

# China Releases New Company Law

Highlights of Amendments and Impacts on Making Investment in China

## In brief

On December 29, 2023, the Standing Committee of the National People's Congress of the People's Republic of China promulgated the amended *Company Law of the People's Republic of China* ("PRC" or "China") (the "**2023 Company Law**"), after its deliberation of four versions of draft amendments in the past three years. The 2023 Company Law will come into force on July 1, 2024.

Following an overhaul in 2005, the *Company Law of the PRC* had two rounds of relatively minor amendments in 2013 and 2018 respectively (the version currently in effect as last amended in 2018 is hereinafter referred to as the "**2018 Company Law**"). This round of amendments in 2023 is another overhaul, as over two hundred articles have been added and amended in the 2023 Company Law, including substantial amendments to over one hundred articles. The amendments cover a wide range of topics, including capital contribution and reduction, equity/share transfer and repurchase, corporate governance matters (such as organizational structure and responsibilities and duties of controlling shareholders, actual controllers, directors, supervisors and senior management, etc.), shareholder rights protection, company establishment and dissolution/liquidation, etc.

The 2023 Company Law not only governs new companies established after its effective date, but also has significant implications on companies existing as of its effective date. Yet, the implementation of quite many articles is still subject to further interpretation and/or guidance of the Chinese authorities and courts. Therefore, companies, investors and other stakeholders should pay close attention to this new legislation and the pertinent regulations, judicial interpretations and other official guidelines that may be issued for its implementation in the near future.

We set out below a summary of some highlights of the amendments in the 2023 Company Law followed by elaboration of such amendments and our key takeaways and recommendations.

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## 1. Capitalization Requirements

### 1.1 Require shareholders of an LLC to make full capital contribution within five years after establishment of the company

In the 2013 version of the Company Law, the minimum registered capital requirements and the statutory term for making capital contribution to LLCs were lifted. This former reform was intended to stimulate investments by offering investors a high degree of flexibility in the timing of making capital contribution. However, after nearly ten years of practice, there have been increasing concerns that investors prefer to set up companies with high registered capital while postponing the actual capital contribution by way of a lengthy contribution period in the articles of association of the LLCs (which may range from ten to thirty years or even indefinitely).

The 2023 Company Law has reinstated the statutory term for making capital contribution and requires that shareholders must inject the registered capital in full within five years after the establishment of the LLC (*Article 47*). This means that for any new LLC to be established after July 1, 2024, a contribution term of the maximum of five years after the establishment of the LLC for capital contribution must be stated in its articles of association.

For LLCs established before July 1, 2024, it is yet to be clarified how this five-year requirement will be implemented. For instance, if an LLC was established in July 2020 and its current articles of association provide for a term of ten years for making capital contribution, the 2023 Company Law is silent on when the outstanding registered capital of such LLC should be paid up by its shareholder(s). The 2023 Company Law only provides that companies established before July 1, 2024 must "*gradually adjust*" its capital contribution schedule to be in compliance with the new law, and company registration authorities may require such companies to make adjustments in case of obvious non-compliance (*Article 266*). According to the 2023 Company Law, the State Council will issue detailed rules in this regard, and it is expected that, among others, a grace period would be given to existing companies to adjust their capital contribution schedules for compliance with the new law.

The 2023 Company Law further codifies the following new rules to secure timely capital contribution to an LLC by its shareholders:

- if a founding shareholder fails to make capital contribution in full in accordance with the articles of association of the company, or if the actual value of the in-kind contribution made by a founding shareholder is significantly lower than the amount of that shareholder's subscribed registered capital, then the other founding shareholders of the company shall bear joint and several liability relating to such capital contribution (*Article 50*);
- the board of directors of a company is obliged to monitor and verify the capital contribution to the company and if any payment is overdue, the board of directors shall issue a payment notice to the relevant shareholders; failing to do so, the responsible directors shall be personally liable to the company for any losses resulting from the delinquent capital contribution (*Article 51*);
- if a shareholder fails to contribute the registered capital after expiration of the grace period as specified in a payment notice issued by the board of directors (which should be no less than sixty days), such defaulting shareholder will lose its equity interest corresponding to the unpaid registered capital. If the aforesaid equity interest has not been transferred or cancelled through capital reduction within the next six months, other shareholders of the company (if any) shall make the capital

contribution (which should have been made by the defaulting shareholder) in proportion to their respective capital contributions in the company (*Article 52*); and

