

## CHINA INTRODUCES SIGNIFICANT CHANGES AND CLARIFICATIONS TO ITS COMPANY LAW

Since 2021, there has been a long period of studies and discussions about revisions to the Company Law and three versions of draft amendments have been issued seeking public opinions. Finally, on 29 December 2023, the PRC Standing Committee of the National People's Congress (the "NPC") adopted a revised *Company Law of the People's Republic of China* (the "New Company Law"), which will come into effect from 1 July 2024.

Since very few foreign-invested enterprises choose the corporate form of a company limited by shares, this Client Alert focuses on key matters concerning limited liability companies, setting out the information foreign investors need to know.

### Editorial

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### BACKGROUND

The first Company Law was enacted by the Standing Committee of the NPC on 29 December 1993 and took effect on 1 July 1994, and has been amended several times since then:

- In 1999, 2004 and 2018, slight revisions were made to certain specific provisions;
- In 2005, comprehensive revisions were conducted, in particular by introducing sole-shareholder companies, improving corporate governance and management, and by improving protection to minority shareholders and employees;
- In 2013, important revisions were made to relax the capital subscription regime, i.e. for companies not subject to specific regulations or sectors, there is no minimum registered capital, no mandatory capital contribution term, no statutory cash injection ratio and no capital verification required by law, which may all be determined by the shareholders at their discretion, unless any specific laws requires otherwise.

In 2023, 30 years after the first law came into force, the Standing Committee of the NPC made another major overhaul of the Company Law, introducing significant changes and clarifications in China's corporate law regime, taking account of key principles in relation to company law set out in other segmented laws (such as the Civil Code and the Securities Law), administrative regulations (e.g. Administration Regulations on the Registration of Market Entities), judicial interpretations in relation to the Company Law issued by the People's Supreme Court, and the courts' practice (e.g. those clarified in the minutes of the National Court Work Conference for Civil and Commercial Trials).

The New Company Law sees various clarifications in corporate matters, especially on capital contributions, liabilities of shareholders, liabilities of directors, supervisors and senior managers, corporate governance and management, applicable to both limited liability companies and companies limited by shares.

## HIGHLIGHTS

This Client Alert illustrates some of the important aspects introduced by the New Company Law; the relevant articles of the New Company Law are referred to hereunder in italics.

### Strengthen and clarify shareholder liabilities

The New Company Law strengthens and expressly clarifies shareholder liabilities in various aspects, notably with respect to:

#### *Capital Contribution*

- **Mandatory maximum contribution term:** shareholders must contribute the registered capital they have subscribed for within a maximum period of five years from the company's incorporation, and must specify the capital contribution date(s) in the company's articles of association ("**AOA**"); special company types or sectors (e.g. bank and insurance company) are subject to specific regulations with regard to the minimum amount, contribution term and actual payment (*Articles 46 and 47*).
- **Joint and several liability of founding shareholders:** if a founding shareholder fails to make proper contributions pursuant to the AOA, or the actual value of an in-kind capital contribution is obviously lower than its subscribed amount, the other founding shareholders bear joint and several liability with the defaulting shareholder for the shortfall in contributions (*Article 50*).
- **Forfeiture of equity for failing to contribute:** where a shareholder fails to make a capital contribution by the date(s) specified in the AOA, the company issues a written payment demand, setting a grace period (not less than 60 days). If the shareholder fails to make the contribution within this grace period, the company may, upon a resolution of the board of directors, send a written notice of forfeiture to the shareholder. From the date of sending this notice, the defaulting shareholder forfeits its equity interest over the unpaid capital contribution (*Article 52 §1*).

If, within 6 months from the forfeiture notice, the "lost" equity is not transferred according to the law or the corresponding registered capital is not reduced accordingly, the company's other shareholders must make a corresponding capital contribution in full, according to their shareholding ratio (*Article 52 §2*).

