The Franchise Lawyer Winter 2024

Primer on Important Amendments to the Chinese Company Law

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Aug 23, 2024 7 min read

Summary

- Under the new amendments to the Company Law, a shareholder of a limited liability company must contribute their subscribed registered capital in full within five years from the date of the company's formation.
- In view of the heightened obligations placed on directors and officers, companies operating in China should consider implementing enhanced compliance and ethics policies with periodic audits to ensure compliance.
- The new amendments also include expanding the grounds upon which a company and its directors and senior management may be held liable.

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BOE Technology Group Co., Ltd. v. Paneltouch Technologies LLC, IPR2025-01483



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Many American and European franchisors have entered the Chinese market by setting up subsidiaries or associated entities in China. Some of these entities are wholly owned subsidiaries that operate direct stores in China, while others provide support to Chinese franchisees, and others are joint venture vehicles. Like every other company registered to do business in China, these subsidiaries and associated entities are governed by China's Company Law.

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At one time, China's Company Law was not particularly demanding. But the Chinese government recently passed a series of amendments to the Company Law, which enact substantial regulation in areas such as capital contribution, corporate governance, and management responsibilities. These new laws took effect on July 1, 2024. This article highlights some of the most important changes to the Company Law and offers general guidance for compliance with the new requirements.

Capital Contribution

China's Company Law has always required some amount of committed registered capital—a minimum level of capital that shareholders must contribute to the company they own. But in the past, the Company Law did not regulate a specific required timeline for capital contributions. It was not uncommon for shareholders of Chinese companies to withhold considerable amounts of outstanding capital contributions until after the entity started generating income.

Under the new amendments to the Company Law, a shareholder of a limited liability company must contribute their subscribed registered capital in full within five years from the date of the company's formation. By analogy, the increased part of registered capital applies the same five-year timeline. On the same date the amendments to the Company Law took effect, the People's Republic of China State Council released new implementing rules, effective immediately, governing registered capital—the Provisions on the Implementation of Registered Capital Registration Management System of the Company Law ("Provisions on Registered Capital"). Thes rules provide for a three-year transition period for the launching of the new registered capital system for existing companies, according to which all existing companies with a contribution period exceeding five years from July 1, 2027, will need to amend their Articles of Association to ensure compliance with the new five-year rule. Companies with a remaining contribution period of less than five years, on the other hand, will not be required to make any adjustments during the transition period.

The new law also provides teeth to these requirements. In the event that a shareholder fails to pay the required capital contribution, or the actual value of the in-kind capital contribution made by a shareholder is significantly lower than the amount of capital subscribed, all the shareholders at the time of the company's formation will be jointly and severally liable for the shortfall in capital contribution. This is a powerful incentive to ensure that all shareholders provide timely capitalization.

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Under the new Company Law, the Chinese company registration authority—the Administration for Market and Regulation or "AMR"—is vested with the power to examine the amount and the permitted period of capital contribution. AMR can require shareholders to adjust their contributions.

Accordingly, with the amendments to the Company Law taking effect imminently, management of companies registered in China should check to see (i) whether any shareholders still owe outstanding capital contributions, and (ii) whether it might be necessary or desirable to reduce the registered capital.

Employee Participation in Corporate Governance

Under the old Company Law, only state-owned companies are required to have employee representatives on their board of directors. The newly amended Company Law goes further, extending application of the employee representative rule to private companies with more than 300 employees, unless the company has a board of supervisors on which employee representatives sit. Either way, employee representatives must be elected by the company's employees through the employees' congress or meetings.

For companies with less than 300 employees, if there is only one supervisor (instead of a full board of supervisors), the new Company Law does not require the company to have any employee representatives. However, if the company has a full board of supervisors, the new amendments require that no less than one-third of that board be constituted by employees.

In light of these changes to the Company Law, Chinese companies should (i) check to determine whether they are above or below the 300-employee threshold, and (ii) if they are under that threshold, consider whether they have a supervisory board as opposed to a single supervisor. If the company exceeds the threshold, or the company has a board of supervisors, they will need to ensure sufficient employee participation in the management of company affairs.

