ADVANT Beiten

THE PRC: WHAT WILL CHANGE UNDER THE REVISED PRC COMPANY LAW?

Welcome to our new **ADVANT Beiten** edition on certain questions and answers on what PRC-registered enterprises and their shareholders must consider to be compliant with the provisions of the revised PRC Company Law! With this publication, we aim to provide you with essential information about this topic. We do this intentionally in a way which seeks to draw your attention to some important issues regarding the changes being triggered by the revised PRC Company Law. Thus, please read this publication to get a first understanding on what aspects to pay attention to in order to become/ remain compliant with your PRC-registered enterprises under the revised PRC Company Law provisions and for any specific questions, please contact us anytime! Unless expressly stated otherwise, this publication only refers to privately invested limited liability companies (i.e. not to State-owned companies and not to joint stock companies).

The PRC's top legislature, the 14th NPC Standing Committee (**NPCSC**) had convened for its 7th session from 25 to 29 December 2023. During such session a revised version of the PRC Company Law underwent its fourth reading, and the thus revised law was passed and **will enter into effect on 1 July 2024**. Long term shareholders in the People's Republic of China (**PRC**) are well aware that the legal and business environment is constantly evolving and changing. The PRC Company Law dates back to 1993 when the PRC started opening up with a view to developing a market economy. It has changed several times since then and has now changed once more.

1. What is changing in regard to capital contribution?

In 2014, the PRC lifted general minimum registered capital requirements (they still exist for some industries/projects though) and relaxed the time periods within which shareholders are required to make contributions. Over time, concerns have arisen that some companies have been established with a high registered capital with the intention of making them appear larger than they are and that some shareholders "inflate" registered capital levels and postpone contributions by stipulating a lengthy contribution period in the articles of association (**AoA**). Hence, some of the relaxations introduced over the last decade will now be tightened again:

- yet to-be established companies must receive the full registered capital within a period of 5 years from the date of the company's establishment;
- already existing companies with AoAs stipulating contribution periods exceeding the 5 years limit may be required to gradually adjust the contribution periods upon request of the in-charge authorities (specific implementation methods are expected to be issued in the future);
- the company's board of directors (**Board**) is obliged to check the capital contribution of shareholders, and the company shall issue a written demand for payment if any shareholder fails to make contributions on time;
- a 60-day grace period will be granted after the Board issues a demand for overdue contribution: if shareholders fail to make contributions within the grace period, the company may issue a written notice to such shareholders to forfeit their equity interest with respect to the unpaid registered capital contributions. Upon receipt of the notice of the forfeiture, shareholders have a window of 30 days to file a lawsuit with the competent court;
- if the forfeited registered capital is not transferred or deregistered through capital reduction within 6 months as of the expiration of the grace period, the other shareholders will be required to make the corresponding capital contribution, in proportion to their capital ratios;
- even the contribution period has not yet expired, the Board or company creditors may request shareholders to make their capital contribution if the company is unable to discharge the debts when they become due.

2. Are there changes to rules governing equity transfers and related liabilities?

Thus far, equity transfers were subject to the consent of more than half of the other shareholders, and subject to a right of first refusal in favour of the other shareholders.

Under the new law, the transferring shareholder only needs to notify the other shareholders in writing, so that the other shareholders may decide whether or not to exercise their right of first refusal and they will be deemed to have waived such right if they do not reply within 30 days.

There is also a change in how to allocate liability between sellers and buyers with respect to unpaid but transferred registered capital: Under the previous law, mainly the sellers remained liable for such unpaid but transferred registered capital, while buyers were only jointly and severally liable with the sellers for payment thereof if sellers could demonstrate that buyers were or ought to have been aware, of such non-payment.

Under the new law, buyers always assume the contribution obligation for such unpaid but transferred registered capital and if buyers fail to pay, the sellers still remain liable for the payment. Also, buyers will be jointly and severally liable if sellers fail to make their contributions on time or if the value of in-kind contributions made by sellers are significantly lower than the subscribed capital. This is something that will need to be considered carefully in the drafting of any future equity transfer agreements.

