

## INTRODUCTION TO THE NEW COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA

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*Abstract:* This article briefly analyzes the new Company Law and its effects on doing business in China. After a brief history of the previous version of the law, this article examines the many changes to management and articles of association, capital requirements, limited liability companies, access to corporate information, piercing the corporate veil, third party loans, and legal remedies for improper actions. It goes on to look at the impact on the structure of foreign investments and discusses the likely effects of the new law in actual practice.

### I. INTRODUCTION

On October 27, 2005, the People's Republic of China adopted a new Company Law. This law became effective on January 1, 2006.<sup>1</sup> The New Company Law replaces the Old Company Law, which had been adopted in 1993.<sup>2</sup> The New Company Law is a complete revision of the old law. Almost nothing of the old law survived the revision. Drafters estimate approximately ninety percent of the provisions of the new law are unique.

The New Company Law governs two types of corporations: limited liability companies (*youxian gongsi*) and joint stock companies. The changes to limited liability companies are especially important to foreign investors in China because the statutes governing foreign direct investment in China require foreign investors to operate through a Chinese limited liability company.<sup>3</sup> For existing foreign invested limited liability companies, the rules on operation of such companies have substantially changed. Potential new investors must realize the old rules no longer apply and consider the new regime. Because foreign investors are currently prohibited from investing directly in China through joint stock companies, the

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<sup>1</sup> Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) LAWINFOCHINA (last visited Nov. 5, 2006) (P.R.C.) [hereinafter New Company Law].

<sup>2</sup> Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, amended Dec. 25, 1999 and August 28, 2004), *translated at* [www.lawinfochina.com/dispecontent.asp?db=1&id=3656](http://www.lawinfochina.com/dispecontent.asp?db=1&id=3656) (last visited Nov. 5, 2006) (P.R.C.) [hereinafter Old Company Law].

<sup>3</sup> See the discussion on foreign invested companies, *infra* Section III.

discussion below will be limited to the New Company Law's changes regarding limited liability companies.

## II. IMPORTANT CHANGES INTRODUCED BY THE NEW COMPANY LAW

### A. *Management and Articles of Association*

Under the Old Company Law, the articles of association for a limited liability corporation was not a living document. Article 22 of the Old Company Law provided a list of items to be included in the articles. As a matter of practice, companies were required to include those provisions and no others. As a result, articles of association were virtually the same for every company regardless of its size or nature. There was no freedom to revise or adapt the articles to meet the specific needs of a particular company. Under the Old Company Law, the roles of shareholders, directors, and officers were taken as mandatory provisions to be followed by all companies. As a result, the articles of association became little more than a "fill in the blanks" form document adopted by every company without regard to the actual management needs of that company.

The New Company Law abandons the rigidity of the old law and encourages shareholders of limited liability companies to take a flexible approach to company management. The articles of association now are intended to be adaptable to meet the specific needs of each company. The New Company Law provides for management of the company by the shareholders, directors, officers and supervisors and provides default provisions concerning the duties and scope of authority for each.<sup>4</sup> However, with respect to many important provisions related to management of the company, the New Company Law specifically provides that the shareholders are free in the articles of association to adopt specific provisions to meet the needs of the company.<sup>5</sup> There are virtually no provisions related to management that cannot be altered or expanded in a manner determined by the shareholders in the articles of association.

The New Company Law also encourages shareholders to include provisions in the articles of association related to the financial management of the company. For example, the Old Company Law required profits earned by the company to be distributed among shareholders strictly in

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<sup>4</sup> See New Company Law art. 37-57 (giving the provisions for management of limited liability companies).

<sup>5</sup> See, e.g., *id.* art. 42-47, 49-51, 54, 56.

accordance with the shareholders' ownership interest in the company.<sup>6</sup> Under the New Company Law, shareholders are entitled in the articles of association to provide for distribution of profits in any manner agreed to by the shareholders, even if that distribution differs from the ownership percentage of the respective shareholders.<sup>7</sup> This provides significant flexibility in financing of limited liability companies that was entirely absent under the Old Company Law.

