

CHINA *journal*

2005 Company Law revision: tuning for a new round of deepened market process

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On October 27, 2005, the Standing Committee of the National People's Congress adopted the latest revision of the Company Law, with its effectiveness coming into force on January 1, 2006 ("2005 Company Law"). The current Company Law was enacted on December 29, 1993 and underwent minor amendments in 1999 and 2004 ("1993 Company Law"). 2005 Company Law has amended 137 provisions, deleted 46 provisions and added 41 provisions on the basis of total 230 provisions of 1993 Company Law, the dimension of which sets a new record of basic-law revision in the legislative history of the People's Republic*.

A quarter of century's market transition has not only enabled China's remarkable economic achievements, but also projected the inborn shortfalls in the system. Momentarily, Chinese policy-makers find themselves fighting at multiple front-lines against acute challenges, which at the top agenda are concerning issues such as unfinished State-owned enterprise restructuring, building up sound corporate governance, revitalization of capital market and investor's confidence, and reformation of financial system and institutions etc. 2005 Company Law is thus embedded in the whirlpool of these challenges and mandates full of expectation and uncertainty.

This issue of **CHINA** *journal* aims to give a brief introduction on the new features of 2005 Company Law and assesses their possible impact on the general environment of doing business

in China. For easier reference, the new features of 2005 Company Law are summarized in the attached table.

Major amendments

Lessened capital burden

The minimal registered capital for a limited liability company ("LLC") and a joint stock limited company ("JSLC") is respectively reduced to RMB 30,000 Yuan and RMB 5 million Yuan. Capital requirement for listing shares at stock exchanges is reduced to RMB 30 million Yuan. In addition, previous requirement of one-off payment of entire subscribed capital is replaced by a more lenient scheme, where at least 20 percent of the subscribed amount should be injected upon incorporation and the rest being paid-off within 2 years. The cap for non-cash contribution is raised up to 70% of the subscribed capital. Former restriction on the amount of investment in other companies (capped at 50% of net assets value) is lifted. These features are welcomed for their potentials to facilitate investment, enhance capital efficiency and encourage innovation.

One-person LLC

A single natural or legal person is now entitled to establish one-person LLC. To ease the worry that the sole investor may misuse the legal person identity of a one-person LLC to escape personal liabilities, certain rules are inserted more stringent than those applicable to an ordinary LLC. For example, the minimal capital is set at RMB 100,000 Yuan and has to be paid entirely upon incorporation. A natural person at one time can establish only one one-person LLC and such LLC is not allowed to set up a sub-layer of one-person LLC. The legal nature of a one-person LLC should be explicitly recorded in the

* The Securities Law was amended on the same date. Considering the correlation of the two laws, it makes more sense under certain circumstances to discuss one law while making reference to related provisions of the other. Therefore, the following discussion on 2005 Company Law would make reference to the stipulations of 2005 Securities Law where appropriate.

business license. A mandatory annual audit of the books is in place. Finally, the sole investor would be jointly liable for the debts of his one-person LLC if he cannot prove that the assets of one-person LLC are independent from his personal assets. However, it is criticized that these precautionary measures may undermine the institutional efficiency that one-person LLC would otherwise promise.

Lowered threshold for JSLC incorporation and IPO

The number of sponsors for incorporating a JSLC is set within the range between 2 persons and 200 persons, with at least half of them having domiciles in the PRC. To incorporate a JSLC no longer needs previous approval from the government and commercial registration can be handled directly with the commercial registry. Private placement (up to 200 targets) of shares is officially recognised, in addition to the conventional means of IPO. In order for going public, a JSLC no longer needs to show profits for the last 3 years. Instead, it is sufficient to present financial records of the last 3 years to demonstrate a continuity of business operation. New issuance of shares is not subject to the 12-month interval rules any more either.

Facilitated transfer and transaction of shares

The frozen period of sponsor share is shortened to 1 year. Situations under which a JSCL is allowed to buy back its own shares are extended to accommodate stock option scheme for employees and dissident shareholders' expression against the resolution of shareholders' meeting on merger and division. Derivatives transactions are officially recognized. For those shares listed at the stock exchanges, trading platforms such as OTC or dealer markets are tacitly endorsed in addition to the centralized trading system of the stock exchanges. Thus, the framework for an increasingly liberal and innovative capital market has been paved out.