3. What is changing in terms of officers' liabilities?

Under the old law there was only a rather general requirement for directors, supervisors and senior managers to bear the duty of loyalty and diligence towards the company, without a clear definition of such duties.

The new law provides some clarification and requires directors, supervisors and senior managers to take measures to avoid any conflict of interest – and in particular, not to use their powers to seek "improper interests". They shall also bear the duty of diligence to exercise reasonable care to ensure that they exercise authority in the best interests of the company. Some of the new rules are summarised below:

- directors, supervisors and senior managers must report and present related-party transactions for examination to either the shareholders' meeting or the Board. The definition of related parties is reinforced by enumerating close relatives of directors, supervisors and senior managers, enterprises directly or indirectly controlled by these relatives, and individuals with other affiliations;

- the prohibition of business opportunity exploitation and industry competition is now extended to apply to supervisors (previously only applicable to directors and senior managers), unless the situation was approved by the Board or shareholders' meeting and is not banned in general according to law/AoA;

- in scenarios involving related-party transactions, business opportunity exploitation, and industry competition, the affected directors must abstain from voting thereon; if the number of unaffected directors ready and allowed to vote on the relevant matter is less than 3, the shareholders' meeting must approve the matter.

Also, the new law specifies certain circumstances where directors, supervisors and senior managers are personally liable for losses of a company:

- unauthorised provision of financial assistance for others to obtain shares of joint stock companies;

- withdrawal of registered capital by a shareholder;

- profit distribution and/or capital reduction in violation of the law.

Further, damages to third parties caused by the company/its officers will result in personal liability if the relevant directors, supervisors or senior managers acted with intent or gross negligence.

4. What is changing in terms of corporate governance?

The **legal representative** of a company has ostensible authority to represent the company vis-a-vis third parties and according to law, each company can only have one but not more than one legal representative.

Thus far, it was required that the role of legal representative had to be filled by the company's chairperson (or in lieu its executive director) or by the general manager. Since there was thus far no statutory requirement that the legal representative must

be actually involved in the company's affairs, it was not uncommon to have an actual gap between the responsibilities of a legal representative and the actual role he/she played in the company.

The new law now requires that the position of the legal representative must be taken up by the general manger or by any (executive) director who represents the company in attending to company affairs, thus encouraging active involvement in the conduct of a company's business. The intention is to encourage legal representatives to act responsibly and remove the excuse that such person was not actually involved in the conduct of the business of the company.

Supervisory Organ and Audit Committee: Under the old law, companies were required to establish a supervisory board with at least 3 members or in case of SMEs to install 1 to 2 supervisors. The duties of such supervisors/supervisory board were to oversee and control the company's directors and senior managers. In practice, such roles were often non-active and the supervisors/supervisory board often did not involve themselves in company affairs. Under the new law, following amendments to the role of the supervisory functions are now made:

- SMEs do no longer require any supervisory organ if this approved by all shareholders;

- limited liability companies may establish an audit committee within the Board to exercise the supervisory functions and in such case, no other supervisory organ is necessary; if the company has over 300 employees and has not established a supervisory board with an employee representative, then the Board of such company must have at least one employee representative.

Under the old law, **the decision-making mechanisms of the shareholders' meetings and of the Board** enjoyed a higher degree of flexibility to be exercised in the AoA. Except for certain reserved matters (AoA amendments, change of registered capital, M&A transactions, dissolutions, changes in corporate form) which required approval by shareholders representing more than 2/3 of voting rights, the decision-making mechanisms for the Board and the shareholders' meeting were subject to the AoA provisions.

Now, the new law sets minimum, mandatory standards for resolutions passed by the shareholders' meeting and Board:

- shareholders' meeting resolutions always require over 50% affirmation of voting rights;

- Board resolutions always require an affirmative vote of over 50% of the directors.

Thus, the new law limits the opportunity for minority shareholders to protect their voting rights to be heard for certain reserved matters on the Board and in the shareholders' meeting.