Legal Representative

The old Company Law allows the chairman of the board, the sole executive director (if there is no board of directors), or the general manager of a limited liability company to act as the company's legal representative, regardless of whether such person is actually involved in the company's business. The new Company Law both expands and contracts the pool of

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candidates that may serve in that role to any director who "handles company affairs" on the company's behalf or the general manager.

While it is not clear what is meant by "handles company affairs," it is likely that any current legal representative could keep his or her position as legal representative by, among other things, attending board meetings that consider resolutions on major business matters and the execution of contracts. Prospective legal representatives must take notice, however, that the newly amended Company Law imposes greater duties and obligations on them. For example, in the event that the Chinese government prosecutes officers for regulatory violations, the new Company Law no longer allows the defense of absence of knowledge of the wrongful acts. Moreover, the new Company Law requires legal representatives to affirmatively exercise reasonable diligence. Accordingly, under the new Company Law, ignorance is not a defense, and legal representatives have a strong incentive to educate themselves regarding the company's business operations.

The new Company Law also clarifies that if the legal representative resigns from his position as a director or manager of the company, his office as the legal representative is vacated simultaneously with that resignation. The company must appoint a new legal representative within 30 days from the date of resignation.

In view of the heightened obligations placed on directors and officers under the newly amended Company Law, companies operating in China should consider implementing enhanced compliance and ethics policies with periodic audits to ensure compliance. Implementing quick corrective action when violations of the Company Law are discovered can help to mitigate exposure and potential liability.

Duties of Loyalty and Diligence

The newly amended Company Law defines the fiduciary duties of loyalty and diligence as follows:

> (a) directors, supervisors, and senior management must take measures to avoid conflict of interests with the company, and they should not use their authority to seek improper personal benefits; and
>
> (b) directors, supervisors, and senior management must perform their duties in the best interests of the company with the reasonable level of care normally

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> expected of management personnel.

Additionally, the controlling individual shareholders and the actual controllers of a company who do not serve as directors of the company, but in an executive role, also bear duties of loyalty and diligence. As these provisions are broad and somewhat vague, it should be expected that their precise meaning and application will be tested over time.

Liability of Directors and Senior Management

The new amendments to the Company Law expand the grounds upon which a company and its directors and senior management may be held liable. Under the new law, if a director or senior manager causes losses to a third party while performing their duties for their company, the company can be held liable for such losses. The directors or senior managers may also be held personally liable if the third party's losses were caused by willful misconduct or gross negligence.

If a controlling shareholder or an "actual controller" (a non-shareholder who can nevertheless control a company through voting rights, investment relations, or by agreements) of the company instructs a director or senior manager to perform any act that violates the law or harms the interest of the company or its shareholders, the controlling shareholder or actual controller may be held jointly and severally liable, together with the acting director or senior manager, for any damages caused by the conduct they directed. In this situation, ordinary supervisors are excluded from the definition of senior management. The prevailing opinion in China remains that, unlike directors and senior management, a supervisor can only cause loss to the company by his or her own acts or omissions in the performance of his or her duties.

Directors and senior management, on the other hand, are required to exercise independent judgment and ensure compliance with all applicable laws while performing their duties. To minimize the risk of liability and safeguard the best interests of the company, as well as its officers and senior management, companies registered in China will be well served by crafting and implementing a careful compliance policy and reinforcing that policy through robust periodic training programs.

Conclusion

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The formal amendments to the Company Law are only the start. Businesses operating in China can expect the Chinese government to pass implementation rules or transitional measures that should help to clarify gray areas. Such implementation rules can be expected in the coming months. In the meantime, franchise-affiliated entities in China should keep an eye on further developments concerning the new Company Law. Companies should also consult directly with their local Chinese counsel and advisers, as the precise scope and application of the new Company Law will become clearer as it is enforced by Chinese regulators.

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