- if a company is unable to pay off its debts when due, then the company or the relevant creditor shall have the right to require the shareholder(s) of the company to make capital contribution which has been subscribed but remains unpaid by such shareholder(s), regardless of whether such capital contribution is already due or not (*Article 54*).

## 1.2 Allocate liabilities between transferor and transferee in the case of an equity transfer in an LLC with an unpaid capital contribution

According to the 2023 Company Law, upon a transfer of equity interest in an LLC, if there is an outstanding capital contribution relating to the equity interest to be transferred which is not yet due, the transferee shall bear the future contribution obligations after the equity transfer. More specifically, if the transferee fails to make the capital contribution when it becomes due, the transferor shall bear a secondary (not joint and several) liability to contribute the overdue capital. In contrast, if the capital contribution relating to the equity interest to be transferred was already due before closing, then the transferor shall remain liable for making the contribution even if the equity has been transferred and the transferee shall be jointly and severally liable for such contribution, unless the transferee is not aware and should not have been aware of such overdue contribution (*Article 88*).

## 1.3 Include a new expedited capital reduction process

Under the 2018 Company Law, a company is required to provide an advance notice of at least thirty days to known creditors and an advance notice of at least forty-five days to unknown creditors in the event of a capital reduction. The 2023 Company Law now allows a company to reduce its registered capital without notifying its creditors, provided however that: (i) the company has used its statutory and discretionary reserves to make up for its losses and there are still losses, (ii) the proceeds from capital reduction must only be used to make up for losses of the company and not be distributed to shareholders; (iii) the capital reduction shall not release any shareholder from its obligation to pay outstanding capital contribution, and (iv) the company shall still make an announcement of the capital reduction on a newspaper or the National Enterprise Credit Information Publicity System within thirty days after the resolutions approving the capital reduction (*Article 225*).

The 2023 Company Law also stipulates that in the event of a capital reduction of a company, all shareholders shall reduce their capital contributions or shares in proportion to their respective shareholding ratios in the company, unless otherwise provided in the applicable laws, the articles of association of the company or agreed by all the shareholders (*Article 224*).

## 1.4 Allow a JSC to issue different classes of shares and authorize its board of directors to issue new shares

Under the current PRC laws, only certain listed companies in China are allowed to issue different classes of shares or preferred shares on an exceptional basis. The 2023 Company Law now explicitly allows a JSC to issue different types and classes of shares in terms of dividends, liquidation proceeds, voting rights and transfer restrictions, etc. (*Article 144*). This new rule will give foreign investors greater flexibility in structuring their investments and financing in China and reflects China's efforts to align with international standards.

It is also noteworthy that under the 2023 Company Law, shareholders of a JSC may authorize the board of directors of the JSC to approve, within a period of three years, the issuance of new shares of not more than 50% of the shares already issued by the JSC. This change is to accommodate the increasing fund-raising activities of JSCs in China in recent years and will afford flexibility and efficiency in share issuance by a JSC for fund-raising purpose.

## 1.5 Allow a JSC to issue shares without par value

The 2018 Company Law only allows issuance of par value shares by a JSC. The 2023 Company Law now also allows a JSC to issue shares without par value. Par value shares and non-par value shares of the same JSC are inter-convertible, but it cannot issue the two types of shares at the same time. For non-par value shares, the 2023 Company Law further provides that at least one half of the proceeds from the issuance of such shares shall be included in the registered capital of the company (*Article 142*).

