

Navigating the New PRC Company Law - Overview of the Changes

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On December 29, 2023, the Standing Committee of the National People's Congress (**NPCSC**) approved the amendments to the PRC Company Law (**New Company Law**), which will come into effect on July 1, 2024, with a universal impact on all companies in the PRC, including foreign invested enterprises. This round of amendments to the Company Law marks the second overhaul since its first promulgation in 1993. We have prepared a series of articles analyzing the major changes introduced, and this article is the first, which aims to provide an overview of the background and key changes in the New Company Law.

I. Background of this Round of Amendments

This round of amendments to the Company Law commenced in 2019 and has undergone four rounds of review over the past five years. The updated New Company Law now comprises 15 chapters, with two new chapters added this time (Chapter II - Registration of Companies and Chapter VII - Special Provisions on the Organization of State-invested Companies), and a total of 266 articles, out of which more than 110 articles have been substantially modified. These comprehensive changes are anticipated to make a profound impact on the business landscape.

According to the explanation of NPCSC, this round of amendments is driven by the following needs: (i) to deepen the reform of state-owned enterprises ("SOEs") and enhance the system of modern enterprises with Chinese characteristics, (ii) to continuously optimize the business environment and boost market innovation vitality, (iii) to strengthen property rights protection, and (iv) to enhance the foundational system of the capital market and foster its healthy development.

II. Overview of the Key Changes

The changes in the New Company Law affect many critical aspects of corporate establishment, operations and governance, and we have tried to categorize the key changes into the following areas.

First, from the overall structure perspective, two new chapters have been added, namely "*Chapter II Registration of Companies*" and "*Chapter VII Special Provisions on the Organization of State-Invested Companies*". Chapter II is dedicated to company registration regulations, explicitly stipulating that failure to make registration or to update the registration of a registered item cannot be asserted against any bona fide third party. This is an optimization of existing Company Law provisions and relevant judicial interpretations, and also aligns with the principles of the Civil Code. Chapter VII expands the scope of state-invested companies from wholly state-owned companies to state-invested companies controlled by the state-owned capital. It highlights the leadership of the Communist Party Committee ("CPC") in these companies and includes requirements for enhancing internal compliance management – reflecting the evolving management philosophy of state-owned capital in practice.

Second, the New Company Law reinforces the shareholder's responsibilities to make capital contributions in the following manners:

(1) Pay-in capital requirements: this particular change has garnered significant market attention and sparked extensive discussions. Over the last three decades, the PRC has gradually moved away from a rigid paid-in capital system, and in 2013 has embraced a full subscribed capital system, which allows companies (other than those in specific regulated sectors) to decide on their own timeline for the actual payment for the subscribed share capital. The New Company Law has introduced

changes in this area, reflecting a trend of enhancing shareholder accountability and curbing the unchecked expansion of capital. Under the New Company Law:

a) for limited liability companies, shareholders must fully contribute the registered capital according to the timeline set out in the articles of association but in any event within five years of establishment; and

b) for joint-stock companies, promoters must fully pay for the shares subscribed before the establishment of the company;

(2) Capital contribution collection system: If a shareholder fails to make timely contributions, the board of directors should urge them to do so within a grace period of at least sixty days;

(3) Forfeiture of shareholders' equity interests: If a shareholder fails to make the contribution within the grace period, the company may forfeit the corresponding rights associated with the equity by written notice; equity rights so forfeited should be transferred or cancelled by a reduction in share capital within six months, otherwise the other shareholders should pay in the capital in proportion to their equity interests;

(4) Acceleration of outstanding capital contribution: If the company cannot repay debts when due, it and its creditors have the right to demand the shareholders who have subscribed for but not paid-in capital to immediately pay the outstanding capital, even if the period of pay-in has not yet expired (this provision does not apply to joint-stock companies, as their registered capital must be fully paid before establishment);

(5) Shareholders' joint and several liability for outstanding capital contribution: At the time of the incorporation of a limited liability company, if a shareholder fails to make the required contribution in accordance with the articles of association, the other shareholders during incorporation are jointly and severally liable for the shortfall in capital contribution. This aligns with the existing mandate for sponsors of joint-stock companies, who similarly assume joint and several liability for the shortfall of capital contribution at the time of incorporation; and

(6) Joint and several liability of the transferor and transferee for unpaid-in equity in limited liability companies: At the time of transfer of an equity interest in a limited liability company, if the relevant capital has not yet been paid in and the pay-in period has not lapsed, the transferee is responsible for the contribution, with the transferor assuming supplementary liability to the extent that the transferee does not pay in when due; if the pay-in period has elapsed, then the transferor and transferee are jointly and severally liable, unless where the transferee can demonstrate that it is not and should not have been aware of the circumstance.

