SQUIRE PATTON BOGGS

Key Considerations for Amending AoAs Under the New Company Law

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The amended PRC Company Law ("New Law") will come into force on July 1, 2024. As the New Law makes significant changes in many respects, including corporate governance, capital contribution, and duties and liabilities of directors and executive officers, companies in China need to revisit and amend their articles of association (AoAs) in compliance with the requirements under the New Law.

This article highlights certain key issues that may need to be considered in amending AoAs of limited liability companies (LLCs). For the implications of the New Law on joint stock companies, please refer to our article "Is It a Good Time To Consider a Joint Stock Company?".

1. Corporate Governance

Currently, all companies in China must have one or two supervisors or a board of supervisors (BOS) composed of at least three members, who have statutory powers to, among other things, inspect financial operation and supervise the directors and officers of the company. In practice, such a supervisory organization may seem superfluous for LLCs. No supervisor or BOS will be required under the New Law if (i) with respect to a company with a limited number of shareholders or otherwise of a small scale, unanimously agreed upon by all the shareholders, or (ii) with respect to any company, an audit committee composed of directors is established to exercise the powers that would otherwise vest in supervisors or BOS.

Companies should assess whether they need to maintain any supervisor or BOS, taking into consideration the requirement under the New Law that a company with 300 or more employees must have at least one employee representative on its board of directors (BOD) elected through a democratic procedure, unless it has such an employee representative on its BOS. Though not entirely clear under the New Law, it appears that such requirement on an employee representative might be applicable only where a company has a BOD as opposed to a sole director.

Given the changes under the New Law, a company that has less than 300 employees may consider a straightforward governance structure composed of a BOD or a sole director only, without a BOS (or any supervisor) or any audit committee. A sole-shareholder company that has 300 or more employees may want to appoint a sole director instead of a BOD, which might exempt it from the requirement on an employee representative. A sole director would unlikely work for a joint venture, and, therefore, a joint venture that has 300 or more employees may need to have an employee representative on its BOS so that such employee representative would not have to sit on its BOD. In any event, having two supervisors respectively appointed by joint venture partners, which is permitted under the current law and typically used by joint ventures in China, will no longer be viable under the New Law.

2. BOD Meeting Quorum and Resolutions

Under the current law, an LLC has broad discretion to determine its rules with respect to the BOD meeting procedures, including those related to the quorum for a BOD meeting. Pursuant to the New Law, the quorum for a BOD meeting must be at least more than 50% of all the directors. In practice, joint venture partners typically agree that if a proposed BOD meeting fails to meet the quorum repeatedly, the directors present at an adjourned meeting will constitute the quorum, subject to certain conditions. Moreover, an exception may also be created with respect to the quorum for a BOD meeting called for the review of related party transactions between the company and one of its shareholders (e.g., directors appointed by the shareholder at issue will be recused and not counted in the quorum). It seems unclear under the New Law whether such exceptions remain enforceable.

The New Law also sets the rule that BOD resolutions must be passed upon affirmative votes of more than 50% of all the directors as opposed to the directors present at a duly convened BOD meeting. Whereas the New Law includes an exception that a director must be recused from, and will not be counted in the total number of directors for the purpose of, voting on certain types of transactions between the company and such director or their associates that would otherwise constitute a conflict of interest, it seems unclear whether other exceptions to the required affirmative votes, if included in joint venture contracts or AoAs, will be enforceable under the New Law.

Given the foregoing statutory requirements on a BOD meeting quorum and resolution, a BOD, especially that of a joint venture, may more likely slip into a deadlock. Therefore, LLCs may want to revisit the deadlock clauses in their joint venture contracts and AoAs to assess whether the existing procedures and consequences (exercise of a buyout option, liquidation of the company, etc.) are still appropriate to resolve deadlocks that may occur more often.

3. Capital Contribution

The New Law requires that the registered capital of an LLC must be contributed in full within five years following the establishment of such LLC. Existing LLCs will have a grace period to amend its capital contribution schedule to comply with such five-year limit under the New Law. Based on a draft regulation released by the State Administration for Market Regulation (SAMR) for public comments, China may require existing LLCs to amend their capital contribution schedules, if non-compliant with the New Law, by June 30, 2027, to the effect that all outstanding capital will be contributed within five years from July 1, 2027 (i.e., the registered capital will be contributed in full by June 30, 2032). If the remaining contribution time limit is less than five years from July 1, 2027, such contribution schedule will not need to be updated. In addition, pursuant to the draft SAMR regulation, where an existing company "undertakes significant strategic assignments, has an impact on national well-being and people's livelihood, or is involved in national security or significant public interest", it may not need to update its capital contribution schedule (even if non-compliant with the New Law), subject to the approval of the competent authority in the State Council or the applicable government at or above the provincial level.