Piercing the corporate veil

"The concept piercing the corporate veil describes a legal decision where an officer, director, or shareholder of a corporation is held liable for the debts of the corporation despite the general principle that those persons are immune from suits in contract or tort that otherwise would only hold the corporation

liable"[†]. The personhood of corporation serves the purpose of raising huge amount of capital from the public without putting their personal assets under risks. However, in reality the personhood of corporation may be misused so that individuals escape liabilities from their misdeeds by hiding behind the shell of a corporate body. Under such circumstance, justice and fairness entail the legal apparatus to deny the personhood of the corporation and hold the individuals behind directly responsible. 2005 Company Law has embraced this principle to provide a wieldable instrument to combat potential misdeeds of shareholders.

Improvement of governance

Detailed function definition and operating procedures are provided for the corporate bodies within a LLC or a JSLC, such as shareholders' meeting, board of directors and board of supervisors. Procedural stipulations have been supplemented to regulate situations that 1993 Company Law fails attending to, which as well demonstrates the improvement of legislative techniques. In addition, obligation of loyalty and duty of care that directors and senior managers towards the company are prescribed more concretely.

Protection of minority shareholders' rights

Statutory apparatuses for minority protection include:

- holders of $\geq 10\%$ of share may summon meetings;
- holders of $\geq 3\%$ of shares may bring motions into the meeting agenda;
- grant of accumulative votes;
- right to inspect books and accounts;
- exit right of LLC shareholders;
- derivative suit against directors, supervisors or executives;
- restrictions on associated transaction and insider dealings

It is timely to introduce these features to fight against rampant embezzlement on minority shareholders' rights and interests in Chinese corporate governance environment, and to rebuild the confidence in the capital market.

[†] http://en.wikipedia.org/wiki/Piercing_the_corporate_veil

Extended corporate autonomy

2005 Company Law by and large enhances its nature towards private law. Shareholders are now given the discretion to formulate governing rules on various matters different from law provisions. Such discretion could be full freedom of deviating from what the law proposes. For example, LLC shareholders may decide profit distribution not according to the proportion of their capital contribution. LLC's articles of association may regulate transfer of shares and duties of general manager differently from the statutory stipulations.

Discretion could also be exerted by adding provisions in the articles of association on top of law provisions. For example, more powers might be delegated to the shareholders' meeting, board of directors, board of supervisors and legal representatives than those stipulated in the law. Allocation of voting rights, meeting rules and procedures of shareholders' meeting or board meeting are subject to the articles of association, provided that law does not otherwise stipulate. The legal representative can be chosen between the chairman of the board, the executive director and the general manager.

Applicability to foreign investment

Bifurcated foreign investment regime is kept largely intact, but with certain new elements to be assessed. Article 218 of 2005 Company Law states: "This Law shall apply to limited liability companies and joint stock limited companies with foreign investment. Where laws concerning foreign investment provide otherwise, such provisions shall prevail". Foreign invested JSLC is thus governed by the Company Law, which renders the validity of Decree (1995) No. 1 of the Ministry of Commerce[‡] lack of certainty. As Decree (1995) No. 1 is of the level of "administrative rule" (规章), it should not have prevailing effects over 2005 Company Law which only recognizes the prevailability of FDI-specified "laws" (法律) adopted by the National People's Congress or its Standing Committee. As such, provisions in Decree (1995) No. 1 that are in contradic-

tion to those of 2005 Company Law should be regarded as obsolete upon 2005 Company Law coming into force.

Foreign invested LLC, i.e. equity joint venture, cooperative joint venture or wholly foreign owned enterprise, shall continue applying their respective laws, the provisions of which do prevail over 2005 Company Law if they are otherwise stated. It is however questionable whether the implementing rules of these laws prevail over 2005 Company Law, as they are only at the rank of "administrative regulations" (行政法规) that are produced by the State Council. Given the facts that they are enacted to implement FDI-specified laws, one logical interpretation could be that article 218 of 2005 Company Law does consider them as having prevailing validity. Certainly, this explanation can only be clarified by concrete cases in practice or through supplementing rules that may be released in the coming days.