Third, the New Company Law introduces significant adjustments to the corporate governance structure:

(1) Under certain circumstances, a company does not have to establish a supervisory board or supervisor. This includes where the company sets up an audit committee under the board that exercises the relevant responsibilities of supervising the directors and senior management, and where the company has a relatively small scale of operations or small number of shareholders (note that under this circumstance, a limited liability company can choose to have no supervisor at all if agreed by all shareholders, while a joint-stock company should still have one supervisor).

(2) On the other hand, the requirement of having employee representative on the board is enhanced. Under the current Company Law, this applies only to an SOE, but under the New Company Law, it becomes mandatory for all companies that have more than 300 employees unless the employees are already represented in the supervisory board.

Fourth, the New Company Law further clarifies the distinction between joint-stock companies and limited liability companies:

On one hand, many of the corporate governance rules are now made consistent for both types of companies:

(1) under the current Company Law, a joint-stock company is required to have at least two shareholders, while a limited liability company can have a single shareholder (referred to as a "single-shareholder company"). The New Company Law allows a joint-

stock company to also have a single shareholder, and all references to "single-member limited liability company" are now removed;

(2) a style change that comes with the above is that the term "general meeting of shareholders", which refers to the shareholders' meeting of a joint-stock company under the current Company Law, is no longer used. Under the New Company Law they are both referred to as the "shareholders' meeting";

(3) the number of directors in a joint-stock company' board is no longer required to be between 5 and 19, aligning with the requirement for limited liability companies, where a minimum of 3 directors is required if there is a board;

(4) joint-stock companies with a relatively small scale or small number of shareholders can now also choose to have no board but to have only one director instead, aligning with the requirements for limited liability companies, and the same applies to the supervisory board of such joint-stock companies;

(5) both joint-stock companies and limited liability companies may now choose to have the audit committee under the board of directors to exercise the functions of the supervisory board. For joint-stock companies, the majority of the audit committee members must be external directors without any relationship that could potentially affect their independent judgment;

(6) the prohibition on joint-stock companies providing loans to directors, supervisors, or senior management is lifted;

(7) the restriction on share transfers within one year of the establishment of a joint-stock company is removed; and

(8) the provision regarding bearer shares is also eliminated.

On the other hand, specific adjustments have been made to unique regulations for joint-stock companies:

(1) introduction of the authorized capital system: The New Company Law allows the articles of association or the shareholders' meeting of a joint-stock company to authorize the board of directors to approve an issuance of new shares, not exceeding 50% of the issued shares within three years. However, if the issuance is paid for by non-monetary property contributions, a shareholders' resolution is still required;

(2) introduction of shares with no par value: A joint-stock company may choose to have all its share capital to be shares with or without par value. In the case of no par value shares, half or more of the proceeds from the issuance of the shares must be included in the registered capital;

(3) introduction of different share categories: the New Company Law allows a joint-stock company to issue different categories of shares, including shares that (i) rank superior or inferior to ordinary shares in the distribution of profits or remaining assets, (ii) have more or fewer voting rights per share than ordinary shares, (iii) require company consent for transfer, and (iv) fall under other category shares as determined by the State Council;

(4) introduction of a prohibition on financial assistance by joint-stock companies for the re-purchase of company shares, except in two cases: (i) where the repurchase is for the implementation of an employee stock ownership plan, or (ii) where the repurchase is for the company's benefit, the financial assistance has approved by the shareholders' meeting or by the board of directors as authorized by the shareholders' meeting. In such cases, financial assistance should not exceed 10% of the issued share capital; and

(5) introduction of a restriction on cross-shareholding between listed companies and their controlling subsidiaries: a controlled subsidiary of a listed company cannot hold shares of the listed company; any shares so held by the subsidiary for any reason should be disposed of in a timely manner, and the voting rights cannot be exercised before disposal.

