Committee of the National People's Congress approved the revised "Company Law of the People's Republic of China" (the *New Company Law*), set to come into effect on July 1, 2024. The New Company Law introduces two significant changes: one concerning corporate governance and the other related to capital adequacy regulations. The successful implementation of these changes hinges on the active involvement of directors, supervisors, and senior executives. As a result, the New Company Law marks a new chapter in the obligations, duties, and liabilities of these key company personnel. This article aims to provide an overview of the shifts in the responsibilities of directors, supervisors, and senior executives under the New Company Law.

1. Enhancement of fiduciary duties

(1) Supplementing the contents of duty of loyalty and duty of care

While the PRC Company law (revised in 2018) (the *Current Company Law*) offers a broad outline of the duty of loyalty and duty of care without delving into specifics, the New Company Law takes a step further by delineating the scope of these responsibilities. It articulates that the duty of loyalty is the duty to conduct oneself in a manner that prevents conflicts of interest with the company, refraining from seeking undue advantages through one's position. It also defines that the duty of care refers to the reasonable care that is typically expected of managers for the maximum benefit of the company. We set out in the table below a comparison of the relevant provisions in the Current Company Law and the New Company Law.

1.png

(2) Aligning supervisors' duty of loyalty with that of directors and senior executives

The fiduciary duty of supervisors under the Current Company Law is notably less stringent compared to that of directors and senior executives. Specifically, Article 148 of the Current Company Law, which outlines the duty of loyalty by setting out various prohibitions, only applies to directors and senior executives. In contrast, the New Company Law elevates the duty of loyalty for supervisors to be on par with that of directors and senior executives. Key changes are set out in the table below.

2.png

(3) Reinforcing regulations of related party transactions

The New Company Law significantly strengthens regulations on related party transactions by (i) extending the scope of regulations to include supervisors, in addition to directors and senior executives; (ii) broadening the rules to encompass companies controlled directly or indirectly by the close relatives of directors, supervisors, and senior executives; and (iii) mandating that all related party transactions must be reported to and approved by the board of directors or shareholders' meeting.

While many of these may not be unfamiliar to listed companies as they are already subject to similar rules set by stock exchanges or the China Securities Regulatory Commission (the CSRC), the New Company Law raises the bar by requiring all related party transactions, regardless of amount, to undergo board or shareholders' approval. This is a stepping up from the current securities rules, where only transactions meeting a specific dollar threshold require such approval. For non-listed companies, the impact of the New Company Law is even more significant as previously they were subject to little restriction in this regard.

3.png

(4) Strengthening the business opportunities doctrine

Under the Current Company Law, the business opportunities doctrine mandates that directors and senior executives must not pursue business opportunities of the company without approval from the shareholders' meeting. The New Company Law extends this doctrine to include supervisors as well. It also allows the company to approve transactions involving business opportunities through either a board resolution or a shareholders' resolution, depending on the provisions in its articles of association. Furthermore, the New Company Law outlines exceptions to this doctrine and provides that, if the company is unable to capitalize on the business opportunities due to relevant provisions in the Laws, Administrative Regulations, or its articles of association, directors, supervisors, and senior executives may exploit such opportunities.

4.png

(5) Enhancing non-compete obligations of directors, supervisors and senior executives

The Current Company Law states that directors or senior executives should not engage in horizontal competition against the company without approval from the shareholders' meeting. The New Company Law extends this restriction to supervisors and also allows companies to delegate the approval authority to the board of directors through their articles of association.

5.png

(6) Expanding the scope of application of the abstention voting mechanism

Under the Current Company Law, only directors of listed companies are mandated to abstain from voting on pertinent issues in the presence of potential conflicts of interest. The New Company Law broadens the scope of this abstention requirement to encompass directors of all companies, regardless of their listing status or corporate structure (i.e., whether a limited liability company or a company limited by shares). Accordingly, related directors of all companies must abstain from voting on matters concerning related party transactions, horizontal competition, and company business opportunities.

