

# New Company Law: More Responsibilities and Risks For Executives?



CHINA

On December 29, 2023, the last working day of 2023, China implemented amendments to the PRC Company Law (“2024 Company Law”), set to take effect on July 1, 2024. This marks the sixth revision of the Company Law since its initial enactment on December 29, 1993, with prior revisions in 1999, 2004, a comprehensive overhaul in 2005, and updates in 2013 and 2018. It is the first major overhaul of the Company Law since 2005 and has made various significant changes to China’s corporate law regime.

This article primarily focuses on the key aspects of the corporate governance under 2024 Company Law, particularly for limited liability companies—the prevalent corporate form for most foreign investments. The 2024 Company Law introduces increased flexibility in organizing a company’s corporate governance structure, along with additional requirements. The legislative intent is clear - to strengthen the duties and responsibilities of directors, supervisors, and senior management personnel in corporate governance.

## I. MAIN CHANGES

### 1. Abolishing Mandatory Supervisory Board /Supervisors

Chinese companies traditionally adopt a «two-tiered» governance structure, encompassing both the board of directors/executive director and a supervisory board/supervisors. However, unlike some civil law jurisdictions, the supervisory board/supervisors in Chinese companies does not engage in business decisions but rather oversees the board of directors and senior managers for compliance with laws, regulations, and the articles of association in the course of performing duties and functions. Consequently, many companies have struggled with the implementation of the supervisory function by the Board of Supervisors efficiently, partly due to the lack of substantial supervisory power.

The 2024 Company Law tackles this challenge by abolishing the mandatory requirement for a supervisory board/supervisors in limited liability companies. This amendment grants the flexibility for relatively small-scale limited liability companies or those with few shareholders to opt not to have a supervisory board/supervisors. Alternatively, it is not mandatory to establish a supervisory board/supervisors for limited liability companies that are not considered relatively small-scale or have fewer shareholders, provided there is unanimous consent among all shareholders.

### 2. Introducing Audit Committee Formation

The 2024 Company Law introduces a novel provision allowing (optionally) the establishment of an audit committee within the board of directors, whose members shall be directors. This committee is vested with the authority to exercise the rights traditionally held by the Board of Supervisors/supervisors. The specific duties and responsibilities of the audit committee will be outlined in the Articles of Association, and there is a possibility of overlap or even partial replacement of the functions traditionally carried out by a supervisory board/supervisors.

However, with the introduction of this new system, there remain certain ambiguities and gaps in the regulations concerning the audit committee. For instance, there are no explicit provisions detailing the deliberation and voting procedures of the audit committee. Additionally, concerns may arise due to the fact that the audit committee is composed of directors, potentially leading to conflicts of interest when overseeing other directors. These aspects warrant further clarification and refinement in the legal framework to ensure the effective functioning of audit committees.



### *3. Legal Representatives:*

Every Chinese company is required to designate a legal representative endowed with statutory powers, subject to any limitations imposed by the articles of association and/or shareholders' meeting, to act on behalf of the company in its civil activities.

At present, only the Chairman of the Board of Directors, or the Executive Director (for companies without board of directors), and the general manager may hold the position of legal representative. The 2024 Company Law now allows any director or manager responsible for executing company affairs to serve as the legal representative. This change reflects a shift towards greater flexibility in determining the individuals eligible to act as legal representatives within a company.

Recognizing the potential personal liabilities associated with the position of legal representative, the 2024 Company Law introduces a clear exit mechanism to address concerns about the permanent fixation of an individual to the role in the absence of a successor. If a director or the general manager serving as the legal representative resigns from their position, they are automatically deemed to have resigned as the legal representative. In such cases, the company is obligated to appoint a new legal representative within 30 days from the date of resignation. This provision ensures a smooth transition and potentially avoids any prolonged vacancy in this crucial position.

### *4. Transforming Board of Directors Structures*

Under the 2018 Company Law, the Board of Directors of limited liability companies is mandated to consist of 3 to 13 members. However, the 2024 Company Law eliminates this numerical restriction, specifying that the Board of Directors shall now consist of 3 members or more. In cases where a company is of a smaller scale or has a fewer number of shareholders, the 2024 Company Law keeps the option of not setting up a Board of Directors, but instead appointing a director (called executive director in the 2018 Company Law) to exercise the powers traditionally vested in the entire board of directors.

The 2018 Company Law mandated employees' representatives in the Board of Directors only for wholly state-owned companies with limited liability. However, the 2024 Company Law introduces this requirement for at least one employee representative on the board in companies with no fewer than 300 employees, especially when there is no employee representative on the supervisory board. Nevertheless, the application of these employee representatives to limited liability companies, characterized by a relatively small scale or a fewer number of shareholders, and with no fewer than 300 employees, appears ambiguous. For them, it remains uncertain whether a sole director can be appointed in lieu of a board of directors. If such an appointment is possible, it raises the question of whether the sole director must also serve as an employee representative.

### *5. Powers of the Board of Directors*

The shareholders' meeting remains the highest authority within a company. But strategic decisions such as the «determining the company's business policies and investment plans» and approving the «annual financial budget and final accounts plan» are no longer exclusively within the domain of the shareholders' meeting. The 2024 Company Law reassigns these powers to the Board of Directors, providing greater decision-making autonomy. Also, besides other powers to be provided in the articles of association, it is also clarified that the board of directors can exercise powers authorized by the shareholders' meeting, such as the issuance of bonds.