## 1.6 Expressly allow additional forms of capital contribution

The 2023 Company Law allows shareholders to make capital contribution to companies in various forms, including equity interest and creditor's rights that are held by shareholders and can be appraised (*Article 48*). These two forms are not expressly mentioned in the 2018 Company Law. In practice, although capital contributions in the form of equity interest and creditor's rights were

successful in some instances in the past, the lack of specific legal basis brought uncertainties to deals and required additional efforts on pre-signing inquiries and communications with the relevant government authorities.

This change is not expected to have a material impact on foreign direct investment in China. The reason is that in practice foreign investors usually choose not to make capital contribution with equity interest and creditor's rights (especially in or against a foreign entity), as that would lead to complications due to relevant restrictions under overseas direct investment (as the invested company in China will as a result hold the equity interest in a foreign entity) and foreign exchange control regime in China.

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## 2. Streamlined and Alternative Corporate Governance Structure

### 2.1 Expand the scenarios allowing appointment of a director / a supervisor in lieu of a board of directors / a board of supervisors

For LLCs, the condition to dispense with a board of supervisors under the 2018 Company Law is that either (i) the number of shareholders or (ii) the size of the company is small. Such condition is retained in the 2023 Company Law.

Where an LLC does not have a board of supervisors, the 2018 Company Law requires the company to have one or two supervisors, while the 2023 Company Law simplifies the governance structure requirement by reducing the number of supervisor(s) (in absence of a board) to one. That said, in Sino-foreign joint venture companies, we often see that both Chinese party and foreign party will each appoint one supervisor. Now that the 2023 Company Law no longer permits appointment of two supervisors, such companies currently having two supervisors may be required by AMR to adjust their supervisor positions once the new law comes into effect and joint venture partners would need to re-negotiate and agree on how the sole supervisor is to be appointed. In addition, the 2023 Company Law also innovatively adds a new provision introducing a second possibility in not having a board of supervisors, allowing an LLC of a small size or having a small number of shareholders not to have any supervisor at all if all shareholders unanimously consent (*Article 83*).

For JSCs, under the 2018 Company Law, it is mandatory to set up a board of directors as well as a board of supervisors. However, the 2023 Company Law lifts such overarching requirement and allows a JSC that is small or has a small number of shareholders to opt for having one director and one supervisor (similar to the rules applicable to LLCs, though still, LLCs enjoy more flexibility in a way that LLCs may choose not to have any supervisor at all while JSCs are still required to have at least one supervisor) (*Articles 128, 133*).

The amendment under the 2023 Company Law, on one hand, reflects the respect for the autonomy of companies and affords more flexible and low-cost corporate governance. On the other hand, the condition of unanimous consent of all shareholders for not setting up a board of supervisor (or a supervisor) (in the case of LLCs) also affords protection to the interests of minority shareholders.

### 2.2 Introduce audit committee under the board of directors in lieu of supervisors

Against the backdrop that the board of supervisors (or supervisors) have been performing relatively limited functions in corporate governance in practice over the years, the 2023 Company Law introduces a new mechanism of audit committees (under the board of directors), which explicitly allows the audit committee to exercise the powers of the board of supervisors (or supervisor(s)) (*Articles 69, 121*). With the setup of an audit committee under the board of directors, the setup or appointment of board of supervisors (or supervisor(s)) will be exempted. This new mechanism aims to strengthen companies' internal financial supervision over companies.

In fact, audit committee mechanisms have been stipulated in existing PRC laws regulating special types of companies, such as state-owned companies and listed companies, but are rarely seen in other non-regulated companies. The 2023 Company Law now expressly allows all LLCs and JSCs to set up audit committee under the board of directors to replace the board of supervisors (or supervisor(s)).

That said, questions remain as to how conflicts of interest between the "supervisory" role and "director" management role of the audit committee member can be resolved where the same person exercises management power as directors and exercises supervisory power over directors and senior management. To illustrate, the board of supervisors has the function of supervising the performance of the company's directors and senior management, and may also represent the company to initiate litigation against the directors and senior management to safeguard the company's rights and interests. According to Article 69 of the 2023 Company Law, the audit committee exercises the powers and functions of the board of supervisors. It may be difficult for the audit committee to objectively and impartially exercise the powers and functions of the board of supervisors if the audit committee itself is composed of directors.

