

Navigating New Company Law – Key Changes to Corporate Governance

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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*), set to be enforced on July 1, 2024. The New Company Law not only brings significant reformation to the corporate capital system but also introduces substantial improvements to the corporate governance structure. These enhancements provide companies with greater flexibility in designing their governance framework while emphasizing the safeguarding of the interests of employees, minority shareholders, and creditors. This article aims to provide an overview of the modifications to corporate governance brought about by the New Company Law.

I. Simplification of the Corporate Governance Structures

1. Supervisory board or supervisor no longer mandatory under certain circumstances

The traditional four-tiered governance structure in China, comprising the shareholders' meeting, the board of directors, the board of supervisors, and senior executives, has long been the accepted norm for all companies. In this structure, the shareholders' meeting holds the highest authority, while the board of directors and senior management oversee day-to-day operations, with the board of supervisors serving as the monitoring body.

However, in practice, supervisors are often selected or influenced by majority shareholders, diminishing their effectiveness in monitoring. To address this issue, listed companies and companies in certain industries, such as commercial banks, have introduced independent directors to oversee and monitor the actions of controlling shareholders and directors, safeguarding the interests of minority shareholders. Nevertheless, the coexistence of the board of supervisors and independent directors has led to redundancy in functions and reduced governance efficiency.

The New Company Law attempts to resolve those issues, providing for the option of not having a supervisory board and/or single supervisors under certain circumstances.

A. If the company has already set up an audit committee under its board of directors that exercises the supervisory functions of a supervisory board

Under the New Company Law, both limited liability companies and joint-stock companies have the flexibility, as outlined in Article 69 and Article 121 respectively, to establish an audit committee under the board of directors. This committee can take on the supervisory board's powers specified in the New Company Law[1], eliminating the need for a separate supervisory board or the appointment of a supervisor.

Article 121 introduces additional requirements for the audit committee of a joint-stock company. These requirements include having a minimum of three members, with more than half of them not holding any position other than a director in the company and having no other affiliations that could compromise their independent and objective judgments. Each member is entitled to one vote during committee deliberations, and resolutions must be passed with a majority consensus.

B. If the company has a relatively small scale or a relatively small number of shareholders

Article 83 of the New Company Law stipulates that limited liability companies with a small scale or a limited number of shareholders

may opt not to establish a board of supervisors. Instead, they can appoint a single supervisor to exercise the powers typically assigned to the board of supervisors as outlined in the law. Furthermore, with unanimous consent from all shareholders, these companies may also decide against appointing any supervisor at all.

Similarly, Article 133 extends this flexibility to joint-stock companies, allowing those with a relatively small number of shareholders to choose not to establish a board of supervisors. These companies may appoint one supervisor to fulfill the supervisory board's duties. However, unlike limited liability companies, joint-stock companies are not permitted to completely forgo the appointment of a supervisor, even with unanimous shareholder consent.

For listed companies, which are required to have an audit committee in accordance with the regulations of the China Securities Regulatory Commission (the *CSRC*) and the stock exchanges, the question arises whether they can now abolish the supervisory board. Caution should be exercised before making such decisions. According to the New Company Law, the supervisory board can only be dissolved if the audit committee has fully assumed all statutory roles of the board of supervisors. Currently, the primary function of audit committees in listed companies focuses on overseeing financial matters, which is significantly narrower in scope compared to the broader responsibilities of the board of supervisors. Therefore, until the governance rules are updated and the audit committees are prepared to fully take on the responsibilities traditionally held by supervisory boards, it is advisable for these companies to maintain their supervisory boards.

2. More flexibility in the composition of board of directors

Under the PRC Company law (revised in 2018) (the *Current Company Law*), joint-stock companies are required to maintain both a board of directors and a board of supervisors. In contrast, limited liability companies can operate with just one executive director and one or two supervisors, thus avoiding the need to establish formal boards. Recognizing that joint-stock companies do not necessarily have a larger scale or more shareholders, the New Company Law grants them the same flexibility as limited liability companies to simplify their governance structures. Now, joint-stock companies can also choose to maintain just one director and one supervisor.