- **Accelerated contribution:** in the event that the company's registered capital has not been paid up in full, if the company is unable to pay off its due debt, the company and the creditors of the due debt have the right to demand an immediate capital contribution from shareholders, even though the payment of capital contribution is not yet due (*Article 54*).
- **Contribution obligation retained in the case of a capital reduction to make up loss:** in the specific circumstance where the company reduces its registered capital to make up its losses, the company cannot make distributions to shareholders and the shareholders cannot be exempted from their obligation to make the capital contribution (*Article 225*).
- **Larger administrative penalty for false contribution:** if a shareholder has made a false capital contribution or has failed to make (or failed to make on time) a cash or in-kind capital contribution, they may be fined from RMB 50,000 to RMB 200,000 (*Article 252*).

Furthermore, the individual in charge and the individual directly responsible for making the false contribution will also be fined from RMB 10,000 to RMB 100,000. In addition, in the event of an illicit withdrawal of a capital contribution by a shareholder, the individual in charge and the individual directly responsible will also be fined from RMB 30,000 to RMB 300,000 (*Articles 252 and 253*).

### *Equity Transfer*

- **Transferor's supplementary liability:** in the event of a transfer of equity for which the capital contribution is not yet due for payment, if the transferee fails to make the contribution on time or in full amount, then the transferor bears supplementary liability for the overdue contribution of the transferee (*Article 88 §1*).
- **Joint and several liability of the transferor and transferee:** if a shareholder transfers equity without making the capital contribution by the date provided in the AOA, or if the actual value of in-kind contribution is obviously lower than the subscribed capital amount, the transferor bears joint and several liability with the transferee on the shortfall in contributions; the transferee may only be exempted from the contribution obligation if it is unaware and has no reason to be aware of the existence of such circumstance (*Article 88 §2*).

### *Controlling Shareholder / Effective Controller*

- **Joint and several liability with directors and senior managers:** where the controlling shareholder or effective controller has instructed any director or senior manager of the company to conduct any act damaging the interests of the company or shareholders, it bears joint and several liability with such director and senior manager for the consequences of that act (*Article 192*).
- **Loyalty and diligence duty:** the controlling shareholder or effective controller who does not serve as a director but actually executes the company's operations, assumes a duty of loyalty and diligence toward the company and bears liability for default (*Article 180*).

### *Indemnification to the Company*

Shareholders are liable for compensating the company for any losses caused by:

- Its failure to make a capital contribution on time and/or in full; this compensation applies in addition to paying the outstanding capital amount (*Article 49*);
- The distribution of profits made by the company in violation of the New Company Law; this compensation applies in addition to refunding the distributed profits the shareholder has received (*Article 211*);
- A capital reduction made by the company in violation of the New Company Law; this compensation applies in addition to refunding any proceeds the shareholder has received from the capital reduction (*Article 226*).

Taking the above into account, foreign investors need to be more cautious when determining the capitalisation of their Chinese subsidiaries. It would be advisable not to set a very high amount of registered capital at the company's incorporation, but rather to increase the amount step-by-step, based on the company's actual financial and operational needs.

### **Reinforce the obligations and liabilities of directors, supervisors and senior managers**

The New Company Law clarifies and reinforces certain obligations and liabilities of directors, supervisors and senior managers (together "DSSM") in various circumstances, especially in the following aspects:

- **DSSM's obligation to report affiliated transactions:** DSSM are required to report to the board of directors or the shareholders' meeting, in advance, any matters relating to the

conclusion of a contract or transaction, whether direct or indirect, between the company and any of the following: (i) themselves, (ii) their close relatives, (iii) enterprises under the direct or indirect control of themselves or their close relatives, or (iv) parties with other affiliated relationships with themselves, and have those contracts or transactions approved by the board of directors or the shareholders' meeting in accordance with the AOA (*Article 182*).