Once the grace period is officially determined, shareholders of LLCs should assess whether they are able to complete the capital contribution within such period. If contribution in cash is onerous, shareholders may want to amend the company's AoA allowing capital contribution in kind. Notably, the New Law expressly allows the assignment of "creditor's rights" as capital contribution, which, at least in theory, include receivables. Alternatively, shareholders may consider reducing the company's registered capital, though such a capital reduction would be subject to restrictions under laws (e.g., creditors of the company would have the right to require a collateral or guarantee or the repayment of debts) and may also trigger obligations and liabilities under contracts with third parties, including local government authorities (e.g., consents of third parties might be required).

The time limit for capital contribution is not the only thing that should be considered in determining whether any amendment to the registered capital (if not fully contributed) of an LLC should be made. In particular, under the New Law, creditors of an LLC may require a shareholder of such LLC to make capital contribution prior to the date on which such contribution becomes due under the LLC's AoA if that LLC is "unable to pay off its due debt," which appears to be a low threshold to reach. If a shareholder fails to make capital contribution in accordance with the AoA, risks are not only on the part of such defaulting shareholder, as any other shareholder existing upon the establishment of such LLC may be held jointly and severally liable, under the New Law, for the outstanding capital that the defaulting shareholder is obligated to contribute.

If a shareholder fails to make capital contribution in accordance with the company's AoA despite a written demand from the company for the payment within a grace period, which must be no less than 60 days of the date of the demand, the New Law allows the company to, upon the approval of its BOD, forfeit the equity interest of such shareholder that relates to the outstanding capital contribution. The forfeited equity interest must be sold to third parties or cancelled by a capital reduction within six months. If such sale or cancellation is not completed within such six-month period, the other shareholders would be obligated to contribute the outstanding capital subscribed for by the defaulting shareholder, resulting in a change in the equity interest of the company respectively owned by its shareholders, which may not always be desirable. Given the potential significant consequences of such a forfeiture, companies may want to consider incorporating the conditions, limitations and procedures in connection with such forfeiture in their AoAs.

4. Removal of Directors

The New Law imposes more stringent duties of loyalty and diligence on directors, supervisors and executive officers and expands their liability exposure. For details, please refer to our article "What Directors Should Know About the New Company Law".

In addition to directors' duties and liabilities, companies should be aware that directors are allowed, under the New Law, to claim compensation from shareholders if they are removed without a "justifiable cause" prior to the expiry of their term of office. The New Law does not specify what "justifiable causes" are, and, therefore, companies may consider enumerating such causes in their AoAs, which might include a director's breach of law, the AoA of the company, or any resolution of the shareholders or the BOD, their repeated failures to attend duly convened BOD meetings, expiry or termination of the employment relationship between such director and the company or any of its affiliates for any reason, and any change in control of the company or its affiliates. Though there is no guarantee that any such cause will be accepted as "justifiable" in judicial practice, it would, at least, establish a legal basis on which shareholders may defend a director's claim for compensation.

From a practical point of view, instead of "removing" directors, it may work better if shareholders have directors sign resignation letters with a release and waiver.

5. Transfer of Equity Interest to Third Parties

Under the New Law, unless otherwise provided in the AoA, the transfer of equity interest in an LLC by a shareholder to a third party will no longer be subject to the consent of other shareholders, though the other shareholders still have the right of first refusal with respect to such equity interest. As a result of the requirements under the current law, AoAs of existing LLCs typically include articles in connection with the consent of non-transferring shareholders required for a shareholder to sell its equity interest in an LLC to a third party. If such articles stay in the AoA after the New Law becomes effective, they would prevail.

As a matter of practice, most LLCs in China do not have a register of shareholders, though this concept is not new. Because the New Law makes it clear that an investor will be recognized as a shareholder of a target company upon being recorded in such company's register of shareholders, LLCs need to create such registers and incorporate articles related to the creation, updating, maintenance and use of such registers in their AoAs.

6. Others

The amendments that may need to be made to existing AoAs are not limited to those discussed above. The New Law may also have an impact on, among other things, the appointment of the legal representative, the allocation of responsibilities of the shareholders' meeting, BOD and the general manager of a company, declaration and distribution of dividends, and liquidation. With the support of advisors, companies should conduct a comprehensive review of their AoAs and, if applicable, joint venture contracts to address the changes arising from the New Law.

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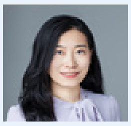

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