5. Are there anti-abuse rules concerning controlling shareholders/actual controllers?

In multiple-shareholder companies, controlling shareholder/actual controller wield significant influence not only at shareholders' meetings but also by appointing Board members, senior managers and supervisors. This poses the inherent risk that controlling shareholders/actual controllers – either directly or through their appointed Board members, senior managers and supervisors – facilitate decisions that undermine the interests of minority shareholders.

The new law has responded to such threats of potential abuses among others with the following amendments:

- extension of fiduciary duties: under the old law, directors and senior managers were bound by diligence obligations, conflict of interest avoidance, and the prohibition of exploiting their authority for undue gains; the new law expands these obligations to controlling shareholders/actual controllers who – even without formally holding any of these positions – actually manage company affairs;

- liability for given instructions: controlling shareholders/actual controllers who instruct directors or senior managers to engage in actions detrimental to the interests of company or shareholder interests now share joint liability with the instructed directors/senior managers for their wrong doings;

- redemption rights for minority shareholders: if controlling shareholders/actual controllers abuse their shareholder rights to the severe detriment of the company or other shareholders, minority shareholders are entitled to request the company to repurchase their shares at a fair price.

6. What is changing in terms of the need and consequence of company change registrations?

Thus far, the PRC applied a corporate registration regime and towards third parties at least, many corporate changes only took effect upon completion of formalities with the authorities.

Under the new law, the effect of registration is to become a mere confirmation mechanism, rather than something to be used to determine the effectiveness of a change. While this does to a certain extent ease the company's burdens to complete the registration to effect a change, it also means less transparency for third parties and an increased burden on companies to ensure they are well organised when preparing, executing and archiving their internal documentation, such as the relevant resolutions, as these will be the documents to determine the effectiveness date and how liability is be allocated.

Besides, the new law introduces the personal liability of the responsible person of a company with respect to violation of statutory registration matters. Such violations can occur e.g. by means fabricating/falsifying registration materials or by other fraudulent means to conceal important registration facts.

7. What is changing for general managers in terms of their rights and duties?

The description of the functions and duties of the general manager have been removed from the new law and thus it is now subject to the AoA to define the role of the general manager in detail.

8. What is the role of the Chinese Communist Party (CCP) in company management?

Under the old law all companies based in the PRC shall allow the establishment of party cells to "carry out the activities of the party" and provide "necessary conditions" for

these party cells to function properly. Under the CCP Charter, every company with at least 3 CCP members shall allow the establishment of a party cell in the company.

Under the new law, the role of the CCP is extended: in addition to the existing provisions, in State-funded companies as well as in companies in which the State holds a controlling share (wholly State-owned companies and State-owned capital holding companies, including State-funded limited liability companies and joint stock companies), the CCP is required to play a leading role, study and discuss business management matters, and "support" the company to exercise its functions in accordance with the law.

9. What is changing in terms of company common reserves?

Under the old law, when a company's losses were covered with common reserves, the discretionary common reserve and the statutory common reserve had first to be used, and the capital common reserve could not be used to make up the company's losses.

The new law now allows that where the discretionary and statutory common reserves are not sufficient to cover the losses, also the capital common reserves may be used according to law. Also, if the company still accounts losses after using the common reserves, the registered capital can be used to make up for the losses. However, after such capital reduction, a company shall not distribute profits until the cumulative amount of the statutory common reserve reaches 50% of the company's registered capital.

10. What is changing in terms of in-kind capital contribution methods?

The old law only allowed shareholders to contribute capital in the form of cash or in kind in the form of tangible items, intellectual property rights and land-use rights.

The new law expands the scope of non-cash contributions to enterprise equity and creditor's rights that can be evaluated and are transferrable according to law.

11. What is changing in terms of the liquidation committee and de-registration of companies?

The old law required that liquidation committees had to be composed of the shareholders.

The new law requires that the liquidation committee shall be composed of the company directors, unless otherwise decided in the AoA or by the shareholders‘ meeting. Besides, if a liquidation committee is not formed in time, the stakeholders (not only creditors) may apply to the competent people‘s court to designate relevant personnel to form a liquidation committee.

In addition, the new law introduces a simplified de-registration procedure which is available to companies that have not incurred debts during their existence or have repaid all debts and further provided the shareholders assume the relevant liabilities (if any).

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