## 2.3 Emphasize employee representation at the board of directors

The 2023 Company Law removes the limitation on the maximum number of 13 persons for the board of directors.

Under the 2018 Company Law, employee representation at the board of directors is only required where the company has certain state-owned interests. The 2023 Company Law extends the scope of such mandatory requirement of having employee representation at the board of directors to all companies with 300 or more employees, **except** where the company has a board of supervisors which includes at least one employee representative (*Article 68*).

In addition to the above, the 2023 Company Law also emphasizes the status of employee representatives by allowing a company to have employee representative(s) on the audit committee under the board of directors (*Article 69*).

Such provisions, by increasing the requirements for directorship in medium and large private companies, are intended to strengthen the protection over the interests of employees and other stakeholders and better safeguard the participation of employees in the democratic management of companies.

## 2.4 Stipulate quorum of a board meeting and voting rights required for a board resolution of an LLC

For an LLC, the 2023 Company Law requires over a half of its directors (being the quorum) to attend a meeting of the board of directors; for the board to pass a valid resolution, over a half of its directors (not just half of the directors present at the meeting) should cast their affirmative votes. The 2018 Company Law has no such specific requirements, and allows greater flexibility of board meetings and decision-making. Hence, LLCs (including Sino-foreign joint ventures) should revisit their articles of association (and joint venture contracts or shareholders agreements as applicable) to assess whether any amendments are necessary.

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# 3. Liabilities of Controlling Shareholders, Actual Controllers, Directors, Supervisors and Senior Management

## 3.1 Define duty of loyalty and duty of care

The 2018 Company Law generally stipulates that directors, supervisors and senior management owe duty of loyalty and duty of care to the company (without defining such duties) while elaborating duty of loyalty by way of enumeration of prohibited acts, but the 2018 Company Law is silent on the scope of duty of care (*Article 180*).

The 2023 Company Law introduces new definitions to clarify the concepts and depicts the general scope of "duty of care" and "duty of loyalty". The 2023 Company Law broadly defines duty of loyalty as avoiding conflicts between directors' own interests and the interests of the company, and not to use directors' powers to seek improper interests, and clarifies that duty of care means that directors, supervisors, and senior management shall exercise **reasonable** care that **managers** shall **ordinarily** exercise, in the **best interests of the company** in performing their duties.

The definition of duty of care appears to be similar to the underlying rationale of the Business Judgment Rule under the US law regime, which is a judicial doctrine arising from US courts' respect for corporate self-governance as well as their dislike for second-guessing the business decisions of corporate directors and senior management. That said, it remains to be seen what level of scrutiny PRC courts will apply in examining whether directors, supervisors, and senior management have fulfilled their duty of loyalty and duty of care.

In practice, directors of a company that are appointed by shareholder(s) sometimes simply defer to their appointing shareholder(s) when the board needs to deliberate a certain matter. There is a risk that such directors may be held liable for failure to perform their duty of care if they do not exercise reasonable care and consider the company's best interests but merely vote pursuant to their appointing shareholder's instruction (whether express or implied). This potential risk needs to be carefully considered especially in the context of a Sino-foreign joint venture: where each joint venture party may wish to have its respective appointed directors vote on a significant but controversial matter at a board meeting pursuant to its own will.

## 3.2 Further regulate connected transactions, seeking business opportunities of the company and engaging in business similar to the company

As part of directors' and senior management's fiduciary duty of loyalty, the 2018 Company Law prohibits directors and senior management from:

- becoming a party to any contract or business dealings with the company in violation of the articles of association or without first obtaining the consent of the shareholders' meeting;
- seeking business opportunities for himself/herself or for any other person by taking advantage of his/her position, or operating on his/her own behalf or on behalf of any other person any business similar in nature to that of the company; and
- operating on his own behalf or on behalf of any other person any business similar in nature to that of the company, without first obtaining the consent of the shareholders' meeting (*Article 148*).

