

Navigating the New PRC Company Law—Share Transfer & Subscription

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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*), scheduled to take effect on July 1, 2024.

This article is a part of our "Navigating the New PRC Company Law" series that we have prepared in relation to this critical legislative advancement. It will explore the regulatory changes related to the transfer of existing shares and the subscription of new shares introduced by the New Company Law, with a comparison to the Current Company Law. The goal is to offer an in-depth analysis of these modifications and to aid businesses and investors to adapt to the changing corporate environment in the PRC.

I. Changes with Respect to Limited Liability Companies

(1) Improving the Mechanism of Preemptive Rights of Existing Shareholders

The New Company Law improved the procedures for transfers of shares to new shareholders (i.e., investors who are not existing shareholders). We set out below a comparison of the relevant provisions under the Current Company Law and the New Company Law:

Current Company Law (2018)	New Company Law (2024)
Article 71: Shareholders of a limited liability company may transfer all or part of their shares to each other. When a shareholder transfers shares to someone other than a shareholder, the consent of more than half of the other shareholders is required. Shareholders should seek consent from other shareholders in writing regarding the transfer of their shares. If other shareholders do not respond within thirty days from the date of receiving the written notice, it is deemed as consent to the transfer. If more than half of the other shareholders do not agree to the transfer, the dissenting shareholders should purchase the shares being transferred; if they do not purchase them, it is considered as consent to the transfer. With the consent of the shareholders for the transfer of shares, under equal conditions, other shareholders have the preemptive rights. If more than two shareholders claim to exercise the preemptive rights, they should negotiate and determine their respective purchase proportions. If they cannot reach an agreement through negotiation, the preemptive rights should be exercised based on their respective capital contributions at the time of the transfer. If the company's articles of association have other provisions regarding the transfer of shares, those provisions shall apply.	Article 84: Shareholders of a limited liability company may transfer all or part of their shares to each other. When a shareholder transfers shares to someone other than a shareholder, such shareholder should provide a written notice to other shareholders regarding the quantity, price, payment method, and deadline of the share transfer. Other shareholders have the preemptive rights under equal conditions. If a shareholder does not respond within thirty days from the date of receiving the written notice, it is considered as waiving the preemptive rights. If more than two shareholders exercise the preemptive rights, they should negotiate and determine their respective purchase proportions. If they cannot reach an agreement through negotiation, the preemptive rights should be exercised based on their respective capital contributions at the time of the transfer. If the company's articles of association have other provisions regarding the transfer of shares, those provisions shall apply.

The changes can be summarized as follows:

- The New Company Law abolishes the requirement that a share transfer to new shareholder requires the consent of more than half of other shareholders, and only requires the other shareholders be notified in writing instead;
- In relation to the written notice, the New Company Law requires that it cover matters such as the quantity, price, payment method and deadline. We note that this is consistent with the judicial interpretation "Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (IV)", according to which the courts should consider "factors such as the quantity, price, payment method, and deadline of the transfer of shares" when determining compliance with Article 71 (3) of the Current Company Law and the concept of "equal conditions";
- Under the Current Company Law, no response within thirty days of the notice is deemed as consent to the transfer, while under the New Company Law, it is deemed as a waiver of the preemptive rights;
- Correspondingly, the obligation of the non-consenting shareholder to purchase under the Current Company Law is repealed.

The aforementioned changes streamline the process of existing shareholders' exercise of the preemptive rights, bringing it in line with market practices and making it easier to bring in new investors.

(2) Optimizing Procedures for Shareholder Register and Filing with Company Registration Authority

Upon a share transfer, the shareholder register maintained by the company and the filing with the competent company registration authority need to be updated. The New Company Law has added Article 86 to enhance this process. Article 86 requires the transferor to notify the company and request the company to update the shareholder register and the regulatory filing, with the

company obligated to cooperate. It allows the parties to sue the company for non-cooperation. In addition, it specifies at which point in time the transferee can assert shareholder rights post-transfer. These mechanisms are necessary as while a share transfer occurs between the shareholders, it is up to the company to update the shareholder register and the regulatory filing, both of which are crucial records of shareholder rights.

