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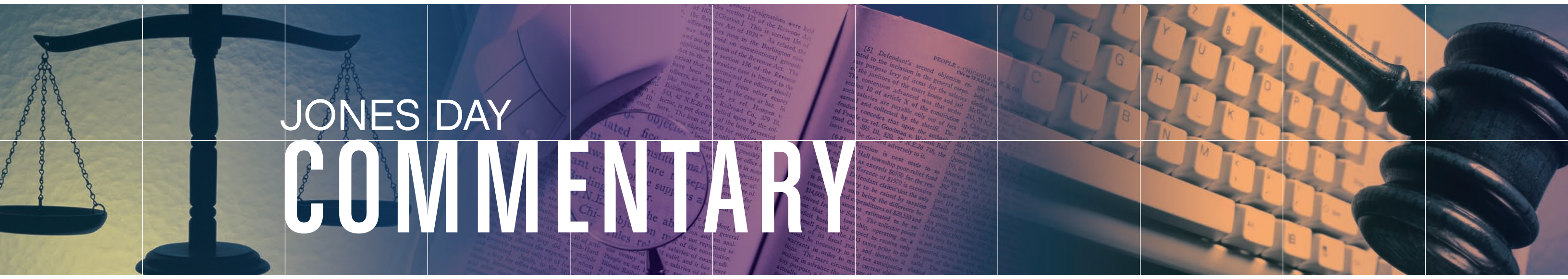


# OVERVIEW OF THE NEW PRC COMPANY LAW

The new Company Law of the People's Republic of China ("New Law"), which was adopted by the Standing Committee of the National People's Congress on October 27, 2005, came into force on January 1, 2006. The New Law is a significant milestone in the reform of the Chinese company law as well as the entire Chinese legal system. Substantial changes have been made in the following areas of the law.

## INCORPORATION THRESHOLD LOWERED

The New Law lowers the incorporation thresholds for both limited liability companies ("LLCs") and joint stock limited companies ("JSLCs") in the PRC.

**Minimum Registered Capital Requirement.** Under the old PRC Company Law ("Old Law"), the minimum registered capital requirement for setting up domestic LLCs varied from RMB 100,000 to RMB 500,000, depending on the type of business principally engaged in by the company. Such variation has been replaced with a standard minimum capital of RMB 30,000 under the New Law. For JSLCs, the New Law also significantly reduces the minimum registered capital threshold from RMB 10 million to RMB 5 million. However, if any specific laws or regulations other than the New Law provide for higher thresholds for different industries, such provisions shall prevail.

**Capital Contribution by Installment.** Another important amendment is that the New Law for the first time allows the registered capital to be paid by installment. It requires the initial contribution to be not less than 20 percent of the total registered capital, with the remainder to be paid within two years (or five years for investment companies), provided such initial contribution reaches the minimum capital requirement as set forth above. However, in the case of a JSLC, it should be noted that no share may be offered to the others by way of public offer or placement of shares until the registered capital is contributed in full.

**Varieties of Capital Contribution.** The previous requirement that capital contribution in the form of technology should not exceed 20 percent of the company's registered capital has been abolished. It has been replaced by a minimum requirement of a 30 percent cash contribution, which means in effect that the proportion of capital contribution in the form of technology can be increased to as much as 70 percent of the company's registered capital. Once again, if any specific laws or regulations other than the New Law provide otherwise, such provisions shall prevail.

The New Law also brings in more varieties of noncash assets that can be contributed to companies' registered capital. Apart from tangible assets, intellectual property rights, and land-use rights, the New Law provides for a catch-all provision permitting contribution of any kind of noncash assets that are transferable and can be monetarily valued. However, this catchall provision has been supplemented by the Administrative Regulations on Registration of Registered Capital of Companies of the PRC ("Regulations"), promulgated by the State Administration of Industry and Commerce ("SAIC") on December 27, 2005, and effective January 1, 2006. The Regulations stipulate that certain categories of noncash assets, such as services, creditworthiness, names of natural persons, goodwill, franchises, or encumbered properties, may not be contributed to companies' registered capital.

## SINGLE-SHAREHOLDER LLC ALLOWED

As in Hong Kong and some other jurisdictions, the requirement that domestic LLCs must have at least two shareholders has been removed. The New Law now permits an LLC to be established by a single natural or legal person. However, the New Law imposes more stringent requirements on single-shareholder companies. The minimum registered capital of a single-shareholder LLC is RMB 100,000, which is much higher than that required for a normal LLC, and it must be contributed in full upon establishment. Moreover, a natural person may establish only one single-shareholder company, and such single-shareholder company is not allowed to invest in or establish any other single-shareholder company.

## RESTRICTIONS ON COMPANY REINVESTMENT ELIMINATED

The restriction limiting the size of a company's reinvestment to 50 percent of its net assets has been eliminated. Under the New Law, a company may freely invest in other enterprises, provided it does not assume any joint and several liabilities for the debts of such enterprises. This would greatly encourage companies' investment activities and liberalize the legal environment for M&A.

## PROTECTION OF MINORITY SHAREHOLDERS INTRODUCED

In order to bring the Chinese company law in line with the international norms in force, the New Law aims to enhance the protection of shareholders. A variety of new provisions on shareholders' rights and remedies have been introduced in this regard.

