SQUIRE PATTON BOGGS

What Directors Should Know About the New Company Law

Asia Pacific – 7 February 2024

One of the significant changes under the amended Company Law ("New Law") that will come into effect from July 1, 2024, is that the board of directors (BOD) of a company no longer "reports to" the shareholders and is, instead, generally expected to act in the best interest of the company. In connection with this change, the New Law expands the duties of the BOD and imposes additional liabilities on directors, supervisors and executive officers.

1. Expanded Duties

A. Inspection of Capital Contributions

The New Law requires the BOD to inspect the shareholders' capital contributions after the formation of the company. If any shareholder has failed to make its capital contribution in full within the timeframe set forth in the articles of association (AoA) of the company, the BOD is obligated to issue, in the name of the company, a demand letter to such a shareholder with respect to the outstanding contribution. Where the BOD fails to perform this obligation, any responsible director would be held personally liable to the company for any loss arising therefrom. The law, however, does not specify the criteria for identifying a "responsible" director in such event.

To fulfil such obligations, each director on the BOD should be aware of the capital contribution schedules set forth in the AoA and make inquiries about the status of any such contribution. Where capital contribution is made in kind, it would be sensible to require and review a valuation report with respect to the assets being contributed to verify that the value of the assets is not lower than the subscribed capital.

B. Withdrawal of Contributed Capital

A shareholder is prohibited from withdrawing any registered capital that has been contributed to the company. In the event of a breach, under the New Law, the defaulting shareholder and any responsible director, supervisor and executive officer would be jointly and severally liable for any loss of the company arising therefrom.

Withdrawal of contributed capital may be disguised in the form of distribution of inflated dividends or fabricated related party transactions. When reviewing a transaction that may result in a payment or distribution by the company to a shareholder or any of its affiliates, directors should, with the assistance of legal and financial professionals, assess the legitimacy of such transaction.

C. Reduction of Registered Capital

Under the New Law, where a company reduces its registered capital in violation of the law, the shareholder must return the funds that it received as a result of the capital reduction, and, among others, any responsible director, supervisor and executive officer would be liable for any loss of the company arising therefrom. Due to the time limit for the full capital contribution under the New Law, as discussed in detail in our article "Key Considerations for Amending AoAs under the New Company Law," many companies may need to reduce their registered capital, giving rise to the risks associated with an illegal capital reduction.

The BOD of a company is responsible for developing a plan for a capital reduction to be approved by its shareholders under both the current law and the New Law. Consequently, directors who voted, without a proper review, in favor of such a plan that does not comply with the statutory requirements under the law might be held "responsible" for any loss of the company arising from capital reduction.

In principle, the statutory requirements on a capital reduction include, among other things, (i) the company must notify creditors within 10 days of the shareholders' resolution approving the reduction and must publish an announcement of the reduction within 30 days of such shareholders' resolution, (ii) creditors of the company have the right to require a collateral or guarantee or the repayment of debts, (iii) unless otherwise agreed upon by the shareholders (or, in the event of a joint stock company, set forth in the company's AOA), the capital must be reduced in proportion to the shareholders' capital contributions (or, in the event of a joint stock company, the shares owned by the shareholders), and (iv) under the New Law, a capital reduction for the recovery of accumulated losses of the company must not result in a return of the reduced capital to any shareholder.

D. Distribution of Dividends

Similar to an illegal reduction of registered capital, in the event that a company distributes dividends to shareholders in violation of law, any responsible director, supervisor and executive officer would be liable for any loss of the company arising therefrom. Notably, the development of a plan of distribution of dividends for the approval of the shareholders falls within the statutory duties of the BOD under the law as well.

In addition to the restrictions under the current law on the distribution of dividends (e.g., recovery of accumulated loss, and allocation of after-tax profits to statutory surplus reserve), directors should be aware of the additional restrictions under the New Law, including (i) where the company reduced its capital for recovery of accumulated loss, no dividend is allowed to be distributed until the statutory surplus reserve and discretionary surplus reserve of the company, in aggregate, reaches 50% of its registered capital, and (ii) the BOD must distribute dividends to shareholders within six months of the shareholders' resolution approving such distribution.

E. Liquidation

Under the New Law, directors rather than shareholders are the "liquidation obligors" of a company, who must set up a liquidation committee for the liquidation of the company within 15 days of the occurrence of a dissolution event. Moreover, unless otherwise set forth in the company's AoA or resolved by the shareholders, the liquidation committee will be composed of directors. A director who fails to perform their liquidation obligations may be held personally liable to not only the company, but also the creditors of the company for their loss.

2. Conflicts of Interest

A. Restrictions Under the New Law

In furtherance of the duties of loyalty owed by directors, supervisors and executive officers to the company, the New Law imposes specific restrictions on certain transactions between the company and such person or their associates that may give rise to conflicts of interest. In particular, the New Law expressly prohibits any director, supervisor and executive officer, any close relative of such person, any enterprise directly or indirectly controlled by such person or their close relative and any other "associate affiliated with such person" from entering into any contract or conducting any transaction with the company, unless the contract or transaction has been reported to, and approved by, the shareholders' meeting or the BOD of the company in accordance with the company's AoA. Such restrictions under the New Law appear to be more stringent than the conflicts of interest rules commonly adopted by companies in many respects, including the prior reporting and approval requirement and the extension of restrictions to cover "associates affiliated with" directors, supervisors and executive officers.

