

China's New Company Law - Prepare for launch

January 2024

Executive summary

The much-anticipated new Company Law of the People's Republic of China (the '**New Company Law**' or '**New Law**') was formally approved by the Standing Committee of the National People's (NPC) on 29 December 2023 and will take effect on 1 July 2024.

The New Company Law reflects the most comprehensive revision to Chinese company law since the law was first enacted in 1993, with reforms to numerous aspects of company administration in China, including corporate establishment and governance. The law essentially adopts most of the changes included in the third version of the draft amendments, and includes improvements with respect to some specific articles. These changes will not only affect all existing companies, but also investors, both foreign and domestic, who intend to set up new companies in Mainland China. In this article, we focus on some of the major changes related to the capital regime, corporate governance system, responsibilities of directors, supervisors and senior management, as well as the simplified procedures. We also highlight their corresponding implications.

Changes on Capital Regime

1. Emphasis on Capital Adequacy

One of the most striking changes in the New Law is the requirement that shareholders of a limited liability company ('**LLC**') will be required to make the entire contribution to the registered capital of the company that they have subscribed for within 5 years of the LLC's incorporation. This is a stark deviation from the current provision in the Company Law, which allows shareholders to decide when and how they will contribute their subscribed capital in full. Since this subscription-based regime was introduced in 2013, investors have been afforded significant flexibility in the timing of the capital contribution, which may have attracted further investment. However, many investors have deliberately delayed their capital contribution, sometimes leaving companies with insufficient equity to fulfil their obligations toward their creditors. The New Law appears to put more weight on the protection of creditors but might cool down investors' enthusiasm to launch start-ups. The New Law also contains various other provisions relating to the payment of the registered capital of an LLC, including the following:

- (i) board of directors' responsibility to verify the status of shareholders' capital contribution to the Company: The board of directors of an LLC shall verify the contribution status of the LLC's registered capital, and shall, in case any shareholder delays its contribution, serve a payment notice on the relevant shareholder demanding prompt rectification;
- (ii) forfeit of shareholder's rights: If a shareholder fails to contribute the register capital after expiration of the grace period as demanded by the board, the company shall, by resolution of the board of directors, issue a notice of loss of rights (relating to the unpaid registered capital) to the defaulting shareholders, of which such shareholding rights will be transferred or cancelled.

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- (iii) clarifying shareholders' liabilities: If a shareholder fails to pay the full contribution to the registered capital on time, apart from paying the insufficient capital contribution, the shareholder shall also be liable for the losses caused to the company. The shareholder and other shareholders at the time of incorporation shall bear joint and several liability within the scope of insufficient capital contribution; and
- (iv) accelerating capital contribution when company cannot pay its due debts: If a company cannot pay its debts when due, the company or the creditor of the debt could demand the shareholders who have subscribed capital but have not contributed to expedite the contribution ahead of schedule.

The above amendments are likely to have a significant impact on existing companies. As of the end of November 2023, there were 48.39 million companies in China, 99% of which are micro and small enterprises, and many of which have stipulated rather flexible capital contribution periods. However, the New Company Law applies retrospectively and requires those companies to follow the new contribution period (i.e. five years) on a transitional and continuing basis. Companies should monitor steps taken to implement the New Company Law, which is still subject to the promulgation of the relevant regulations by the State Council.

Meanwhile, Article 266 of the New Company Law sets out that *'for companies with abnormal capital contribution amount and period, the company registration authority may require it to make timely adjustments in accordance with the law.'* This article aims to give the company registration authority the right to adjust the capital contribution period; but it is worth close observation as to how the relevant authority will balance the shareholders' agreement and the authority's use of its discretionary power.

It should also be noted that, compared to the 'limited subscription based contribution' regime as applicable to a limited capital company, the New Company Law requires promoters of a joint-stock company ('JSC') to implement the 'paid-in' regime, and pay for the shares it subscribes to prior to the incorporation of the company.

2. New and refined provisions on capital reduction

- (i) According to the New Company Law, the reduction of a company's registered capital shall be based on the principle of proportionate capital reduction by all shareholders. Unless otherwise provided by law, agreed by all shareholders of an LLC, or stipulated in the articles of association ('AoA') of a JSC, the capital cannot be reduced in a targeted manner (favouring any specific shareholder);
- (ii) Article 225 of the New Company Law adds a new provision of capital reduction to make up for losses, which stipulates that, for the purpose of making up for the company's losses, the company shall use the arbitrary reserve fund first, followed by the statutory reserve fund; if the losses still cannot be made up, the capital reserve may be used. If there are still losses after the use of capital reserves, the losses can be made up by way of capital reduction. In the capital reduction procedure, the company is not required to notify the creditors, which is a must-have in normal capital reduction procedures.

Improvements in corporate governance

The New Company Law introduces sweeping changes to corporate governance, resulting in the corporate governance structure of a JSC becoming more aligned with that of an LLC, and the status and role of the board of directors in corporate governance being significantly enhanced.

1. Shareholders' Meeting

Once the New Company Law takes effect, the decision-making body of both LLCs and JSCs will be the 'Shareholders' Meeting'. Compared with the current Company Law, the statutory powers of the shareholders' meeting no longer include 'deciding on the company's business policies and investment plans' and 'considering and approving the company's annual financial budget and final accounts'. At the same time, The New Company Law cancels the special section for one-person limited companies and clarifies that there is no longer a limit on the number of shareholders in a JSC, which means that we are likely to see more single-shareholder JSCs in the future.