Under the former company law system, officers and directors often used their companies to secure financing of other businesses with which the officers and directors were involved. To restrict such behavior, the New Company Law provides that the shareholders may impose limitations on the authority of the directors and senior management. If officers or directors exceed the authority given them, their actions are void and the shareholders may file suit to compel compliance and for damages.<sup>8</sup>

### *B. Reduced and Simplified Minimum Capital Requirements*

Chinese company law emphasizes registered capital requirements as a means to protect creditors. Since credit reporting is still primitive in China, the New Company Law emphasizes registered capital reporting and full capitalization of all new companies.<sup>9</sup> It simplifies and significantly reduces minimum capital requirements in an effort to make the corporate form available to more individual investors and to more investors from China's less developed regions. The Old Company Law imposed minimum capital requirements of 500,000 RMB for manufacturing and wholesale trade businesses, 300,000 RMB for sales businesses and 100,000 RMB for service businesses.<sup>10</sup> Though these limits did not significantly restrict state owned enterprises or individual investors in China's wealthier coastal regions, they imposed significant barriers for individual investors and for businesses in the less developed regions.

The New Company Law eliminates both the high minimum registered capital requirement and the system of capitalization based on the type of business. Under the new system, the minimum capital requirement for limited liability companies with two or more shareholders is reduced to 30,000 RMB.<sup>11</sup> For single shareholder limited liability companies, the

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<sup>6</sup> Old Company Law art. 33.

<sup>7</sup> New Company Law art. 35.

<sup>8</sup> *See id.* art. 38, 46, 50.

<sup>9</sup> *See generally id.* art. 26-32.

<sup>10</sup> Old Company Law art. 23.

<sup>11</sup> New Company Law art. 26.

minimum capital requirement is set at 100,000 RMB.<sup>12</sup> The minimum capital requirement is the same for all types of business activities. The intent of this change is to channel as much economic activity as possible into companies formed and registered under the New Company Law. The hope is that the protection of limited liability will encourage economic activity, particularly in currently underdeveloped regions of China.

### C. *Single Shareholder Limited Liability Companies*

The New Company Law now allows natural persons or legal persons to form single shareholder limited liability companies.<sup>13</sup> Under the Old Company Law, a limited liability company was required to have two or more shareholders.<sup>14</sup> In contrast, the new statute provides for a simplified management structure appropriate to single shareholder entities. However, in order to prevent abuse of the corporate structure in single shareholder companies, the New Company Law provides for a number of restrictions:

- the registered capital requirement is increased to 100,000 RMB,<sup>15</sup>
- the entire registered capital amount must be paid in a single installment,<sup>16</sup>
- a single investor may form only one single shareholder company,<sup>17</sup> and
- if the shareholder fails to maintain adequate distance between the finances of the company and the shareholder's personal finances, the shareholder will lose the protection of limited liability and will have joint financial liability for company debts.<sup>18</sup>

These single shareholder provisions illustrate the manner in which the New Company Law attempts to balance the benefits of limited liability status to potential investors while still providing protection to creditors.

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<sup>12</sup> *Id.* art. 59.

<sup>13</sup> *Id.* art. 58-64.

<sup>14</sup> Old Company Law art. 20.

<sup>15</sup> New Company Law art. 59.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* art. 64,

*D. Public and Shareholder Access to Company Information*

The Old Company Law was silent regarding public access to information about companies, and in practice, access was extremely limited. Without the assistance of an attorney or other legal professional, it was generally not possible to access a company's basic registration information.

The New Company Law takes an entirely different and much more public approach. The New Company Law provides that the public has the right to access basic company registration information and further provides that the registration authority must provide consulting assistance in accessing that information.<sup>19</sup> The public will now have access to the following information on limited liability companies:

- name
- registered address
- legal representative
- registered capital
- business classification
- scope of business
- termination date
- identity of shareholders<sup>20</sup>

Under the Chinese system, all of this information is considered essential for creditor protection. The New Company Law takes the reasonable position that creditor protection requires this basic information to be freely available to the public. Since the identity of shareholders is freely available, it is now impossible to use a Chinese limited liability company to conceal the identity of the true party in interest.