Under the 2023 Company Law, the obligations to observe the procedural requirement of first obtaining proper internal approval before proceeding with such connected transactions, seeking business opportunities of the company and engaging in similar business are extended to supervisors (in addition to directors and senior management). Moreover, restrictions on connected transactions are also extended to connected persons of directors, supervisors and senior management (including, *inter alia*, their close relatives, enterprises directly or indirectly controlled by directors, supervisors and senior management and their close relatives) (*Article 182*).

At the same time, according to the 2023 Company Law, shareholders' meeting statutorily is not the only proper level of governance body to grant such approval. Rather, the 2023 Company Law makes it as an internal corporate governance matter that should be determined pursuant to a company's articles of association which shall stipulate the approval authority (be it the board or the shareholders' meeting) for connected transactions, seeking business opportunities of the companies and engaging in similar business.

Moreover, the 2023 Company Law further provides that when the board of directors resolves as to the aforesaid conflict-of-interest matters, an interested director shall abstain from voting (which is similar to the existing rules applicable to listed companies). If the number of unrelated directors in presence is less than 3, the matter shall then be further submitted for deliberation at the shareholders' meeting (*Article 185*). However, the 2023 Company Law is still silent on whether shareholders shall abstain from voting on conflict-of-interest matters (except in the case of companies providing guarantee to shareholders or actual controllers in which case interested shareholders' abstention is mandatorily required), which remains to be clarified by authorities and in judicial practice.

Notably, the 2023 Company Law also introduces a new exemption to the prohibition of directors, supervisors and senior management's seeking business opportunities of a company, i.e., where a company is unable to take the business opportunity according to the laws, administrative regulations or its articles of association, its directors, supervisors and senior management are allowed to seek such business opportunities without seeking approval from the board of directors or shareholders' meeting (since in such case, no conflict would exist as the company would not be in a position to take such opportunities in any case) (*Article 183*).

In terms of restriction on engaging in business similar to the company, interestingly, the prior drafts of the amendments qualified "similar" business by "competing" with the company. However, the 2023 Company Law has dropped such "competing" qualification, which seems to implicate the legislator's view that any business which directors, supervisors and senior management engage in that is similar to the business of the company is *per se* competing and should be discouraged.

### 3.3 Hold directors and senior management liable toward third parties in the case of gross negligence or intentional act

The 2023 Company Law adds a new Article 191, providing that directors and senior management shall be liable for compensation if they have intentionally or grossly negligently carried out their duties, which caused damage to others. It means that third parties (the scope of which is not defined) can directly claim against and hold directors and senior management liable (apart from claiming against the company) where the directors or senior management caused damages to third parties in the course of exercising their duties, provided that directors or senior management's act is intentional or grossly negligent.

In contrast, as a general rule, the 2018 Company Law only stipulates the liability of directors and supervisors for the losses caused to the company in execution of their duties in Article 149, but does not stipulate the liability for the damages caused to third parties (though there are a few scattered rules or interpretation which address special circumstances where directors can be held liable to third parties (e.g., directors' failure to exercise the duty of care to urge shareholders to fulfil their capital contribution obligations, directors' abetting shareholder to illegally withdraw injected capital)).

While this new Article 191 provides another recourse to third parties, it may also lead to concern of directors over their personal liability exposure in exercising their duties as directors (including those potential liability that may arise from frivolous action).

### 3.4 Impose liabilities on "de facto directors" and "shadow directors"

The 2023 Company Law newly provides that:

- a controlling shareholder or actual controller of a company who does not serve as its director, but attends to the company's affairs shall also owe duty of care and duty of loyalty to the company (*Article 180*); and
- where the controlling shareholder or actual controller of a company instructs a director or senior management to engage in an act against the interests of the company or shareholders, the controlling shareholder or actual controller shall be jointly and severally liable with the director or senior management (*Article 192*).

Such provisions are akin to the rules around "de facto directors" and "shadow directors" under certain common law systems.

Under the 2023 Company Law, *de facto* directors who are not officially appointed or registered as directors but actually manage the business of the company are captured as having the same statutory fiduciary duties as a director.