- **DSSM's obligation to report competing business:** if they fail to report to the board of directors or the shareholders' meeting and obtain approval in accordance with the AOA accordingly, DSSM may not then engage in any business similar to that of the company where they hold office, whether for themselves or for others (*Article 184*).
- **DSSM's liability to compensate the company:** the accountable DSSM are liable for compensating the company for any losses caused by:
  - A shareholder's illicit withdrawal of a capital contribution, where the DSSM have joint and several liability with that shareholder (*Article 53*);
  - A violation of any laws, administrative regulations or the AOA while performing their duties (*Article 188*);
  - The distribution of profits made by the company in violation of the New Company Law (*Article 211*);
  - A capital reduction made by the company in violation of the New Company Law (*Article 226*).
- **Directors' and senior managers' personal liability in the performance of their duties:** Directors and senior managers will be personally liable for damage caused to others through their intentional act or gross negligence in the performance of their duties (*Article 191*).
- **Directors' and senior managers' joint and several liability with the controlling shareholder/effective controller:** Where a director or a senior manager carries out any act damaging the interests of the company or shareholders under instructions given by the controlling shareholder or effective controller, they bear joint and several liability with the controlling shareholder or effective controller (*Article 192*).
- **Directors' obligation not to vote where there is a conflict of interest:** when the board of directors makes a resolution on any matters about concluding affiliated transactions with the company, seeking business opportunities available to the company and conducting competing business by a director, that director may not vote, and its voting rights will not be counted in the total voting rights (*Article 185*);
- **Directors' obligation to verify the shareholders' capital contribution status:** the company's board of directors must verify the status of capital contributions made by shareholders and, if it finds that a shareholder has not made a capital contribution on time or in the full amount as provided in the AOA, it must send a written payment demand to that shareholder calling for the contribution. In the event of a failure to perform this verification obligation in a timely manner, causing losses to the company, the accountable director is liable for compensation (*Article 51*).
- **Directors' obligation to liquidate:** in the event of the dissolution and liquidation of a company, directors are designated as the liquidators and form the liquidation committee (composed of directors, unless otherwise provided in the AOA or decided by the shareholders' meeting). In the event of a failure to perform the liquidation obligation in a timely manner, causing losses to the company or creditors, the directors are held liable for compensation (*Article 232*).

## Simplify corporate governance

The New Company Law brings many changes in corporate governance particularly in terms of the composition of corporate bodies, meeting quorums and the voting regime. Key changes are the following:

### *Shareholders' Meeting*

- **Matters subject to approval by the shareholders' meeting:** the company's business policies, investment plans, annual financial budgets and final accounts are no longer statutory matters subject to approval by the shareholders' meeting (*Article 59*).
- **Minimum vote for adopting resolutions:** except for those matters requiring a 2/3 majority vote, resolutions made by the shareholders' meeting are adopted by shareholders representing more than half of the total voting rights (not the 2/3 of those present or represented at the meeting); the current Company Law allows the minimum vote to be freely determined in the AOA (*Article 66*).

### *Board of Directors*

- **No maximum number of board members:** a board of directors is composed of at least three members, but without a statutory maximum limit; the current Company Law sets a maximum of 13 (*Article 68*).
- **Employee director:** if a company has 300 or more employees and does not have a board of supervisors, its board of directors must include one or more employee representatives, elected democratically by the employees, but without a statutory minimum number or percentage under the New Company Law (*Article 68*).
- **Directors' right to claim compensation for dismissal without a justifiable reason:** if a director is removed prior to the expiry of term of office without any justifiable reason, that director has the right to ask the company for compensation (*Article 71*).
- **Minimum meeting quorum:** no board meeting may be validly held unless more than half of the directors are present (or represented by proxy); the current Company Law allows the quorum to be freely determined by the AOA (*Article 73*).
- **Minimum vote for adopting resolutions:** resolutions made by the board of directors are adopted by more than half of all the directors (not by simple majority of those present or represented at the meeting); the current Company Law allows the minimum vote to be freely determined in the AOA (*Article 73*).

### *Legal Representative*

- **Served either by a director or general manager:** the legal representative can be either a director involved in company operations (not necessarily the chairman of the board of directors) or the general manager; the concept of "executive director" (if no board of directors) is removed from the New Company Law (*Article 10*).

### *Supervisory Organ*

Compared to the current Company Law, the New Company Law provides more flexibility in setting up the supervisory organ:

- **Board of supervisors:** the principle remains unchanged, requiring a board of at least three supervisors, of which 1/3 should be democratically elected employee

representatives; resolutions must be adopted by more than half of all the supervisors, with each supervisor having one vote (*Articles 76 and 81*).