Impacts on foreign investment

At this stage, no corresponding regulations have been released regarding foreign investment in the aftermaths of 2005 Company Law. Based upon general principles laid down by the Legislation Law and above-mentioned article 218, certain new features introduced in 2005 Company Law would apply to foreign investment LLC since they do not conflict with the present foreign investment laws. These include mainly the following:

- lowered minimal capital (joint venture RMB 30,000 Yuan, wholly foreign owned RMB 100,000);
- up to 70% non-cash contribution;
- non-capped investment in other companies;
- exit right of shareholders;
- derivative suit against directors, supervisors or executives;
- restrictions on associated transaction and insider dealings

Features that do NOT apply to foreign investment LLC include:

- incorporation without previous approval;
- profits distribution not according to capital contribution;
- autonomy of articles to decide transfer of share ;

[‡] Interim Regulation of the Ministry of Foreign Trade and Economic Cooperation on Certain Issues Concerning the Establishment of Joint Stock Limited Companies with Foreign Investment, promulgated on January 10, 1995 and effective as of the same date.

- free choice of legal representative between chairman of the board, executive director and general manager;
- no provisions on unanimous resolutions

As mentioned before, foreign investment JSLC should fully adapt to the stipulations of 2005 Company Law.

Above assessment on applicability of 2005 Company Law on foreign investment will be tested in practice and subject to possible further supplementing rules.

Conclusion

2005 Company Law has conducted a major overhaul of its previous version. Based upon more than a decade of modern corporation experiment, the law presents the gradual achievement of legislative and judicial practices. It has laid down the fundamental groundwork for the deepened market reform that is confronted with various ongoing concerns. In general, it spells out a more market-oriented, liberal and shareholder-protective corporate law involvement. It is crucial for foreign investors to follow its implementation and the possible supplementary regulations that might be released in the coming days, to keep on track with their corporate strategies in the Chinese market.

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Table New Features of 2005 Company Law (compared to 1993 Company Law)

	Limited Liability Company (LLC)	Joint Stock Limited Company (JSLC)	Under 1993 Company Law
Number of sponsors	N/A	2 - 200	>= 5
Number of investors	1 - 50	>= 2	For LLC at least 2
Minimal Capital (RMB)	30,000 (100, 000 for 1-person LLC)	5 million	LLC: 100,000, 300,000 or 500,000 for respective businesses JSLC: 10 million
Schedule of capital payment	Upon incorporation at least 20% of the subscribed capital; Rest paid off in 2 years (holding companies in 5 years)	Upon incorporation at least 20% of the subscribed capital; Rest paid off in 2 years (holding companies in 5 years)	All subscribed capital has to be fully paid in upon incorporation
Non-cash contribution	<= 70% of subscribed capital	<= 70% of subscribed capital	<= 20% of subscribed capital
Legal representative	Chairman of the board, executive director or general manager	Chairman of the board, executive director or general manager	Chairman of the board
Investment in other companies	No more capped amount of investment	No more capped amount of investment	Capped at 50% of the net assets value
Execution of shareholders' right	Voting and profit sharing according to the articles of association	N/A	LLC: according to the capital contribution
Transfer of shares to outsiders	Subject to the articles of association; or Approval by no less than half of the other shareholders	N/A	Approval by no less than half of all shareholders; articles of association may not stipulate otherwise
Frozen period of sponsor shares	N/A	1 year	3 years
Right of exit	Dissident shareholders may require the company to purchase his shares at a reasonable price: (1) where the company refuses to distribute profits for continuous 5 years; (2) where the company merges, divides or transfers its substantial assets; or (3) where the duration of the company is extended. Such right could consist of cause of action under judicial proceedings.	N/A	No such instrument
Protection of minority shareholders	<ul style="list-style-type: none"> - Guarantee provide to shareholders or controlling parties have to be adopted by resolutions of shareholders meeting, where such shareholders or controlling parties have no right to vote; - Prohibition of association transaction with controlling shareholders, controlling parties, directors, supervisors, senior managements; - 10% of share holders can summon meeting; - Right to inspect accounts and books; - Derivative suit against directors and senior management 	In addition to those for LLC <ul style="list-style-type: none"> - 3% share holders may bring motions in the meeting agenda; - Accumulative voting rights 	
Piercing the corporate veil	Yes	Yes	Not explicitly
Duty of care and loyalty of directors and senior management	Yes	Yes	Not explicitly
Condition of listing shares	N/A	Deleted and governed by the stipulations of the Securities Law	
Incorporation by offering shares	N/A	Private placement of shares to specified targets (up to 200) is also recognized	Only IPO
Conditions of bonds issuance	Deleted and governed by the stipulations of the Securities Law	Deleted and governed by the stipulations of the Securities Law	