**Company's Books and Records.** Shareholders of either an LLC or a JSLC are granted a statutory right to access the company's information under the New Law. Shareholders may now ask to inspect and make copies of the company's articles, its financial reports, minutes of the shareholders' meetings, and resolutions of the meetings of the board of directors and the supervisory board. Shareholders of an LLC may even ask to inspect the company's accounting books and records.

Among the most important changes is that company search services are now available to members of the public. In the past, filings by private companies at the SAIC might not be open for inspection by the general public. The practice varied from city to city within the PRC, making company searches very difficult, and how this new policy will be implemented by each of the local authorities remains to be seen.

**Shareholders' Meetings and Resolutions.** Shareholders of either an LLC or a JSLC holding 10 percent or more of the voting rights of the company are now entitled to convene a shareholders' meeting themselves if both the board and the supervisory board are unable to convene such a meeting or if they fail to do so. The New Law also confers upon the shareholders the right to petition the court to revoke any shareholders' or board resolution if either (i) the convening procedures or voting methods adopted in the relevant meeting violate the law or the company's articles; or (ii) the resolution itself runs counter to the company's articles.

**Cumulative Voting System.** The New Law also allows for a cumulative voting system for the appointment of directors or supervisors of a JSLC. Under such a voting system, each share will carry the same number of votes as the number of directors or supervisors to be elected, and the shareholder may cluster his/her votes.

**Share Repurchase.** Another major breakthrough introduced by the New Law is the exit mechanism provided for shareholders, in particular minority shareholders. They may now ask the company to repurchase their shares at a reasonable price if they oppose: (i) the company's decision not to distribute dividends for five consecutive profit-making years; (ii) any merger or spinoff of the company or the disposition of the company's major assets; or (iii) the renewal of the company's term of operation upon its expiration or the amendment of the company's articles upon the occurrence of any other grounds for dissolution as specified in the articles.

It should be noted that the above option for share repurchase is not available to shareholders of JSLCs. The only exception is in cases of mergers or spinoffs. Any shareholder of a JSLC who votes against the relevant resolution may ask the company to repurchase his/her shares. Other instances where a JSLC may repurchase its own shares include reducing its registered capital, merging with another company holding its shares, and granting incentive shares to its employees. Shares so repurchased by the company shall have no voting rights and no right to dividends. Share repurchase is a relatively new concept in the Chinese company law, however, and how this will work in practice remains uncertain.

**Dissolution.** Apart from the share repurchase mechanism, the New Law provides for an alternative way out for minority shareholders in situations in which they have been unfairly prejudiced. Shareholders of either an LLC or a JSLC holding 10 percent or more of the voting rights may petition the court to dissolve the company if (i) the company is in serious operational difficulties; (ii) its continuing existence will seriously prejudice the interests of the shareholders; and (iii) such difficulties cannot be resolved through any other means.

**Derivative Suits.** The New Law also offers minority shareholders a number of legal remedies for recourse. A major amendment to this regime is that the New Law gives the minority shareholders a statutory right to bring derivative suits in court. Any shareholder of an LLC or shareholders of a JSLC holding more than 1 percent of the shares of the company for more than 180 consecutive days (which is the lowest shareholding threshold among those required for other shareholders' remedies under the New Law) may bring legal proceedings in their own name on behalf of the company against (i) directors, supervisors, or senior management who fail to comply with the laws and regulations or the company's articles in the course of performing their duties, causing loss to the company; or (ii) third parties infringing upon the lawful rights and interests of the company, causing loss to the company.

## PROTECTION OF CREDITORS INTRODUCED

The New Law introduces into the Chinese company law the common-law doctrine of "piercing the corporate veil," which allows creditors to access the assets of the shareholders for the repayment of company debts. Under this principle, shareholders will be jointly and severally liable with the company for the company's debts if they abuse the "independent corporate legal personality" or the "limited liability" of the company in order to evade liabilities, and therefore seriously prejudice the interests of the company's creditors.

In case of a single-shareholder LLC, more stringent requirements are again imposed by the New Law by shifting the burden of proof onto the single shareholder. The New Law stipulates that if the single shareholder fails to prove his/her assets are independent from those of the company, the single shareholder shall be personally liable for the company's debts.

However, since the New Law does not lay down detailed guidance or definitions for the use of the specific terms under these new provisions, court interpretations will be needed to see how this new concept will work in practice.

## CORPORATE GOVERNANCE

Various efforts have also been made by the drafters to improve corporate governance in the PRC. For instance, the New Law expressly provides that directors, supervisors, and senior management shall owe the company a duty of care and a duty of loyalty, and that no company loan shall be granted to them. Further, if any board resolution violates the law, articles, or resolutions of any shareholders' general meeting of a JSLC, thereby causing serious loss to the company, the directors who voted for such resolution shall be made personally liable to the company for such loss.

## APPLICATION ON FIEs

Foreign investors should note that the applicability of the New Law is generally limited to domestically invested companies in the PRC. The New Law shall apply to foreign-invested enterprises ("FIEs") only where the law governing foreign investment is silent. It is still uncertain whether subsequent amendments will be made to the laws relating to FIEs in order to match the New Law.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

**Ying Li**
852.3189.7303
yli@jonesday.com

**Debbie Chau**
852.3189.7302
dchau@jonesday.com