China’s pending Company Law reform: Preparing for the key changes

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Executive summary

China is in the process of finalising amendments to its new Company Law which are likely to be implemented in the near future. The changes affect many critical aspects of corporate establishment, operations and governance, including imposing greater personal liability for directors, supervisors and management and requiring mandatory employee involvement in the governance of large companies. As such, shareholders of Chinese companies should carefully consider the changes and start to prepare for their implementation. Investors considering setting up a Chinese company should also be considering the pending changes to capital contribution requirements. This article summarises ten of the key changes for companies in the proposed amendments.

Background

The Standing Committee of the National People’s Congress (the ‘**NPC**’) has released three versions of draft revisions to the Company Law (‘**Company Law**’) for public comments: on 24 December 2021 (the ‘**First Draft**’), on 30 December 2022 (the ‘**Second Draft**’) and on 1 September 2023 (the ‘**Third Draft**’).

The Third Draft was based on the First Draft and Second Draft but included some new changes which have sparked intense discussions and analysis among market players, academia and practitioners. While the debate around the Third Draft continues, we note that it is typical under PRC law for a draft law to be presented to the NPC for voting after three drafts (or ‘readings’). This means that, technically, the Third Draft could be implemented into law at any time, with the revised Company Law becoming effective a few months later. On that basis, it is prudent for Chinese companies to prepare for the implementation of the revised law now and, in particular, to be aware of the important issues highlighted in this article.

Capital

1. Capital contribution accelerated

One of the most striking changes in the Third Draft 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 Third Draft appears to put more weight on the protection of creditors but might cool down investors’ enthusiasm to launch start-ups. The Third Draft also contains various other provisions relating to the payment of the registered capital of an LLC, including the following:

(i) the board of directors of the 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) if a shareholder fails to contribute the registered capital after expiration of the grace period as demanded by the board, such defaulting shareholder will lose its rights relating to the unpaid registered capital. If the defaulting shareholder's rights are not transferred or cancelled through capital reduction within the next 6 months after the forfeit notice made by the board, other shareholders of the LLC (if any) shall make the deficient capital contribution in proportion to their shareholding ratios in the LLC; and

(iii) 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 and have not contributed to expedite the contribution ahead of schedule.

2. Capital reduction

In the case of a capital reduction, the Third Draft requires that all shareholders shall reduce their capital contributions in proportion to their shareholding ratios in the company, unless otherwise provided in other applicable laws. If this provision forms part of the finalised law, the current practice where a certain shareholder, sometimes financial investor, exits from the company by way of disproportionate capital reduction, will be illegal. Presumably this will affect investments made by financial investors such as private equity, or where particular early-exit provisions are included in the investment agreements or shareholders agreements.

3. Reconsider companies limited by shares?

LLCs are the primary form of companies under the current Company Law. However, under the Third Draft, companies limited by shares ('**CLS**') might attract more attention for the following reasons:

(i) compared with the current Company Law which requires at least two shareholders for a CLS, the Third Draft now allows a single investor to set up a CLS;

(ii) the Third Draft proposes that the articles of association or shareholders' meeting of a CLS may authorise its board of directors to approve, within a period of three years after the authorisation, the issuance of up to 50% more shares. This might be appealing to companies that vest the decision power to the board of directors and that are interested in flexible and efficient fund-raising.

(iii) all CLSs, and not just listed companies, are permitted under the Third Draft to issue separate classes of preferred shares with preferential rights in relation to dividends, proceeds upon liquidation, voting rights and transfer restrictions. It remains to be seen how such an approach will fit into the new corporate governance system but there will be ample room for innovative investors/shareholders to explore.

Corporate Governance

4. No mandatory supervisor

Under the current Company Law, a company (LLC or CLS) is required to appoint a board of supervisors (or a single supervisor) to oversee the performance of the directors and management. However, in practice, the board of supervisors has not proved to be an effective means to maintaining a healthy balance in the corporate governance structure. Under the Third Draft, supervisors are no longer mandatory for small companies. Further, as an alternative to the supervisor, the company may choose to set up an audit committee under the board of directors to assume the functions of the board of supervisors or supervisor. The audit committee should have three or more directors, with more than half of them not holding any other position within the company or having any other relationship that may negatively affect their independence.