### *6. Empowering the General Manager's Role*

Under the 2024 Company Law, the general manager's powers and functions are no longer specified in the law. Instead, they may be as set out in the articles of association or as delegated by the directors. Moreover, a general manager can even take the place of a sole director. Therefore, it is critical to have a well-defined and transparent delineation of the responsibilities of the general manager's role within the company.

### *7. Defining Fiduciary Duty*

The 2024 Company Law defines, for the first time, the fiduciary duty of directors, supervisors, and senior managers, which, under Chinese law, is divided into two related concepts: the “duty of loyalty” and the “duty of diligence.”

Under the duty of loyalty, directors, supervisors, and senior managers shall take measures to avoid conflicts between their own interests and the interests of the company and shall not use their powers to seek improper benefits.

Under the duty of diligence, directors, supervisors, and senior managers shall exercise reasonable care, normally expected of managers, in the best interests of the company when performing their duties.

There are also more specific requirements on directors, supervisors, and senior managers under the 2024 Company Law. For example:

- They shall report their contracts and other transactions with the company (including those of their close relatives and affiliates) to the shareholders’ meeting or the board of directors and seek its approval as required under the articles of association.
- They shall not take advantage of their positions to seek business opportunities belonging to the company for themselves or other persons unless the company cannot pursue such opportunities or it is reported to and (as required under the articles of association) approved by the shareholders’ meeting or the board of directors.
- They shall not engage in the same type of business as that of the company for themselves or other persons without reporting to and (as required under the articles of association) getting approval from the shareholders’ meeting or the board of directors.

Finally, it is crucial to highlight the inclusion of «De Facto Director» and «Shadow Director» within the framework of the 2024 Company Law, concepts akin to the «shadow director» under UK company laws. These additions specify that the «Controlling Shareholder» or «De Facto Controller,» even if not holding formal positions as a supervisor, director, or senior management within the company, shall be held to the same fiduciary duties as those in official roles if they actively perform corporate duties. They shall also be jointly liable with the company’s director, or senior management who are instructed by such «Controlling Shareholder» or «De Facto Controller» and thus harm the company or shareholders’ interests.

### *8. Extended Compensation Liabilities of Directors, Supervisors, and Senior Management Personnel*

The 2024 Company Law brings about a broadening of responsibilities and liabilities for directors (including the De Facto Director and Shadow Director), supervisors, and senior management. Specifically, directors may face liability for compensating the company if they fail to pursue deficient capital contributions. Additionally, if a third party experiences losses due to intentional or grossly negligent actions in the performance of a director’s or senior officer’s duties, the director or senior officer becomes jointly and severally liable with the company for compensating these losses. This underscores a raised standard of accountability, underscoring the crucial need for individuals in key positions to be held responsible for their actions.

## **II. RECOMMENDATION AND ACTION PLAN**

To effectively navigate the updated regulatory landscape for foreign-invested companies and ensure compliance with the 2024 Company Law, we propose the following recommendations and action plan for foreign-invested limited liability companies:



### *1. Review the Impact of the 2024 Company Law:*

Conduct a comprehensive review to understand the specific implications of the 2024 Company Law on foreign-invested limited liability companies.

### *2. Understand Key Roles and Responsibilities:*

Gain a detailed understanding of the rules governing the powers, duties, and liabilities associated with crucial roles, such as legal representatives, directors, supervisors, and general managers, for example attend training sessions on this topic to enhance knowledge.

### *3. Optimize Corporate Governance Structure:*

- Optimize the company's corporate governance structure, considering factors like size, number of shareholders, relationship among the shareholders and operating costs.
- Make necessary adjustments, such as removing the supervisor role or changing the legal representative.

### *4. Revise Company Bylaws:*

- Revisit and amend company bylaws or internal management rules to align with the 2024 Company Law.
- Clearly define roles and responsibilities and set up transparent procedures for the equitable allocation of responsibility and liability among legal representatives, directors, supervisors, and general managers.
- Create comprehensive protocols for handling compensation claims in the event of breaches of duty.

### *5. Implement Proactive Measures:*

Take proactive steps to minimize personal liability risks for key personnel. For example, consider purchasing director and senior management insurance.

### *6. Conduct Periodic Compliance Reviews:*

Periodically review company practices to ensure continuous alignment with the provisions of the corporate governance under the 2024 Company Law.

Lastly, please be reminded that following the entry into force on January 1, 2020 of the Foreign Investment Law, which replaced, in particular, the *Law on Sino-Foreign Equity Joint Ventures* and the *Wholly Foreign-Owned Enterprise Law*, foreign-invested enterprises have a five-year period which will expire on December 31, 2024 to align with the provisions of the 2018 Company Law (which shall be replaced by 2024 Company Law after July 1, 2024). This alignment mainly consists in providing in the bylaws that the authority body of the Company is the shareholders' meeting (or the sole shareholder) instead of the board of directors. Therefore, it is advisable for the enterprises that have not conducted the change to quickly and in all cases make the change before the end of 2024.



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12 January, 2024