DRAGON'S DECREE: UNDERSTANDING THE IMPACT OF CHINA'S COMPANY LAW REFORMS

George Wang Duan & Duan

The recent overhaul of China's Company Law is a pivotal moment for foreign investors and multinational corporations with stakes in one of the world's largest and fastest-growing markets. As China tightens its corporate governance, enhances shareholder responsibilities, and amplifies directorial duties, understanding these changes is crucial.

After four rounds of review and public consultation over five years, the National People's Congress of the People's Republic of China officially ratified the sixth revision of the Company Law on December 29, 2023. 228 articles have been added or amended, including substantial amendments to 112 articles. This newly amended Company Law (New Company Law) will come into effect on July 1, 2024, with a universal impact on all companies in China, including foreign-invested enterprises.

This article highlights some of the key amendments, including the changes in the capital contribution requirements, corporate governance matters, and shareholder rights protection, and explores how these changes would affect the foreign-invested companies operating in China, and those engaging in business with Chinese companies.

FIVE-YEAR MAXIMUM CAPITAL CONTRIBUTION PERIOD

The New Company Law has introduced a five-year maximum capital contribution time limit that applies to all limited liability companies. Under the New Company Law, shareholders are required in most cases to make capital contributions within five years following the establishment of the company. Contribution dates should be specified in the company's articles of association. The same five-year period will apply in cases of capital increase. Existing limited liability companies that are not currently meeting this five-year criterion are expected to modify their capital contribution plans to comply with the five-year requirement, with details remaining to be clarified in the implementation rules to be released by the State Council.

The amendment enforces actual capital contributions and protects the interests of creditors. Since the 2013 shift to a registered-based regime, investors had the flexibility to decide the timing of their capital contributions, a move aimed at fostering investment and entrepreneurship. However, this flexibility has led to instances of delayed capital injections, resulting in companies lacking adequate equity to meet creditor obligations. In addition, certain companies have overstated their actual capital contributions, thereby appearing financially stronger than they are in reality. The amendment addresses these issues by ensuring substantial capital contributions, thereby enhancing the financial stability and reliability of Chinese companies. This increased protection for creditors could also lower the perceived risk for foreign investors in China.

RECONSTRUCTION OF CORPORATE GOVERNANCE STRUCTURE

The New Company Law introduces notable changes to the rules governing corporate governance, which to some extent reconstructs the organizational structure and reallocates governance powers of companies.

Audit Committee as Alternative to the Board of Supervisors

Under the current Company Law, a company must have a supervisor or a board of supervisors, which has the right to monitor, investigate, and supervise the company's operation in view of protecting the interests of the company. However, it has been commonly observed in practice that, especially in private companies, this supervisory system often does not function effectively, with many supervisors remaining largely inactive.

To optimize corporate governance, the New Company Law offers the option of establishing an audit committee as an alternative to the traditional supervisory system. This provision allows companies to form an audit committee within the board of directors, composed of directors who can perform the roles and responsibilities typically assigned to a board of supervisors.

This shift means that the power to make decisions and the duty to supervise is now more concentrated among the directors.

To simplify the company's organizational setup, the New Company Law permits smaller limited liability companies or those with fewer shareholders to opt out of having a board of supervisors or an individual supervisor, provided there is unanimous agreement among all shareholders.

Executive Personnel as Legal Representative

The current Company Law allows the chairman, executive director, or general manager of a company to act as the company's legal representative, regardless of whether this person is actually controlling or executing the company's business operations.

The New Company Law now requires the legal representative to be a director or the general manager who actually executes the business operations of the company. The New Company Law also provides that the resignation of a director or general manager who serves as the legal representative shall be deemed to be a simultaneous resignation from the position of legal representative. If the legal representative resigns, the company shall have a new legal representative appointed within 30 days from the date of the legal representative's resignation.

LIABILITIES OF CONTROLLING SHAREHOLDERS, ACTUAL CONTROLLERS, DIRECTORS, SUPERVISORS AND SENIOR EXECUTIVES

Duty of Loyalty and Duty of Care

The New Company Law clarifies the concepts and depicts the general scope of the "duty of loyalty" and "duty of care." It broadly defines the duty of loyalty as avoiding conflicts between directors' own interests and the interests of the company, and not using directors' powers to seek improper interests. The duty of care mandates that directors, supervisors, and senior executives shall exercise reasonable care that managers shall ordinarily exercise in the best interests of the company in executing their duties.