6.png

2. Enhancing accountability of directors, supervisors and senior executives in the maintenance of capital adequacy

The strengthened capital adequacy requirement is a key highlight of the New Company Law. In conjunction with its implementation, the New Company Law holds directors, supervisors, and senior executives accountable as the gatekeepers of the company's capital adequacy. It imposes compensation liabilities on those responsible for any illegal loss in company capital, such as default in capital contribution, illegal withdrawal of capital, illegal distribution of dividends, illegal reduction of capital, and illegal financial assistance to others. The responsibility of safeguarding the company's capital adequacy may be considered a part of the fiduciary duty of directors, supervisors, and senior executives.

Era for Key Company Personnel-7_副本.png

3. Supplementing directors' and senior executives' direct liability to third-party

Under the Current Company Law, directors, supervisors and senior executives are liable for compensation to the company and to the shareholders under certain circumstances. Article 191 of the New Company Law introduces another compensation liability, holding directors and senior executives directly accountable to third parties for losses caused by their wrongful actions when handling corporate affairs.

This seems a breakthrough from the agency theory and the principle of independent legal personality of the company, pursuant to which a company is an independent legal person, directors and senior executives are agents of the company, and the company as the principal should be liable for their acts. Article 1191 of the Civil Code of the PRC upholds this principle by providing that the employer shall bear the tort liability for any damages by its employees in the performance of their work; the employer may seek recourse from such employees whose conduct is intentional or grossly negligent. Interestingly, with respect to the acts of the legal representative, the New Company Law also adheres to this principle by providing in Article 11 that the company should bear the legal consequences of any acts of the legal representative in the execution of corporate affairs, and may seek recourse from the legal representative who is at fault. The breakthrough with respect to the acts of directors and senior executives embodies a value orientation of focusing on the protection of creditors.

8.png

4. Strengthening the responsibilities of directors during the liquidation processes

In addition to holding directors responsible for capital calls, maintenance of capital adequacy and day-to-day operations of the company, the New Company Law also enhances directors' responsibilities during the liquidation.

The Current Company Law only requires that a liquidation team must be formed within a certain period of time after the occurrence of a dissolution event, without specifying who is responsible for the formation of such liquidation team. In practice, this often leads to situations where the liquidation process is not initiated long after a company has become delinquent. Therefore, the New Company Law adds Article 232, which introduces the concept of "liquidation obligors", and provides that directors are liquidation obligators, i.e., persons that are obligated to form a liquidation team within a specified time after the occurrence of a dissolution event.

With respect to the composition of the liquidation team, the Current Company Law provides that for a limited liability company, the team should comprise its shareholders, while for a joint-stock company it should comprise directors or persons designated by the shareholders' meeting. The New Company Law provides that directors are the default members of the liquidation team for all companies, unless the company's articles of association or the shareholders' meeting designate otherwise. The New Company Law also specifies that when performing liquidation obligations, the members of the liquidation team bear the duty of loyalty and duty of care.

9.png

5. Introducing rules on de facto directors

In the corporate governance of PRC companies, how to balance the interest of controlling shareholders and actual controllers with that of minority shareholders, has always been a contending issue. Learning from the de facto director regime in other jurisdictions, Article 180 of the New Company Law requires the controlling shareholders or actual controllers who are in fact executing corporate affairs to be subject to the same level of fiduciary duties for directors. In addition, Article 192 provides that where the controlling shareholder and actual controller of a company instruct a director or senior executive of the company to engage in acts that damage the interests of the company or shareholders, such controlling shareholder and actual controller should be held jointly responsible with the director and senior executives. Nevertheless, what kind of acts would constitute "de facto execution of corporate affairs" requires further clarification in practice.

10.png

****

Conclusion：

Over the past thirty years, the corporate governance system in the PRC has evolved from a shareholder-centric approach to a director-centric model. Directors, supervisors, and senior executives are now expected to assume a more significant role in governance. Consequently, the responsibilities of these key roles are entering a new era. However, some of the new liability provisions introduced by the New Company Law remain rather general. In the upcoming judicial practice, it is crucial to implement them with prudence to avoid any potential "chilling effect" and realize the goal of enhancing the business environment and promoting market innovation vitality.

2024-04-29