The New Company law also significantly expands shareholder access to company information. Under the former system, shareholders had no practical way to obtain information about company operations. This allowed the directors and officers to operate the company for their own benefit and without any effective supervision by the shareholders. Under the new law, the company must maintain the following basic records and make those records available to the shareholder at the shareholder's request:

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<sup>19</sup> *Id.* art. 6, 7.

<sup>20</sup> *Id.* art.7, 25.

- articles of association<sup>21</sup>
- minutes of meetings of the board of directors
- minutes of meetings of the board of supervisors
- tax returns and financial reports<sup>22</sup>

The statute also provides for shareholder access to the company's full financial records. In this case, though, the company has the right to deny access if it believes such access will damage it.<sup>23</sup> This could occur, for example, where a shareholder is also a competitor of the company. If the company willfully withholds information from the shareholder, the shareholder may file suit to force the company to release information.

*E. Abuse of Shareholder Rights and Piercing the Corporate Veil*

The New Company Law introduces the new concept of the abuse of shareholder rights.<sup>24</sup> This concept is intended to protect both the company and third party creditors. The new law provides that shareholders must exercise their rights in accordance with the law, the regulations, and the company articles of association. The shareholder must not abuse the independent legal person status of the company or his own limited liability rights in a manner that harms the interests of the company or its other shareholders or creditors.

Where such abuse damages the company or other shareholders, the offending shareholder is liable for such loss. Where such abuse is used by the shareholder to escape liability for his own debts in a manner that seriously damages the interests of a creditor of the company, the shareholder is jointly liable for such debts. A similar provision is contained in the single shareholder company section. It provides that the shareholder of a single shareholder company who cannot prove that the finances of the company are independent of his or her own finances will have joint liability for the debts of the company.<sup>25</sup> This "piercing the corporate veil" concept is entirely new to China and though it may be useful to prevent obvious abuses, it could also be used to undermine the concept of limitation of liability, which is the foundation of the corporation law concept.

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<sup>21</sup> *Id.* art. 23(3).

<sup>22</sup> *Id.* art. 165, 166.

<sup>23</sup> *Id.* art. 34, para. 2.

<sup>24</sup> *Id.* art. 20.

<sup>25</sup> *Id.* art. 64.

*F. Limitations on Third Party Loans and Guarantees*

Unrestricted debt guarantees to unrelated companies were a major problem under the former company law system. Large companies that appear to be financially solvent are often actually insolvent because they used their profits to acquire unrelated companies or to guarantee the debts of companies related only through the private financial interests of directors, officers, or controlling shareholders. To the detriment of legitimate creditors, the extent of such loans, guarantees, and other security arrangements are oftentimes not exposed until bankruptcy or insolvency proceedings are commenced.

Articles 15 and 16 of the New Company Law seek to remedy this. Article 15 permits a company to invest in another company, but prohibits it from doing so in a manner such that it becomes jointly liable for the debts of the other company. Article 16 provides additional rules concerning the providing of investment or debt guarantees to third party companies:

- the investment or guarantee must be approved by either the board of directors or by the shareholders, as provided in the articles of association,
- where the articles of association limit the amount of investment or guarantee, such limit may not be exceeded, and
- the shareholders must approve a guarantee provided to a shareholder or to the person actually controlling the company. In such cases, the benefiting shareholder may not participate in the decision and approval must be by a majority of the remaining shareholders.<sup>26</sup>

Under this approach, the senior management of the company and individual directors have no authority to make investments or to provide guarantees. This is a significant departure from former practice. This is also an example of the new approach to the articles of association, where shareholders are encouraged to limit potential abuses by specifically limiting the authority of directors and officers.

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<sup>26</sup> *Id.* art. 16.