The new "shadow director" provisions regulate those controlling shareholders or actual controllers who exercise management power by way of instructing the appointed directors or senior management. In fact, such provision on liabilities of "shadow directors" follows the logic of joint tort under the civil law. According to the provisions of Article 1169 of the *Civil Code of the PRC*, persons instigating, abetting and aiding others to commit infringement shall be jointly and severally liable with the perpetrator. Since the acts are committed by controlled directors/senior management under the instruction of shadow directors (i.e., the controlling shareholder or actual controller), the 2023 Company Law stipulates that both of them shall be jointly and severally liable.

The purpose of these articles is to further regulate the behavior of controlling shareholders and actual controllers to deter acts in pursuit of their own interests to the detriment of the company and minority shareholders and to further protect interests of creditors of the company.

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## 4. Shareholders' Rights and Protections

### 4.1 Enhance shareholders' information rights to review accounting documents of the company and its wholly-owned subsidiaries

Apart from the articles of association, shareholders' register, corporate resolutions, financial audit reports and the accounting books, the 2023 Company Law also allows any shareholder of an LLC or shareholder(s) holding (alone or in aggregate) at least 3% of the issued shares of a JSC for at least 180 consecutive days, to review (or entrust accounting firms, law firms and other intermediaries to review) the underlying accounting documents of the company and any of the aforesaid documents of a wholly-owned subsidiary of the company (*Articles 57 and 110*). This new rule will protect minority shareholders by giving them additional statutory information rights. It is unclear whether such information rights would also extend to controlled subsidiaries or other entities whose financial statements are otherwise consolidated in practice.

### 4.2 Improve other shareholders' rights

In addition to the information rights above, the 2023 Company Law also enhances some other rights and protections for shareholders (especially for minority shareholders), including:

- shareholders have the right to request the company to acquire their equity at a reasonable price if a company's controlling shareholder abuses shareholder rights and seriously damages the interests of the company or other shareholders (*Article 89*);
- shareholder(s) holding (alone or in aggregate) more than 10% of the issued shares of a JSC may request to convene extraordinary shareholders' meetings and shareholder(s) holding (alone or in aggregate) more than 1% of the issued shares may put forward an interim proposal in writing to the board of directors at least ten days before a shareholders' meeting (*Articles 114, 115*); and
- shareholders have the right to file a lawsuit against directors, supervisors, or senior managers of a company's wholly-owned subsidiaries if they are found to violate laws, administrative regulations, or the company's articles of association, and cause losses to the company (*Article 189*).

## 5. Streamlined Policies for Company Setup and Closure and Other Amendments

### 5.1 Introduce a new chapter on company registration

The 2023 Company Law introduces a new chapter on company registration of establishment, alteration and termination by reorganizing relevant provisions in the 2018 Company Law and certain regulations and implementation rules concerning market entity registration and adding some new articles. The new law requires company registration authorities in China to streamline their procedural requirements for company registration, enhance the efficiency of company registration by promoting convenient online channels and other informatized means (*Article 40*). In particular, company registration authorities must inform applicants of all materials that are missing or need to be corrected in one go in order to enhance the efficiency of the registration process (*Article 30*) (although we understand this has been a long-standing general principle under Chinese administrative laws).

All of the above are aimed to ease the burden on companies when going through administrative procedures, but meanwhile companies have the statutory obligation to be responsible for the truthfulness, validity and effectiveness of the materials they submit. This is in line with the overall regulatory philosophy of the Chinese government in recent years that while a looser *ex ante* review is conducted, more stringent in-process and *ex post* liabilities may be imposed.

### 5.2 Simplify the rules on companies with only one shareholder

The 2023 Company Law has simplified the rules on companies with only one shareholder.