In practice, company directors sometimes cast their votes based on the guidance of the shareholder who appointed them, whether explicit or implicit. Under the New Company Law, these directors could be held accountable for not fulfilling their duty of care if they fail to exercise due diligence and prioritize the company's interests.

Moreover, the New Company Law imposes statutory penalties on directors, supervisors, and senior executives for breaching the fiduciary duty of loyalty by providing that the income derived from such acts shall belong to the company.

Regulation on Connected Transactions

To strengthen the regulation of connected transactions, the New Company Law extends the obligations to supervisors, alongside directors and senior executives. These obligations include adhering to procedural requirements such as securing appropriate internal approval before engaging in connected transactions, pursuing business opportunities of the company, and participating in similar business activities. In addition, restrictions on connected transactions are extended to connected persons of directors, supervisors, and senior executives, including their close relatives, enterprises directly or indirectly controlled by directors, supervisors, and senior executives and their close relatives.

Directors' and Senior Executives' Liability toward Third Parties

The New Company Law introduces Article 191, which stipulates that directors and senior executives shall be liable for compensation if they have intentionally or grossly negligently carried out their duties, which caused damage to others. This implies that third parties, whose exact scope is not specified, have the right to pursue claims directly against directors and senior executives, in addition to the company itself, if these officials cause damage to third parties while carrying out their duties, provided that their actions are either intentional or grossly negligent. While this new article provides another recourse to third parties, it also raises concern among directors over their personal liability exposure in exercising their duties as directors.

SHAREHOLDERS' RIGHTS AND PROTECTIONS

The New Company Law extends information rights to shareholders, particularly those in limited liability companies and minority shareholders in joint-stock companies. It allows any shareholder of a limited liability company, or those holding at least 3% of the issued shares of a joint-stock company for 180 consecutive days, the right to inspect the company's underlying accounting documents. This includes access to documents of wholly-owned subsidiaries, such as the articles of association, shareholders' register, corporate resolutions, financial audit reports, and accounting books. This amendment aims to safeguard the interests of minority shareholders by granting them enhanced statutory rights to information.

Furthermore, the law bolsters various other rights and protections for shareholders, especially those holding minority stakes. Key enhancements include the right for shareholders to demand the company buy back their shares at a reasonable price in cases where the controlling shareholder misuses their rights and significantly harms the interests of the company or other shareholders. Shareholders holding over 10% of a joint-stock company's issued shares can call for extraordinary shareholders' meetings, and those with more than 1% can submit interim proposals in writing to the board of directors at least 10 days before a meeting. Additionally, shareholders are empowered to sue directors, supervisors, or senior managers of a company's wholly-owned subsidiaries for violations of laws, administrative regulations, or the company's articles of association that result in losses to the company.

The New Company Law emerges in the context of China's rapidly evolving and competitive international market, as the country persists in its efforts to reform and open up to both foreign and domestic investments. The State Council, the People's Court, and other relevant Chinese authorities are set to release new rules for implementation, practical guidelines, interpretations, and transitional measures in the future. Foreign investors and businesses will be well advised to acquaint themselves with the amendments and seek legal counsel to ensure that their existing and new subsidiaries in China adhere to the New Company Law, both during the transition period and continuously thereafter.

George Wang is managing partner of Duan & Duan Law Firm in Shanghai, China. He holds a Magister of Juris from Oxford University and was awarded Chevening Scholarship from the UK government. He has represented foreign investors (including multiple Fortune 500 companies) to handle over 100 FDI and M&A projects. He serves as a member of the Foreign Affairs Committee of the Shanghai Bar Association and legal counsel of Shanghai Foreign Investment Association. He was also awarded as Foreign Leading Talent, the "A-List" 100 Lawyers of China Business Law Journal, and Chambers "Leading Lawyer" in Corporate & Commercial Practice 2022.

– Amy Wang, the intern at Duan & Duan and candidate of JD class of 2027 of Washington University, also contributed to the article.