Fifth, the New Company Law strengthens the protection of minority shareholders:

(1) The scope of company materials accessible to shareholders is broadened:

- a) shareholder of a limited liability company can now request access to accounting vouchers;
 - b) shareholder of a joint-stock company can now request access to accounting ledgers and accounting vouchers, provided they hold 3% or more shares continuously for over 180 days; and
 - c) the right to access materials for both limited liability companies and joint-stock companies is extended to cover the materials of wholly-owned subsidiaries.
- (2) The shareholding threshold for shareholders of joint-stock companies to propose temporary motions is lowered from 3% to 1%.
- (3) A statutory repurchase right for minority shareholders of limited liability companies is introduced: in cases where controlling shareholders abuse their shareholder rights, causing serious harm to the company or other shareholders, other shareholders are entitled to request the company to repurchase their equity at a fair price.
- (4) The right of the dissenting shareholder to request repurchase is now made available to shareholders of non-listed joint-stock companies, in addition to just limited liability companies.
- (5) In the current Company Law, shareholders may petition a court to revoke shareholders' resolutions and board resolutions that violate the articles of association or originate from shareholders or board meetings conducted in violation of laws and articles. The New Company Law introduces specific provisions:
- a) shareholders who were not notified about a shareholder meeting have a defined period to file a revocation lawsuit (within 60 days from the date of knowing or should have known about the shareholder meeting resolution);
 - b) a clear timeframe for the expiration of revocation rights has been provided (i.e., one year from the date of the resolution).
- (6) In the current Company Law, resolutions of shareholders or board meetings may be "invalid" or "revocable" if they are defective. The New Company Law expands on this by introducing situations where such resolutions may be considered "not established". This occurs when no meetings are conducted, no votes are cast, no quorum is present, or the necessary threshold is not achieved.
- (7) The current Company Law provides for a derivative action system, allowing shareholders to take legal action on behalf of the company if directors, supervisors and senior management personnel harm the interests of the company in the course of their duties. However, in some cases, harm may be inflicted on a subsidiary of the company, depriving the company's shareholders of this right. The New Company Law addresses this issue by providing enabling shareholders to initiate derivative actions against the relevant personnel of a wholly-owned subsidiary or on behalf of the subsidiary.

Sixth, the New Company Law strengthens the responsibility of controlling shareholders, directors, supervisors, and senior management:

- (1) The New Company Law enhances the specific provisions regarding the duty of loyalty and duty of care of the directors, supervisors, and senior management. It provides clarity on permissible instances of related transactions, horizontal competition, and the acquisition of company business opportunities. In addition, a new requirement is introduced, mandating affiliated directors to abstain from voting during board deliberations on matters where their affiliations may pose a conflict of interest. Notably, while the current Company Law limits this abstention requirement to listed companies, the New Company Law extends this provision to all companies.
- (2) The New Company Law enhances the accountability of the directors, supervisors, and senior management in ensuring the company's capital adequacy. This includes holding them accountable for instances such as shareholders underpaying contributions, embezzling contributions, illegal distribution of dividends, illegal reduction of capital, and illegal provision of financial assistance for the acquisition of company shares. In such cases, the responsible directors, supervisors and senior

management are obligated to compensate the company for the resulting losses.

(3) A new provision is added to provide that where directors and senior management cause harm to others while carrying out their duties, the company is responsible for compensation to the affected parties, where the directors and senior management act intentionally or with gross negligence, then they are also liable for compensation.

(4) Another new provision is added to provide that where controlling shareholders or actual controllers instruct directors and/or senior management to undertake actions that harm the company or shareholders' interests, such controlling shareholder or actual controller will share joint liability with the directors and/or senior management involved.

(5) The New Company Law expands the application of the "piercing the corporate veil" system: If a shareholder abuses the limited liability protection by utilizing two or more companies under its control to inflict significant harm on creditors' interests, each of these companies should bear joint liability for the debts of any single company.