For example, under Article 57 of the 2018 Company Law, the sole shareholder of an LLC (which may also include a wholly foreign-owned enterprise) must either be a natural person or a legal person. Under the PRC laws, a partnership (whether a general one or a limited one) is deemed as an organization without legal personality, thus a partnership is ineligible to establish a 100% subsidiary in China. In practice, this constraint may sometimes extend to a foreign partnership that may or may not have legal personality under the laws of its own jurisdiction, simply because the foreign investor is a partnership. Even though the *Foreign Investment Law of the PRC* (the "FIL") has no explicit requirement on the legal personality of a foreign investor that is allowed to individually establish a 100% subsidiary in China, some local company registration authorities may refuse to register the setup of a company that is 100% owned by a foreign partnership in accordance with Article 57 of the 2018 Company Law, without regard to the FIL. The 2023 Company Law no longer imposes requirements on the identity of the sole shareholder. That means in the future, a foreign or domestic partnership (whether or not with legal personality under applicable laws) is supposed to be allowed to establish a 100% subsidiary.

In addition, a JSC is now allowed to have a sole shareholder as well (unlike the previous provision under the 2018 Company Law requiring it to have at least two shareholders) (*Article 92*). Some other requirements particularly for companies with only one shareholder have also been abolished in the 2023 Company Law.

### 5.3 Improve the company liquidation rules

Article 232 of the 2023 Company Law stipulates directors' new obligation to form a liquidation group for liquidation within fifteen days after the occurrence of any matter triggering a company's dissolution. If directors fail to discharge their liquidation obligation promptly and have caused losses to the company or its creditors, directors shall be liable for compensation.

Accordingly, as the default position under the 2023 Company Law, the liquidation group should consist of all directors, unless otherwise provided by the company's articles of association or resolved by the shareholders' meeting (*Article 232*). Under the 2018 Companies Law, for LLC (including most foreign-invested enterprises, "FIEs"), the liquidation group should consist of shareholders. The rationale of this change to the composition of liquidation group is that compared to shareholders (who may be legal entities), directors are supposed to be more familiar with the company's financial conditions and other situations and thus are in a better position to handle detailed liquidation work. As the 2023 Company Law allows flexibility, existing companies will not be mandated to amend the composition of liquidation group in their articles of association if they still prefer to form a liquidation group consisting of shareholders.

Interestingly, the previous law for Sino-foreign equity joint ventures (which has been repealed) generally required members of a liquidation committee to be selected from directors. Some equity joint ventures have not yet amended their articles of association and joint venture contracts to reflect the provisions under the 2018 Company Law that are currently applicable to them, as they are granted a five-year grace period until December 31, 2024. Such equity joint ventures may directly refer to the 2023 Company Law, which stipulates the composition of liquidation group that is similar to that of liquidation committee under the superseded law for equity joint ventures. It is worth noting that "liquidation committee" is now an outdated terminology and should be replaced with "liquidation group".

Article 238 of the 2023 Company Law imposes duties of loyalty and care upon members of the liquidation group, and if they are slack in fulfilling their liquidation duties and have caused losses to the company, they shall be held liable for compensation.

#### 5.4 Introduce simplified company deregistration and mandatory company deregistration mechanisms

A company is allowed to quickly go through a simplified procedure for company deregistration once all shareholders undertake that the company has no or has settled all debts and an online public announcement has been made for twenty days (*Article 240*).

A company registration authority may directly deregister a company *ex officio* after an online public announcement for sixty days, if the company has not applied for deregistration within three years after revocation of business license, ordered closure or cancellation (*Article 241*). Such mandatory deregistration does not affect the relevant duties of shareholders and directors.

#### 5.5 Emphasize the governance roles of Party organizations within State-invested companies

Article 170 of the 2023 Company Law stipulates that the organization of the Communist Party of China in a State-invested company shall play a leading role in studying and discussing major operation and management matters of the company, and support the relevant organization of the company in exercising their functions in accordance with law. This is not a completely new requirement, as similar provisions have been included into certain rules issued by the authorities in charge of State-owned assets supervision.

Under the 2023 Company Law, a "State-invested company" includes any LLC or JSC controlled by State-owned capital, but the meaning of the term "control" is not further explained. There is no consistent definition of "control" under the existing scattered rules on State-owned assets supervision, but it is generally believed that "control" may include absolute control by over 50% majority shareholding or actual control by certain agreed arrangements that lead to actual control over significant matters of a company.