Under the Current Company Law, a share transfer requires the consent of over half of the other shareholders, and if no consent is obtained, the non-consenting shareholders have an obligation to purchase. In practice, when handling the filing update following a share transfer, some registration authorities require the company to submit written documents from the other shareholders waiving their preemptive rights, creating hurdles if certain shareholders are uncooperative. This issue is exacerbated by the lack of motivation for non-consenting shareholders to cooperate. The implementation of the New Company Law will significantly mitigate this challenge. To streamline the process further in practice, we suggest that the companies request to be included in the correspondence between the transferring shareholder and the other shareholders, enabling them to oversee the transaction and facilitating the subsequent regulatory filing procedure.

(3) Introducing Provisions for Determining Payment Obligation for Unpaid Shares Being Transferred

A company may have issued shares that remain unpaid for, and these unpaid shares can still be transferred. In such case, it is unclear who should bear the obligation of capital contribution for these unpaid shares as the Current Company Law is silent on this issue. The New Company Law, drawing from industry practices and relevant judicial interpretations, addresses this issue by the introduction of Article 88. According to Article 88, if the payment period for the transferred shares has not lapsed, the transferee assumes the payment responsibility, with the transferor bearing a supplementary obligation to the extent the transferee defaults on payment. In cases where the payment period has expired or the value of non-cash assets used for payment is significantly lower than the corresponding share capital, both the transferee and transferor are jointly liable for the payment shortfall, unless the transferee can demonstrate lack of awareness, in which case the transferor bears full responsibility.

In accordance with Article 88, in a transfer of unpaid shares, it is recommended that transferors carefully assess the transferee's financial ability to fulfill the payment for the shares, while the transferee should diligently review the payment status of the shares and maintain accurate records.

(4) Introducing Additional Repurchase Right for Minority Shareholders Being Oppressed by Controlling Shareholders

The Current Company Law provides for specific circumstances in which dissenting shareholders are entitled to request the company to repurchase their shares at a fair value. These scenarios include instances where the company fails to distribute dividends for five consecutive profitable years despite being financially capable, during major corporate changes like mergers, splits, or major asset transfers, and upon the expiration of the operational term or other dissolution triggers specified in the articles of association.

In practice, there are occurrences where a company's controlling shareholder exploits their position to the detriment of the company or fellow shareholders. The Current Company Law contains a broad provision stating that shareholders who misuse their rights, leading to losses for the company or other shareholders, are liable for compensation. The New Company Law strengthens this by introducing an additional provision triggering the repurchase right. This provision applies when controlling shareholders misuse their powers, resulting in substantial harm to the company or other shareholders. In such cases, other shareholders have the right to request the company to repurchase their shares at a fair value. This measure enhances the protection of minority shareholders and establishes a more robust deterrent against the abuse of shareholder rights by controlling shareholders.

II. Changes with Respect to Joint-Stock Companies

(1) Cancelling the One-year Lock-up Period for Promoter Shares

The requirement of locking the shares held by promoters for a specified period from the company's inception can be traced back to

the three-year lock-up period mandated in the 1993 Company Law. This provision was later amended in 2005 to reduce the lock-up duration to one year, which has been in effect ever since. According to the interpretation of the Company Law by the Legislative Affairs Commission of the National People's Congress, promoters are seen as the "advocates" of a joint-stock company, typically defining the company's purpose, business scope, and operational strategies. This role requires promoters to retain their shares for a designated period after the company is established to maintain the company's operational stability and continuity. In addition, the Company Law allows for the incorporation of a joint-stock company through public stock floatation. Allowing promoters to transfer their shares shortly after the company's formation could potentially lead to illicit fundraising or stock manipulation under the guise of establishing a company. These concerns have historically justified the imposition of a lock-up period on promoters' shares.