Moreover, directors, supervisors and executive officers are also prohibited, under the New Law, from (i) taking advantage of their positions to seek any business opportunity of the company, unless it has been reported to, and approved by, the shareholders' meeting or the BOD of the company in accordance with the company's AoA or the company is unable to utilize such a business opportunity due to the restrictions under law or the company's AoA, and (ii) engaging in, on their own or for the benefit of others, any business that falls within the same category of business as conducted by the company, unless it has been reported to, and approved by, the shareholders' meeting or the BOD of the company in accordance with the company's AoA.

B. Restrictions under the Criminal Law

In addition to the New Law, directors should be aware of the changes under Amendment 12 to the Criminal Law of the People's Republic of China (Amendment), which will become effective on March 1, 2024. Under the Amendment, the scope of subjects that may commit a criminal offense in relation to conflicts of interest is expanded from personnel of state-owned enterprises only to personnel of all enterprises, including their respective directors, supervisors and executive officers.

Pursuant to the Amendment, personnel of any company would be subject to criminal liabilities if they (i) assign any profitable business of the company to any of their relatives and friends, (ii) purchase products or services from any vendor operated or managed by any of their relatives and friends at a price obviously higher than the market price, or sell products or services to any customer operated or managed by any of their relatives and friends at a price obviously lower than the market price, (iii) purchase substandard products or services from any vendor operated or managed by any of their relatives and friends, (iv) take advantage of their positions in the company to conduct, on their own or for the benefit of others, any business that falls within the same category of business as conducted by the company, or (v) sell or contribute any asset of the company at a low price for personal gain, in each case resulting in significant loss for the company. The monetary thresholds for "significant loss" are currently quite low (e.g. between CN¥100,000 and CN¥300,000) and are being amended.

Notably, like the term "associates affiliated with such person" as used in the New Law, the Amendment is applicable to transactions between the company and any "relatives and friends" of any personnel of the company, which may be interpreted to include a broad scope of people.

3. Liabilities to Third Parties

Under the New Law, where a company is liable to third parties for damages caused by directors and executive officers in the performance of their duties, such director or executive officer would also be held personally liable to third parties if such damage arises from their willful act or gross negligence. Currently, a third party may claim personal liabilities of directors only in very limited circumstances, e.g., misrepresentation made by a listed company arising from directors' breach of their duties of diligence.

It seems unclear under the New Law whether a third party may claim personal liabilities of directors in the situation where the third party's interest is indirectly damaged, e.g., the company suffers loss as a result of directors' willful act or gross negligence, which makes the company unable to pay such third party.

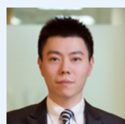
4. Mitigation of Risks

Given the changes under the New Law, directors should become familiar with the obligations and requirements under applicable laws and the company's AOA that are related to their duties. In addition, they may consider obtaining advice from professionals on significant matters of the company that may give rise to personal liabilities.

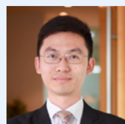
From a company's perspective, they may need to update their AoAs and internal ethics policies to be consistent with the requirements under the New Law and the Amendment, especially those in relation to the prior reporting and approval of proposed related party transactions with directors, supervisors and executive officers or their associates. A company may also consider requiring disclosure by such person of any transaction that may constitute conflicts of interest on a regular basis.

It may also be advisable that a company procures directors and officers liability insurance (D&O liability insurance) or, if already procured, review the existing D&O liability insurance policy to determine whether the exceptions to the insurance coverage are appropriate (e.g., whether liabilities arising from directors' gross negligence are excluded) and whether such insurance covers the directors and officers of the joint ventures established by such company.

Contacts



Ryan Chen
Partner, Shanghai
T +86 21 6103 6358
E ryan.chen@squirepb.com



Jerry Wang
Associate, Shanghai
T +86 21 6103 6310
E jerry.wang@squirepb.com

About Us

With more than 1,500 lawyers located in more than 40 offices across four continents, we are a truly global legal practice with the eighth largest footprint of all international law firms. Our presence in all the major financial and industrial centers, as well as emerging markets, allows us to provide seamless corporate advice to our clients wherever they do business. We provide a "one-stop shop" service with expertise in relevant practice areas, such as corporate, competition/antitrust, labor and employment, intellectual property, public policy, regulatory compliance, and tax strategy and benefits.

Composed of experienced professionals from the public and private sectors, as well as the international community, our public policy platform provides unique support to our corporate clients and guides them through the complex intersection of business, law and policy.

The opinions expressed in this update are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

squirepattonboggs.com

© Squire Patton Boggs. All Rights Reserved 2024

64519/02/24