Previously, the Current Company Law specified a minimum and maximum number of directors: three to thirteen for limited liability companies and five to nineteen for joint-stock companies. The New Company Law, however, allows companies to set their own limits on the number of directors, requiring only a minimum number of three for both types of companies. This change lowers the cost of running the board and enhances corporate autonomy by allowing companies more freedom in determining their governance structures.

II. Mandatory Employee Representation on the Board

Under the Current Company Law, only wholly State-owned enterprises are mandated to include employee representatives on the board, while for other types of companies, this remains optional rather than compulsory. The New Company Law, however, extends this requirement, mandating that any company with more than three hundred employees, which does not already have a board of supervisors with employee representatives, must include employee representatives on the board of directors. These representatives should be elected by the company's employees through staff representative meetings, all-staff meetings, or other democratic election processes.

Additionally, it is important to note that under the New Company Law, at least one-third of the board of supervisors in all companies must be composed of employee representatives. These changes emphasize the employee-centric approach of the New Company Law, as outlined in Article 1, which aims to protect the legitimate interests of corporations, shareholders, employees, and creditors.

III. Enhancing Corporate Autonomy in Power Allocation and Streamlining Deliberation Procedures

Regarding shareholders' meeting, the New Company Law streamlines the responsibilities and powers of all companies by removing clauses related to "deciding on business strategies and investment plans" and "reviewing and approving annual budgets and accounting plans." These matters relate to the daily operations of the company and can now be delegated to the boards.

In terms of the board, the New Company Law expands the board's autonomy in corporate financing and improves decision-making efficiency, especially for listed companies. According to Article 59 and Article 112 of the New Company Law, shareholders' meeting can authorize the board to make decisions regarding the issuance of corporate bonds. Additionally, with the introduction of the authorized capital system under Article 152, joint-stock companies can authorize the board, through the articles of association or shareholders' meeting, to issue new shares up to fifty percent (50%) of all issued shares within the next three (3) years. However, the capital contribution in non-monetary form still requires approval from the shareholders' meeting.

Regarding management teams, while the Current Company Law outlines their powers and responsibilities, the New Company Law delegates this authority to the articles of association and the board's authorization. By holding management teams accountable to the board, the New Company Law strengthens the board's role in corporate governance.

During the COVID-19 pandemic, many companies have transitioned shareholders' meeting, board meeting, and board of supervisors' meeting to online platforms. The New Company Law explicitly recognizes the legal validity of virtual meetings. According to Article 24, these meetings can be conducted online, allowing shareholders, directors, and supervisors to participate and vote unless specified otherwise in the articles of association.

Furthermore, the New Company Law addresses voting mechanisms for limited liability companies by specifying: (1) the approval threshold for ordinary resolutions in shareholders' meeting, set at over half of all voting powers unless stated otherwise in the articles of association; (2) the quorum and approval threshold for board meeting, requiring over half of all directors present and over half of all directors approval; and (3) the voting power of each supervisor in board of supervisors' meeting, set at one vote per person. These matters were left ambiguous in the Current Company Law.

IV. Changes in the Scope of Candidates for Legal Representative

Under the Current Company Law, the legal representative of a company is limited to the chairman of the board, the executive director (in the absence of a board), or the general manager. In contrast, the New Company Law expands the eligibility criteria to include any director or manager who carries out corporate affairs on behalf of the company.

Moreover, the Current Company Law mandates that the name of the legal representative must be specified in the articles of association. This requirement creates a practical challenge as it necessitates amending the articles of association each time the legal representative changes. The New Company Law addresses this issue by only requiring the procedures for appointment and replacement to be outlined in the articles of association.

However, the definition of "executing corporate affairs on behalf of the company" remains ambiguous. In a Board comprising shareholder representatives, independent directors, employee representatives, directors with executive roles, and those without such roles, it is unclear which individuals should be considered as executing corporate affairs on behalf of the company. This is a matter that requires further clarification in practice.