G. *Legal Remedies for Improper Acts of Directors and Senior Management*

As noted above, a major problem affecting companies in China has been that individual directors and senior management operate the company to benefit themselves while disregarding shareholders' interests. The New Company Law seeks to address this matter directly. First, Article 149 expressly prohibits directors and senior management from engaging in the following acts:

“(1) Misappropriating company funds; (2) Depositing company funds into an individual account; (3) Loaning company funds or providing a company guaranty without shareholder approval; (4) Signing a contract or trading with another company in violation of the articles of association, unless the shareholders expressly consent; (5) Without shareholder consent, seeking business opportunities for oneself or for any other person by taking advantage of one's authority, or operating for oneself or for any other person any business similar to that of the company for which one works, without shareholder consent; (6) Taking commissions on a company transaction ; (7) Disclosing company secrets without permission; (8) Other acts inconsistent with the obligation of fidelity to the company.”<sup>27</sup>

This detailed list of prohibitions is a good summary of the kinds of problems that occurred under the old system.

The Old Company Law did not provide any clear method for shareholders to protect their rights when directors and managers behaved improperly. It was silent on the power of the shareholders to take action in the court system if such activities occurred. As a result, some courts refused to hear shareholder complaints on the ground that the Old Company Law did not authorize them to interfere in a company's internal affairs.

The New Company Law provides a clear set of procedures for shareholder action and specific authority to appeal to the courts to resolve such matters. Article 152 provides that when a director or senior manager violates the provisions of Article 149, noted above, the shareholder(s) holding one percent or more of the total shares of the company may require the company to file suit in the people's court. If the company refuses to file suit, the shareholder may file suit on behalf of the company. In addition, if the interests of the shareholders are directly affected, then the shareholders

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<sup>27</sup> *Id.* art. 149.



may file suit on their own behalf. Article 153 further provides that if any director or senior manager damages a shareholder's interest by violating any law, administrative regulation, or the company's articles of association, the affected shareholders may file suit for compensation.

Under the New Company Law, the court system is intended to be the final authority for protection of shareholder rights and for ensuring that companies comply both with government regulations and with the provisions of their articles of association. These provisions in the New Company Law further underline the importance of the articles of association in governing the company and in protecting shareholder rights.

### III. THE NEW COMPANY LAW'S IMPACT ON FOREIGN INVESTORS

Direct foreign investment in China may be carried out in three forms: a wholly foreign owned entity,<sup>28</sup> an equity joint venture,<sup>29</sup> or a contractual joint venture.<sup>30</sup> These forms of foreign invested enterprise are organized in China as limited liability companies. The statutes and associated regulations provide for specific and unique provisions concerning each of these three forms of foreign investment in China. Where the unique provisions do not apply, the provisions of the New Company Law will control.<sup>31</sup> The foreign invested enterprise statutes and regulations are concerned with approvals and investment percentages, but not with day to day management issues. Accordingly, the fundamental changes introduced by the New Company Law will significantly impact both existing and future foreign invested enterprises in China.

The three foreign invested enterprises laws provide for special treatment of investors in a limited liability company based on the status of the investor. In this case, the status is foreign nationality. Similar status-based distinctions formerly existed for domestic enterprises. For example, wholly state owned enterprises and town and village enterprises were governed by their own unique statutes and regulations. A primary goal of the New Company Law is to eliminate such status-based distinctions for

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<sup>28</sup> See generally Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Oct. 31, 2000) LAWINFOCHINA (last visited Nov. 7, 2006) (P.R.C.).

<sup>29</sup> See generally Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (promulgated by the Nat'l People's Cong., Mar. 15, 2001, effective Mar. 15, 2001) LAWINFOCHINA (last visited Nov. 7, 2006) (P.R.C.).

<sup>30</sup> See generally Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (promulgated by the Nat'l People's Cong., Oct. 31, 2000, amended Oct. 31, 2000) LAWINFOCHINA (last visited Nov. 7, 2006) (P.R.C.).

<sup>31</sup> New Company Law art. 218.

domestic enterprises. As a result, all Chinese companies are in principle formed under the provisions of the Company Law, regardless of the status of the investor.