5. Legal representative

The pool of candidates from which a company can select its legal representative is significantly broadened under the Third Draft. Currently, the Company Law requires the chairman of the board of directors, the executive director (where no board of directors is set up) or the manager to be the legal representative of the company. The Third Draft will permit the legal representative to be any director of the company or the manager, to the extent that the legal representative will execute company affairs on behalf of the company. If the legal representative of a company is intended to be a nominal figure at a

distance from the company's business on the ground, it would be sensible to ensure that the position is held by someone who is in control of the company, particularly given the enhanced liability under the new Company Law (please see further below).

6. Employee representatives on the board?

The Third Draft removes the restriction on the maximum number of directors sitting on the board of directors (currently capped at 13 directors). However, a company with more than 300 employees must have employee representatives elected by the employees' congress on its board of directors, unless at least one-third of the company's board of supervisors (if any) are employee representatives.

Shareholder Rights

7. Shareholder rights

The Third Draft introduces some additional measures to further protect shareholders' rights and interests. For example, a shareholder of an LLC or shareholder(s) holding (alone or in aggregate) more than 3% of the issued shares of a CLS for at least 180 consecutive days, will be allowed to review the underlying accounting documents of the company (which form the basis of its accounting books), in addition to its articles of association, shareholders register, corporate resolutions, financial audit reports and the accounting books of the company.

8. Right of first refusal

To relax restrictions on shareholders disposing of their investment in a company by transferring their equity, the Third Draft no longer requires the other shareholders to consent to the transfer. Instead, the other shareholders will be given a right of first refusal to acquire the shares on the same terms and conditions as the proposed transferee. The transferring shareholder will be required to inform the other shareholders of the terms of the proposed transfer including number of shares, price, payment method and proposed timing. The other shareholders will be deemed to have waived their right of first refusal if they do not respond within 30 days of receipt of the notice.

Liability

9. Personal liability

One of the most notable changes under the Third Draft is the greater personal liability imposed on directors, supervisors and management ('**DSMs**'). For example,

(i) DSMs shall compensate the company if they abuse their affiliation with the company and cause losses to the company (Article 22);

(ii) directors shall compensate the company for losses caused by their negligence in identifying delayed or deficient capital contributions from shareholders and causing losses to the company (Article 51);

(iii) DSMs must compensate the company on a joint and several basis for losses caused by a shareholder withdrawing capital after contribution (Article 57);

(iv) DSMs providing financial assistance to a third party to acquire the shares of the company must compensate the company for any losses caused (Article 163);

(v) all DSMs responsible for losses caused by a company distributing profits before making up for losses and allotting provisions for the statutory reserve must compensate the company (Article 211);

(vi) if a reduction in registered capital of a company is made in violation of the law and causes losses to the company, the responsible DSMs, must compensate the company (Article 226); and

(vii) if the directors of a company fail to form a liquidation group or otherwise fail to commence liquidation procedures and the company incurs losses, the responsible directors must compensate the company (Article 232).

10. Shadow accounts

The Third Draft prohibits the keeping of separate sets of accounting books for management discussions or other purposes. If a company creates accounting books in addition to the statutory accounts, or provides financial and accounting reports that include a false entry or conceal material facts, the company may be punished according to the Accounting Law and all other relevant laws and administrative regulations.

Let's talk

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

PwC China

Jing Wang
China Tax & Business Advisory - Corporate & Regulatory Partner
+86 (10) 8553 1566
jing.jm.wang@cn.pwc.com

Liang Jiang
China Tax & Business Advisory - Corporate & Regulatory Partner
+86 21 2323 8873
liang.l.jiang@cn.pwc.com

Tiang & Partners

Martyn Huckerby
Head of Competition Law, Asia Pacific
+852 2833 4918
martyn.p.huckerby@
tiangandpartners.com

www.pwccn.com
www.tiangandpartners.com

Tiang & Partners
程偉賓律師事務所

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