- **Audit committee:** instead of having a board of supervisors or appointing any supervisors, a company may set up an audit committee within its board of directors, which is composed of directors and exercises the functions and powers of the board of supervisors (*Article 69*).
- **Single or no supervisor:** companies with a relatively small number of shareholders, or being relatively small, may appoint a single supervisor without establishing a board of supervisors or an audit committee; alternatively, upon unanimous approval by all the shareholders, there may be no supervisor at all (*Article 83*).

### *General Manager*

- The New Company Law removes the statutory functions and powers of the general manager; the general manager exercises their functions and powers in accordance with the AOA or authorisations given by the board of directors.

In view of the above, the simplest corporate structure for a small-scale company (e.g. wholly foreign-owned enterprises with a single shareholder) would, in theory, be having a single director who also serves as the general manager and legal representative, without appointing a supervisor in the company. This would simplify the corporate governance structure.

### **Clarify corporate matters**

The New Company Law enacts some corporate matters and provides legal bases for practical operations, for example:

- **Capital contribution using equity and creditors' rights:** the New Company Law explicitly provides that equity and creditors' rights that may be evaluated in monetary terms and are legally transferable can be used for capital contributions (*Article 48*).
- **Make up a loss using capital reserve:** where a company uses its reserves to make up losses, it must first use any discretionary reserves and statutory common reserves; if there is still a shortfall, the capital reserve can be used according to relevant regulations, which is prohibited under the current Company Law (*Article 214*).
- **Shareholders' right to consult:** shareholders have the right to consult the company's accounting vouchers (in addition to accounting books), and to consult the AOA, resolutions of the board of directors and board of supervisors, financial accounting reports, as well as the accounts and accounting vouchers of the company's wholly-owned subsidiaries (*Article 57*).
- **Consult employees on dissolution or application for bankruptcy:** in addition to restructuring and major issues of business operations, when making a decision on dissolution or application for bankruptcy, the company must also consult its trade union (if any) and its employees (*Article 17*).
- **Interested person's right to force liquidation:** if no liquidation committee is formed within the statutory time limit, or if it fails to carry out liquidation matters after its formation, any interested person may ask the competent court to designate relevant persons to form the liquidation committee and to undertake the liquidation tasks; the current Company Law only allows the company's creditors to exercise this right (*Article 233*).

## OUTLOOK

The New Company Law indeed brings many changes, yet some are still left open for further interpretation. The associated regulations, rules and other specific measures for implementation are expected, especially on the following matters:

- The New Company Law requires existing companies to gradually adjust their capital contribution term, but remains silent on how to implement such an adjustment (e.g. whether to grant existing companies a grace period after 1 July).
- The New Company Law gives the company registration authority the power to require a correction in a timely manner in the event of “*obvious abnormalities in contribution term and amount*,” but does not define what qualifies as such an abnormality.
- As the audit committee is composed of directors and created within the board of directors, there are questions about how the committee will perform the duties of the supervisory organ and assume their independent liabilities, especially given that a director and a senior manager cannot simultaneously serve as a supervisor.
- In the event that a director or senior manager has caused a loss to the company because of their misconduct, the qualified shareholder must ask the company’s supervisory body to take legal action against the director or senior manager before the shareholder can claim compensation on behalf of the company. In that case, how can such a claim be issued if a company does not have a supervisory body (or at least a supervisor)?

The Foreign Investment Law (effective as from 1 January 2020) requires all foreign-invested enterprises to strictly comply with the Company Law in terms of organisational form, corporate structure and operational rules by 31 December 2024, which will be six months after the New Company Law comes into effect. Pending the issue of implementing rules or interpretations on the New Company Law, foreign investors will have a very tight schedule to make necessary amendments to their existing governance to ensure compliance.

Foreign-invested enterprises will need to closely monitor the further development of the New Company Law, proactively assess and implement necessary amendments in accordance with the changes introduced by the New Company Law. This will be essential in order to adapt successfully to the new legal environment.

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