However, with the evolution of company law practices and the maturation of investors in the Chinese market, the need to view promoters as exclusive "advocates" of a joint-stock company has gradually diminished. Additionally, in practice, joint-stock companies are predominantly established through promotion instead of public share issuance, thereby reducing the risk of illicit activities during company formation. Furthermore, many joint-stock companies are restructured from limited liability companies, where all existing shareholders, including external investors other than the founders, are considered promoters and become subject to the lock-up restriction. The lock-up requirement has increasingly been seen as burdensome by investors, and its removal would be welcomed by the market. Still, promoters might opt to include relevant lock-up period restrictions in the company's articles of association to ensure the company's stability.

(2) Preventing Circumvention of Selling Restrictions through Early Resignation by Directors, Supervisors, and Senior Executives

Under the Current Company Law, directors, supervisors, and senior executives are prohibited from disposing of their shares while in office and within six months after leaving their positions. This restriction creates a loophole where these individuals could expedite their share transfers by resigning, allowing them to transfer after a six-month waiting period. In the case of listed companies, stock exchange regulations address this loophole by stipulating that these individuals are not permitted to sell shares during their original term as determined when they assumed their roles, and for six months following their departure. The New Company Law adopts this approach, applying it to both listed and unlisted companies. It mandates that even if directors, supervisors, and senior executives of companies resign before their terms, their shareholdings remain restricted within the originally scheduled term, thus preventing them from swiftly cashing out through early resignations.

(3) Permitting Share Pledge During Lock-up Period

The Current Company Law is silent on pledging shares during the lock-up period. The New Company Law clarifies this by stating that although share transfers are prohibited during the lock-up period, share pledging is permitted. The pledgee, however, is not allowed to exercise the pledge rights during the lock-up period. These rules enable shareholders to pledge shares for economic value but prevent the pledgee from acting on these rights, ensuring compliance with lock-up restrictions.

(4) Providing for Right to Repurchase for Dissenting Shareholders of Joint-Stock Companies

Under the Current Company Law, only the dissenting shareholders of limited liability companies have a right to request the companies to repurchase their shares. The New Company Law expands this right to the dissenting shareholders of joint-stock companies as well, excluding those companies that publicly issue shares. Article 161 of the New Company Law provides that:

"Shareholders who cast dissenting votes against a resolution of the shareholders' meeting under any of the following circumstances may request the company, other than companies that publicly issue shares, to repurchase their shares at a reasonable price:

- the company fails to distribute profits to shareholders for five consecutive years, despite being profitable during these five years and meeting the profit distribution conditions stipulated by this law;
- the company transfers its major assets;

■ the company's operating term as specified in the articles of association expires, or other dissolution reasons as stipulated in the articles of association occur, and the shareholders' meeting amends the articles to continue the company's existence.

If an agreement for share repurchase is not reached between the shareholder and the company within sixty days from the date of the shareholders' meeting resolution, the shareholder may file a lawsuit with the People's Court within ninety days from the date of the shareholders' meeting resolution.

Shares repurchased by the company due to the circumstances specified in the first paragraph of this article shall be transferred or cancelled in accordance with the law within six months."

Comparing this with Article 89 of the New Company Law which grants the same right to shareholders of limited liability companies, one will see that the two provisions are substantially the same except that Article 161 does not cover the scenario of mergers and acquisitions. However, this does not mean that the dissenting shareholders of joint-stock companies do not have this right in the case of mergers and acquisitions, as this right is provided for in Article 162, according to which the company is permitted to buy back its own shares in certain limited circumstances, including where "shareholders voting against the mergers and acquisitions of the company and requesting the company to buy back their shares". As such, the dissenting shareholder rights to repurchase of joint-stock companies and limited liability companies are the same.