(6) The New Company Law explicitly provides that directors serve as responsible liquidators. If they fail to fulfill their liquidation obligation in a timely manner, resulting in losses to the company or creditors, they are held accountable and liable for compensation. In addition, by default, the liquidation team should be composed of directors, unless otherwise provided for by the articles of association or otherwise appointed by shareholders' meetings.

Other noteworthy changes include:

(1) inclusion of Environmental, Social, and Governance (ESG) aspects, promoting companies' engagement in social welfare activities and publication of social responsibility reports;

(2) elimination of the restriction that a natural person can only establish one single-member limited liability company and that this company cannot further establish another single-member limited liability company;

(3) introduction of a deadline for profit distribution, set within 6 months following the shareholder resolution date;

(4) removal of the requirement for majority consent from other shareholders when transferring equity of a limited liability company to a new shareholder, while retaining the right of first refusal unless specified otherwise in the articles of association;

(5) mandate for the disclosure of the names of promoters of a joint-stock company, the number of shares they subscribe for and the changes therein are now required to be published on the National Enterprise Credit Information Publicity System (*NECIPS*), aligning them with shareholders of limited liability companies;

(6) permission of private issuance of corporate bonds;

(7) abolition of the restriction on using capital reserves to make up for losses, allowing for the use of capital reserves after discretionary reserves and statutory reserves to cover losses;

(8) simplification of capital reduction procedures, enabling capital reduction for the purpose of making up for losses without notifying creditors if losses persist after utilizing reserves;

(9) requiring that capital reduction should be proportionate to shareholding unless otherwise stipulated by law, agreed upon by all shareholders of a limited liability company, or stipulated in the articles of association of a joint-stock company;

(10) streamlining the merger procedure with a subsidiary in which the company holds 90% or more equity, where the shareholder resolution of the merged company is not required. However, the other shareholders should be notified and have a right to request repurchase;

(11) streamlining the procedure for small-scale mergers, which can be executed without a shareholders resolution if the merger consideration is under 10% of the company's net assets, unless otherwise stipulated in the company's articles of association;

- (12) providing for a summary deregistration procedure in cases where there are no outstanding debts or debts have been settled. Upon the unanimous undertakings of all shareholders, the company can announce the deregistration plan on the NECIPS for a minimum of twenty days for objections before proceeding with the deregistration application;
- (13) introduction of a compulsory deregistration if a company's business license is suspended, ordered for closure or revocation but has not completed liquidation within three years, enabling deregistration by the State Administration for Market Regulation or its local counterparts after public announcement.

Given the significant change in capital contribution time limit introduced by the New Company Law, how to address the time limit of capital contribution for existing companies has attracted significant concerns from the marketplace. To address this issue, the New Company Law provides that the existing companies must gradually align the capital contribution periods previously stipulated with the requirements of the New Company Law, and the company registration authority may also proactively require adjustments. The specific implementation measures are to be stipulated by the State Council.

III. Transitional Arrangement for Payment of Subscribed Capital of Existing Companies

As previously mentioned, the introduction of a time limit for the payment of subscribed shares has generated significant market interest, particularly regarding the actions that existing companies with outstanding subscribed share capital need to take to comply with this new regulation. Addressing these concerns, on February 6, 2024, the State Administration for Market Regulation released the Draft for Comment on the Provisions of the State Council for Implementing the Registration Administration System for Registered Capital under the Company Law of the PRC. This draft aims to gather public feedback.

The proposed draft includes a three-year transitional period, running from July 1, 2024, to June 30, 2027, allowing existing companies to make necessary adjustments to align with the New Company Law. For existing limited liability companies, if the remaining capital contribution period expires by July 1, 2027, no adjustments are required. However, if the remaining period extends beyond this date, it must be shortened to within five years during the transitional period. The adjusted period should be recorded in the articles of association and be made public on the NECIPS. Shareholders of existing joint-stock companies are expected to fully pay for subscribed share capital within the three-year transitional period. Companies failing to make the required adjustments within the transitional period may be prompted by the company registration authority to do so.

The New Company Law represents a comprehensive revision of the existing Company Law, building upon its fundamental framework and core systems. We are preparing a series of informative articles to elucidate the significant amendments introduced by the New Company Law, and we invite all interested readers to stay tuned for updates.

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