



Broad Reforms to China's Company Law Will Affect Most PRC Companies

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Key Points

- Comprehensive amendments to China's Company Law will allow more flexibility in corporate structures, set deadlines for committed capital to be paid in and define more specifically the roles and duties of directors and executives.
- The revised law will apply to PRC subsidiaries of foreign companies and their shareholders, directors and senior management.
- The changes affect so many aspects of corporate organization that most PRC-incorporated entities will have to adapt in some way to the new regime.

On December 29, 2023, China enacted the amended Company Law of the People's Republic of China (Amended PRC Company Law), which will come into effect on July 1, 2024. These are some of the most significant changes to the laws governing corporations in China in recent years.

The amendments affect important aspects of capitalization (e.g., setting deadlines for capital to be paid in), enhance corporate governance (spelling out obligations of boards and managements and potential liabilities), increase shareholder rights and protections, and streamline establishment and deregistration procedures.

Applicability to Foreign Investments in China

For overseas-listed issuers and foreign entities with business operations in China, PRC subsidiaries typically take the form of foreign-invested enterprises (FIEs), which are governed by the Foreign Investment Law of China. Under that law, which took effect in 2020, FIEs are required to conform their corporate practices to the Amended PRC Company Law by December 31, 2024.

This means the Amended PRC Company Law will apply equally to FIEs and non-FIEs starting in 2025.

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Key Changes at a Glance

Capitalization

To give creditors added protection and address concerns that up-to-date information about paid-in versus authorized capital may not always be available, the Amended PRC Company Law:

- Establishes a five-year capital contribution time frame for shareholders of limited liability companies (LLCs) to make their capital contributions in full.
- Introduces a series of measures to enforce timely contribution, including liability for defaulting shareholders; joint and several liability for other shareholders, directors, supervisors and senior management for defaults under certain circumstances; forfeiture of equity interests of defaulting shareholders; and accelerated contribution when a company with unpaid capital contribution is delinquent.

The Amended PRC Company Law also provides greater flexibility for joint stock limited companies (JSCs) by allowing them to issue:

- Different classes of shares.
- New shares with authorization by the board of directors rather than the shareholders, subject to certain conditions.

These changes may also make JSCs more appealing to foreign investors, allowing them to access the level of flexibility that they are used to in an offshore structure for their investments and financing activities in China.

Corporate Governance

To further improve corporate governance and shareholder protections, the Amended PRC Company Law:

- Clearly defines the duty of loyalty and duty of diligence for directors, supervisors and senior management.
- Strengthens regulation of related-party transactions.
- Enhances the liability of directors and senior management toward third parties for gross negligence or intentional misconduct.
- Emphasizes employee representation on the board of directors or the supervisory board.

Other

Other amendments bolster shareholders' rights and simplify processes. For instance, the changes:

- Enhance protection of shareholders' information rights.
- Strengthen responsibilities of the actual controlling person.
- Streamline procedures for corporate establishment and deregistration.

Implications for Overseas Listed Issuers and Other Foreign Entities

The Amended PRC Company Law and a series of implementation rules and interpretations to be promulgated will continue to shape how business is conducted in China, and suggest actions that foreign investors should consider.

Review capital commitments, including those of joint venture partners. Most importantly, issuers and foreign entities with PRC subsidiaries in the form of LLCs should revisit their unfulfilled capital contribution commitments due to the five-year statutory deadline. Notably, those that adopt a variable interest entity (VIE) structure — where the foreign investor does not hold any direct ownership of an operating company in China but obtains controlling interest in it through contractual arrangements with the PRC operating company and its nominee shareholder(s) — need to pay attention to the obligation and capability of the nominee shareholder(s) of the VIE to fulfill the capital contribution commitments in order to maintain the stability of the VIE structure.

If there are unfulfilled capital contribution commitments for any material subsidiaries or VIEs, these entities, their shareholders and their actual controlling person(s) should consider planning ahead to meet the contribution obligation in a timely fashion and make adequate disclosures for risk management purposes along the way.

Further, foreign investors who establish joint ventures with other parties should consider tracking the timeliness and sufficiency of capital contributions by their business partner(s) because the Amended PRC Company Law makes shareholders jointly and severally liable to the LLCs for any deficiency in capital contribution.

A yet-unconfirmed transition period is expected to allow existing LLCs to gradually adjust their capital contribution schedules to fit the five-year statutory time frame.

Monitor the effect of the corporate governance changes in practice. The changes represent a significant advance in the PRC regulatory regime. That said, these currently remain conceptual in nature and need to be tested in practice.

Substantial implementation, enforcement and judicial rulings will be needed to ensure that corporate governance practices actually evolve in the direction intended by the PRC authorities, in particular to clarify what level of scrutiny directors and senior management will be subjected to.

For example, it is common for a PRC operating company to have the same directors and senior management as its overseas-incorporated and -listed parent company. It remains to be seen whether these directors and senior management can be held

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liable if they act in the best interests of the entire group but not necessarily of the PRC operating entity.

Consider opportunities offered by new flexibility in share capital structures of a JSC. For decades, the LLC has been the most commonly used corporate form for foreign investors to invest and do business in China. This may change under the Amended PRC Company Law. While a JSC is subject to more stringent requirements than an LLC with regards to establishment and operations, the amendments now give JSCs the right to issue different types and classes of shares with variations in their rights (including voting rights, dividend rights and transfer restrictions, among others). They also allow the board of directors of a JSC to increase its issued shares by up to 50% within any three-year period.

These features present advantages for multinational corporations and other foreign investors that seek greater flexibility in their investments and financing activities in China.

Additionally, the amendments may pave the way for PRC-incorporated JSCs to be more compatible with the listing rules of The Stock Exchange of Hong Kong Limited (HKEx). Being able to issue different classes of shares means JSCs could have the option to list on the HKEx under their "weighted voting rights" regime with dual share structures.

The provisions permitting JSCs to issue new shares with authorization from the board of directors rather than the shareholders also afford listed PRC-incorporated JSCs more leeway in raising additional equity capital through follow-on offerings and placings. Until now, PRC businesses had to adopt an offshore structure (typically a Cayman Islands holding company) in order to access that level of flexibility.

A New Era of PRC Operations

The Amended PRC Company Law incorporates a wide range of changes, not only integrating some existing judicial practices and regulatory considerations but also adopting practical measures that are compatible with the evolving market environment.

We anticipate that PRC authorities will issue various rules, transitional measures, interpretations and practical guidance over time to implement and enforce the Amended PRC Company Law. Given the significance and the comprehensiveness of the changes, most PRC-incorporated entities will likely need to take a number of measures to conform to the new regulatory regime.

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