(5) Introducing Prohibitions against Financial Assistance for Acquisition of Company's Shares

Article 163 of the New Company Law, a new provision added, provides that:

"The company shall not provide gifts, loans, guarantees, or other financial assistance to third parties for the acquisition of shares in the company or its parent company, except for implementing an employee stock ownership plan.

For the benefit of the company, the company may, with the resolution of the shareholders' meeting, or a decision made by the board of directors in accordance with the company's articles of association or the authorization of the shareholders' meeting, provide financial assistance to third parties for the acquisition of shares in the company or its parent company. However, the total amount of financial assistance shall not exceed ten percent of the total issued share capital. A decision by the board of directors must be approved by a majority vote of two-thirds of all directors.

Directors, supervisors, and senior executives who are responsible for causing losses to the company by violating the provisions of the preceding two paragraphs shall be liable for compensation."

The practice of prohibiting companies from providing financial assistance to facilitate the acquisition of shares in the company or its holding company has its roots in the United Kingdom. It emerged in response to the leveraged buyouts of publicly listed companies in the 1920s, in particular management-led buyouts orchestrated by acquirers in collaboration with the company's leadership. In this acquisition strategy, the acquirer, including the management team, leverages the acquired company's assets to finance the purchase. If integration post acquisition is successful, the acquirer stands to reap significant profits. However, in cases of failure, the acquirer may only incur limited losses, while the company faces risks of insolvency, jeopardizing the interests of minority shareholders and creditors.

In China, a similar requirement exists within the framework of acquiring shares in listed companies. According to Article 8 of the Administrative Measures on Acquisitions of Listed Companies, "The directors, supervisors and senior executives of a target company shall bear the obligations for loyalty and diligence to the company and shall treat all acquirers who acquire the company fairly. The decision made and measures adopted by the board of directors of the target company in respect of an acquisition shall be beneficial to the safeguarding of the interests of the company and its shareholders; the board of directors shall not abuse its official powers to create inappropriate obstacles for an acquisition, shall not use company resources to provide any form of financial assistance to any acquirer and shall not harm the legitimate interests of the company and its shareholders."

The New Company Law incorporates and elevates this principle to a national legal standard, extending its scope to all joint-stock

companies, whether listed or not. It includes exceptions, such as a specific provision for implementing employee ownership plans and a general procedural exception for cases where appropriate approvals are obtained, and the assistance does not exceed a specified limit. Furthermore, it imposes compensatory obligations on directors, supervisors, and senior executives who breach these obligations and cause harm to the company, underscoring that this duty is fundamentally part of their fiduciary responsibilities.

(6) On Issuance of New Share Capital

The Current Company Law specifies that shareholders of a limited liability company possess preemptive rights when the company increases its registered capital, unless the shareholders unanimously decide otherwise. However, it does not address whether shareholders of a joint-stock company enjoy preemptive rights. The New Company Law upholds the provision granting preemptive rights to shareholders of limited liability companies. Simultaneously, it clarifies that unless the company's articles of association or a shareholder meeting resolution states otherwise, shareholders of a joint-stock company do not hold preemptive rights. Therefore, under the New Company Law, the default stance for limited liability companies is that existing shareholders retain preemptive rights, while for joint-stock companies, existing shareholders do not hold preemptive rights by default, unless agreed upon by shareholders or specified in the articles of association. This differentiation recognizes the distinct dynamics between the shareholders of limited liability companies and joint-stock companies.

Conclusion:

The New Company Law builds upon the existing framework, and integrates requirements from judicial interpretations and listing company regulations that have been proven to be effective in practice. It places a stronger emphasis on regulating equity transaction behaviors and upholding transaction certainty and security and brings the revised rules more in line with contemporary equity transaction practices.

Nevertheless, as previously noted, certain detailed provisions in the New Company Law may require additional refinement through detailed implementation rules, judicial interpretations and other mechanisms based on real-life practices to effectively regulate equity transaction behaviors and ensure transaction security.

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