V. Strengthening the protection of minority shareholders

The New Company Law also strengthens the protection of minority shareholders in a number of ways:

1. Expanding shareholder's information right

Under Article 57 and Article 110 of the New Company Law, shareholders of all companies are entitled to inspect and copy articles of association, register of shareholders, minutes of shareholders' meeting, resolutions of meetings of the board of directors or board of supervisors, as well as financial accounts and accounting vouchers of a company, although for joint-stock companies, only shareholders who have held shares of no less than 3% for no less than 180 days can request to inspect financial accounts and accounting vouchers. The addition of financial accounts (in the case of joint-stock companies) and accounting vouchers (for all companies), among other things, represents an expansion from the information rights previously granted under the Current Company Law.

Nevertheless, for listed companies, how does the right to inspect financial accounts and accounting vouchers by certain shareholders reconcile with the companies' information disclosure obligation remains an area that needs further exploration and testing in practice.

2. Lowering the threshold to raise interim proposals

When a joint-stock company convenes a shareholders' meeting, a notice containing details such as the time, venue, and agenda items must be dispatched to shareholders 20 days in advance for regular meeting and 15 days in advance for special meeting. However, shareholders holding a minimum shareholding percentage have the right to submit interim proposals to be included in the agenda within 10 days before the meeting. The Current Company Law stipulates a minimum shareholding requirement of 3%, and the New Company Law reduces it to 1%.

It is interesting to note that a preliminary draft suggested that certain matters, such as director and supervisor nominations, articles of association amendments, changes in registered capital, and mergers and divisions, should not be proposed as interim proposals. However, this restriction was not retained in the final law. Consequently, the rights of minority shareholders to submit interim proposals have been significantly enhanced.

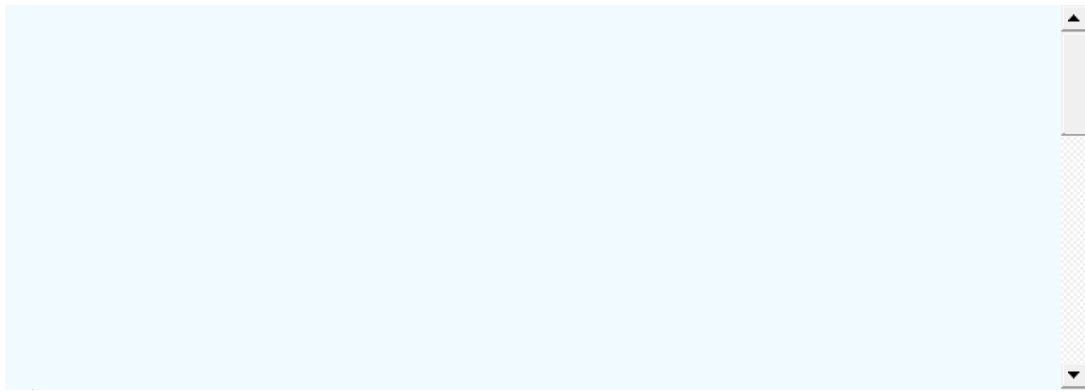
3. Expanding the repurchase right for minority shareholders

In accordance with the Current Company Law, a shareholder of a limited liability company has the right to request the company to repurchase its shares under specific circumstances. These circumstances include situations where the company fails to distribute dividends despite having the capacity to do so, when the company divests its major assets, in instances of a merger that the shareholder has opposed, and etc.

The New Company Law takes a step further by making such repurchase right available to shareholders of an unlisted joint-stock company as well. In addition, the New Company Law broadens this repurchase right for minority shareholders to encompass cases where controlling shareholders abuse their rights, resulting in significant harm to the company or other shareholders, although this expansion only applies to shareholders of limited liability companies and does not extend to shareholders of joint-stock companies.

Conclusions:

In conclusion, the revisions introduced by the New Company Law significantly reshape the corporate governance landscape across multiple dimensions. These changes include making the supervisory board optional under certain conditions, introducing greater flexibility in board composition, and enhancing employee representation. Moreover, the enhancements in corporate autonomy for power allocation among shareholders, board and senior executives, and the streamlining of deliberation procedures across the various governance bodies, along with the expansion of minority shareholders' rights to information, proposals, and repurchase, mark a progressive shift toward more adaptable and inclusive corporate structures. These amendments empower stakeholders and align with international best practices, collectively enhancing corporate transparency, accountability, and stakeholder engagement. We believe these reforms are set to strengthen the overall business environment in China.



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