Where a foreign investor enters into a joint venture with a State-owned enterprise in China (as the controlling shareholder), such Chinese joint venture partner may require the formation of a Party organization that will play certain roles in the operation and management of the joint venture and incorporate relevant rules into the articles of association of the joint venture. Foreign investors usually have great concerns about the implications of such arrangements. In our experience, through negotiations the joint venture partners can usually conclude mutually acceptable middle-ground provisions on Party organizations.

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## 6. Key Take-aways and Recommendations

- 6.1 The FIL (effective from January 1, 2020) grants a grace period allowing corporate governance structure of existing FIEs to continue for five years, but changes need to be made to comply with the FIL before January 1, 2025. In practice, certain FIEs established before the promulgation of the FIL have not yet adapted their corporate governance structure to the FIL and the 2018 Company Law (since the five-year grace period has not expired). With the promulgation of the 2023 Company Law, FIEs now need to update their articles of association and joint venture contracts / shareholders agreement (as applicable) based on both the 2023 Company Law and the FIL in the course of 2024.
- 6.2 It is advisable for companies and their investors to revisit the companies' governance structure and assess (i) if any mandatory adjustment is required in view of the new company law requirements (e.g., number of supervisors or alternatives, applicability of mandatory employee representation (and at which internal authority), board meeting quorum and resolution), and (ii) if the governance structure can be improved (and if a streamlined governance structure would be preferable) in view of the greater flexibility introduced by the 2023 Company Law and based on specific needs of the companies.
- 6.3 Considering the increasing exposure to personal liabilities of directors, supervisors and senior management, companies may consider including indemnification clauses in the articles of association (or enter into separate indemnification agreements with those individuals) and/or purchasing (director) liability insurance to give more comfort and afford more protection to directors, et al, acting in good faith and with due care. That said, whether local company registration authorities will accept filing of amended articles of association with such special clauses (including indemnification clauses) is to be tested in practice.
- 6.4 While the 2023 Company Law will not take effect until July 1, 2024, it is advisable for foreign investors to keep abreast of the new and upcoming regulations, rules, guidelines and policies relating to capital contribution for establishing new companies in China or injecting additional capital into existing invested entities in China. This will help avoid the risk and burden of being challenged by company registration authorities to amend the articles of association of the company shortly after its establishment. If investors intend to set up an LLC ultimately with a significant amount of registered capital, they may consider not committing a significant initial amount (but only a reasonable amount that is sufficient for early-stage operations of the

company) and then inject additional capital in phases to the company by way of capital increase as needed. This will give investors more flexibility in scheduling the capital contribution plan given the five-year statutory time limit.

- 6.5 In light of the statutory liabilities of a transferor and a transferee with respect to unpaid capital contribution, in the event of an equity transfer, the transferee is advised to conduct thorough due diligence on the status of capital contribution of the target company and include appropriate representations and warranties in the transaction documents to seek protections; if the transferee is aware of the transferor's failure to make timely capital contribution, the transferee should either request for a closing condition that the transferor's subscribed capital has been fully contributed and/or seek other contractual protection between the transaction parties (although the transferee may still be held liable for the unpaid amount on a joint and several basis). From the transferor's perspective, a specific indemnity can be included in the transaction documents to expressly specify that the transferee agrees to make the remaining capital contribution when due after closing (as the outstanding capital contribution should normally have already been taken into account by the parties in negotiating the purchase price), and if the transferor were made liable for making any contribution under the 2023 Company Law after closing, then the transferee shall indemnify the transferor for such contribution and any other losses incurred by the transferor.
- 6.6 As compared to LLCs which have been much more commonly utilized by foreign investors, the alternative corporate type (i.e., JSCs) may be further considered and explored by investors in setting up joint ventures or with a view of future financing, in light of the greater flexibility given to JSCs in issuing different types and classes of shares provided under the 2023 Company Law.

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