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2. Board of directors and managers

The New Company Law amends the composition of the board of directors by unifying the lower limit of three members of the board of directors for both LLCs and JSCs, but not setting an upper limit. For an LLC with more than 300 employees, except for a supervisory board established with employee representative(s), the company must appoint employee representative(s) to the board of directors. At the same time, the title of executive director of an LLC is cancelled. Moreover, the New Company Law gives more power to the board of directors. For example, the board of directors retains the 'decision on the company's business policies and investment plans', which had been deleted in earlier drafts of the new law. The board of directors of a JSC can be authorised by the AoA or by the shareholders' meeting to decide to issue new shares no more than 50% of the issued shares within three years.

3. Set up audit committees

The New Company Law allows an LLC, a JSC, a listed company or a wholly State-owned company to set up an audit committee comprising directors. Its basic function is to replace the supervisory board. On this basis, the New Law has different levels of provisions on the composition, rules of procedure and other functions of the audit committee for different types of companies.

4. Supervisory board or supervisors are no longer necessary

An LLC or JSC with a small scale or a small number of shareholders may elect not to establish a supervisory board but only have one supervisor. With the establishment of an audit committee or with the unanimous consent of all shareholders, an LLC may not have a supervisory board or supervisor. In contrast, a JSC may not have a supervisory board or supervisors only if the board of directors establishes an audit committee.

5. Legal representative

The New Company Law specifies that the legal representative shall be the director or manager who executes the affairs of the company on behalf of the company, and in the meantime increases and refines the duties of the legal representative, especially in issuing internal documents and handling company registration matters.

6. De facto controller

The New Law adjusts the definition of de facto controller to cover a person who, through an investment relationship, agreement or other arrangement, is able to effectively dominate the acts of the company, making it clear that de facto controller includes controlling shareholders. The New Company Law imposes more restrictions on de facto owners. According to the New Company Law, a controlling shareholder or de facto controller of a company who instructs a director or senior management to engage in an act detrimental to the interests of the company or its shareholders shall be jointly and severally liable with such director or senior management. In addition, controlling shareholders and de facto controllers of a company who do not serve as directors of the company but actually execute the affairs of the company are also subject to the duty of loyalty and duty of care to the company.

Emphasis on the duties of Directors, supervisors and senior management

The New Company Law further emphasises the principle of separation of company ownership and management, and strengthens the duty of loyalty and duty of care of directors and supervisors, including but not limited to the following:

1. the board of directors is responsible of verifying and calling for the payment of shareholders' contributions;
2. the board of directors of a JSC may, within the scope of the company's AoA or the authorisation of the shareholders' meeting, decide within three years to issue shares not exceeding fifty per cent of the issued shares, provided that a resolution of the shareholders' meeting shall be passed in the case of the consideration is made in the form of non-monetary contribution;
3. the board of directors may, within the fulfilment of certain conditions and in accordance with the AoA or the authorisation of the shareholders' meeting, resolve that the company shall provide financial assistance to others for the acquisition of shares in the Company or its parent company, and that the directors and supervisors who are responsible for the violation of the relevant provisions and the damage caused to the company shall be liable for compensation;

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4. the board of directors may replace the shareholders' meeting to pass a resolution in the case of a merger between a company and a subsidiary in which the company holds ninety per cent or more of the shares, as well as in the case of a merger for a consideration not exceeding ten per cent of the company's net assets;
5. the directors shall be the obligors of the company's liquidation, and in principle, the liquidation group shall be composed of directors;
6. the New Company Law clarifies duty of loyalty and duty of care, and refines the duties and obligations of directors, supervisors and senior management in the event of connected transactions, business opportunities of the Company, and competition with the company in the same industry; and
7. the New Company Law specifies that the directors and supervisors shall be liable for damages caused to the company if they perform their duties in violation of laws, administrative regulations or company's AoA; the company shall be liable for damages caused to others by the directors and senior management in the performance of their duties; and the directors and senior management shall also be liable for damages where they have intentional fault or gross negligence.

Streamlining corporate life cycle processes

1. New requirement on company registration

- (i) The New Company Law summarises company registration matters in accordance with the life cycle of a company and includes a separate chapter II, covering registration and publicity matters such as company establishment, alteration and cancellation;
 - (ii) The New Law clarifies that the electronic business licence has the same legal effect as the paper business licence; and
 - (iii) The New Law clarifies that company registration matters are not effective against bona fide counterparties without proper registration or change registration.
2. In case of capital reduction after the use of capital reserve is still unable to make up for the loss, creditors may not be notified, and only an announcement may be made in the newspaper or the National Enterprise Credit Information Publication System within 30 days from the date of the shareholders' meeting's resolution on the reduction of registered capital.
 3. New simplified cancellation (applicable when the company has not incurred any debts during its existence or has settled all its debts) and mandatory cancellation (applicable when the company's business licence has been revoked, ordered to close down, or revoked) have been added. The new law provides for a simplified process in these cases, which will greatly reduce the time required for company cancellation.

Preparing for launch

The substantial changes brought about by the New Company Law will pose new compliance challenges for companies and all their stakeholders, including shareholders, directors, supervisors and employees. Clients should continue to monitor developments, particularly any implementation rules that are released. Given that there is less than 6 months until the New Company Law takes effect, all companies operating in China and their investors should start considering the following:

1. what changes to governance arrangements are required, particularly with regard to office-holders, board committees, decision making and accountability?
2. will the company procure director and officer insurance and/or review the agreements with the stakeholders?
3. how best to train executives and board members on the new rules, particularly with regards to director duties.
4. what steps are required in relation to company administration and implementing changes in office-holders and employee director?
5. are there any business opportunities arising from the New Company Law?
6. how best to deal with third parties and the execution of contracts in light of the changes.

Let's talk

For a deeper discussion of how this impacts your business, please contact us.

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The materials contained in this document were assembled in January 2024 and were based on the law enforceable and information available at that time.



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