This change in principle is not the case for foreign investment, primarily because China still provides significant tax benefits and other incentives to foreign invested enterprises. It is essential to be able to characterize a limited liability company as a foreign invested enterprise to maintain these special benefits.

For example, an extremely favorable tax regime provides foreign invested companies with benefits not available to domestic enterprises.<sup>32</sup> This foreign invested enterprises tax regime provides for numerous tax reductions, including the following:

- a reduced fifteen percent tax rate instead of the normal thirty-three percent rate
- exemption from all income tax for certain periods
- rebates of taxes paid upon reinvestment of profits
- exemption from import duty on imports of equipment<sup>33</sup>

In addition, local authorities are authorized to provide additional tax and related incentives to foreign invested enterprises.

This special regime for foreign investors has survived adoption of the New Company Law. These tax and related benefits give foreign invested enterprises a significant business advantage over purely domestic Chinese competitors in the Chinese market, which makes investment in China more attractive for foreign investors.

#### IV. CONCLUSION

The New Company Law intends to make a revolutionary change in the practice of formation and management of corporations in China. However, a mere change in the law is not sufficient to bring about such change. The change will come only if the principles and procedures embodied in the new law are actually adopted and used by entrepreneurs, attorneys and the courts. There is much that suggests that the process of change will be slow and difficult.

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<sup>32</sup> See generally Income Tax Law of the People's Republic of China for Enterprises With Foreign Investment and Foreign Enterprises (promulgated by the Nat'l People's Cong., Apr. 9, 1991, effective Jul. 1, 1991) LAWINFOCHINA (last visited Nov. 7, 2006) (P.R.C.).

<sup>33</sup> *Id.* art. 7, 8, 10.

Some elements of the New Company Law will have an immediate impact. These are elements that can be applied automatically by local government officials and that do not require the participation of legal professionals or the courts. There are three such provisions that should have such immediate impact: the reduction in the amount of registered capital,<sup>34</sup> the provision allowing single shareholder limited liability companies,<sup>35</sup> and the provisions that allow for a simplified management structure for limited liability companies with a limited number of shareholders.<sup>36</sup>

It is realistic to presume that these provisions will be implemented within the existing Chinese system. Each of these provisions can be implemented without the commitment of resources and in a way that is entirely automatic. For the reduction in registered capital and single shareholder companies, this is obvious. The changes are uniform and are applicable throughout the system without the need for local officials to make discretionary evaluations. Management structure is similar. Local authorities can devise a check box form that allows the party forming the company to choose one of two options: either a full board or a single director. Once the choice is made, the local authorities can then proceed in a rigid and formalized manner that does not require discretion or judgment.

The other, more dramatic changes introduced by the New Company Law will encounter implementation problems. As with most Chinese laws, the New Company Law was drafted by a group of sophisticated legal professionals at the top levels of government but with little input from the public or lower levels of the bureaucratic structure.<sup>37</sup> These changes require demand from the public, legal professionals for implementation, government officials for registration, and a court system for enforcement. Given the weak judiciary system and a bureaucracy unaccustomed to handling complex corporate law questions, the New Company Law likely will have little impact on closely held limited liability companies in China. Absent public or institutional demand for such sweeping legislation, the only way the legislation may have any impact is through a combination of massive, government-imposed education and vigorous government enforcement. Since neither of these may happen in China, the New Company law likely will fail to have the significant impact the drafters hoped for.

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<sup>34</sup> New Company Law, art. 26, 59.

<sup>35</sup> *Id.* art. 58-64.

<sup>36</sup> *Id.* art. 61, 62.

<sup>37</sup> The transparency of the legislative process in China has been studied and criticized by many legal scholars. For a brief treatment of this issue and the Chinese law-making system generally, *see generally*, Congressional-Executive Commission on China, *Legislative Transparency of China's NPC*, <http://www.cecc.gov/pages/virtualAcad/gov/legistransp.php>.