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CHINA'S NEW COMPANY LAW

Foreign Investors looking to incorporate in China should be aware that although they are required to comply with the Chinese laws and regulations specific to Foreign-Invested Enterprises (FIEs), they will also be subject to the Company Law to the extent that there is no clear stipulation in the regulations specific to FIEs. The changes to the Company Law are also relevant to foreign investors in that they will further imbalance the corporate "playing field" in favor of domestic enterprises by loosening requirements such as minimum capital investment. It may be that these imbalances will be redressed in future changes to the FIE legislation, but as things stand, the changes that have come into force on January 1st 2006 will give Chinese investors much easier routes to incorporation in comparison with foreign investors.

Lower Incorporation Capital Required

The Company Law previously provides that the minimum registered capital for a company limited by shares is RMB 10 million (USD 1,250,000). The revised Company Law, lowers the minimum registered capital requirements to RMB 5 million (approx. USD 625,000) and the minimum number of promoters required to establish a company limited by shares now stands at two, compared to five previously.

For Limited Liability Companies (LLC's), the Company Law previously provides for

different levels of minimum registered capital depending on the type of business being carried out. The new law for the minimum registered capital has been put on a unified level for all types of business to RMB 30,000 (approx. USD 3,750).

However, please note that the threshold requirement for the registered capital for either LLC's or companies limited by shares is also subject to specific laws and regulations which may set higher thresholds for different industries.

On average the local governments "recommend" the following minimum registered capital for FIE LLC's:

(i) Trading WFOE (within a Free Trade Zone): USD 140,000 (minimum required in order to apply for VAT invoices when selling goods onto the local market) or USD 62,000; (ii) Trading WFOE with distribution rights (FICE): USD 200,000 - 250,000 (iii) Retail WFOE: USD 36,000; (iv) Manufacturing WFOE: USD 140,000 (minimum required in order to apply for VAT invoices when selling goods onto the local market); and (v) Service WFOE: Varies from USD 12,500 in Shenzhen/Beijing to USD 140,000 in Shanghai

The Company Law both before and after the recent amendments expressly reserves the government's power to intervene in incorporation requirements by setting even

higher registered capital requirements for companies limited by shares or LLC's operating in specific industries (for example, insurance companies must have a minimum registered capital of RMB 200 million.)

Other Chinese laws and regulations even expressly provide for different capital requirements for foreign-invested companies (for example, the registered capital requirement for a foreign-invested company limited by shares is RMB 30 million, instead of the previous RMB 10 million or the revised RMB 5 million; a foreign-invested investment company (Group Holding Companies), its registered capital shall be no less than USD 30 million and shall be contributed in the form of convertible currencies or RMB only.)

On a separate note, the Ministry of Commerce (MOFCOM) lifted restrictions on foreign investment in wholesale, retail and distribution from December 11th 2004, the average time for MOFCOM to approve such a FICE application is around two to three months. However, facing an ever-growing number of FICE applications and in an attempt to improve efficiency and approval of applications (depending on location), the MOFCOM has issued a new regulation that will take effect on 1st March 2006

Under this new regulation, the MOFCOM asked the local commerce authorities to assume responsibility for the approval of FICE applications, unless the proposed FICE is involved in a restricted industry (for example advertising WFOE's) or in the distribution of strategic raw materials. As a result, most wholesale FICEs can be approved by the local commerce authorities

directly, without going through the current long application process at the MOFCOM.

In addition the new regulation further allows the local commerce authorities to be responsible for the approval of a retail FICE of larger scale. For FICE projects which have already been approved by the MOFCOM before the effective date of the new regulation, future amendments can also be submitted to the local commerce authorities for approval.

Injection of the Registered Capital

Although local governments and regulations may indeed specify "minimum amounts" - the actual amount of registered capital to be injected into the business should be catered for on the basis of this being its initial operational capital needs - the amount of money required to sustain operational cash flow until the business can support itself in China. Attention to detail should be taken when drafting cash flow projections to break even - as the shortfall in operational costs is the amount that may be injected as registered capital.

Another encouraging development for those who want to run a business of their own is that the revised Company Law no longer requires the registered capital to be paid up at one time but only requires that the first capital contribution of all shareholders (except for those investing in one-person companies) should not be less than:

- the required minimum amount of registered capital; and
- 20% of the total amount of the registered capital.

The remainder should be paid within two years after the incorporation of the company, regardless of whether it is a LLC or a company limited by shares. In comparison, investment companies will only have to pay the remainder within five years. This is not applicable to FIEs.

FIEs are allowed to contribute their registered capital by installments, provided that:

- The first installment of no less than 15% of the total registered capital should be paid within 90 days upon establishment; and
- The remainder should be paid normally within one to three years depending on the amount of the registered capital. However, if your business has performed ahead of schedule and becomes profitable before the full capitalization has occurred, this can still be catered for without having to burden the parent company with this. RMB profits ahead of full capitalization can be retained by the business and re-injected as registered capital. Permission is required, however generally the government is happy to approve to this as the business has succeeded ahead of schedule and certain tax incentives may be provided to the company.

Furthermore, certain Chinese laws and regulations, such as three laws on foreign-invested enterprises (which include Wholly Foreign Owned Enterprises, Contractual Joint Ventures and Equity Joint Ventures), and the Regulation on Proportion between Registered Capital and Total Investment, have imposed a separate set of capital requirements on foreign invested companies, for example by providing that the registered capital of a foreign-invested company must be in proportion to its scale of operations and its total investment.

Expansion in Forms of Capital Contribution

The revised Company Law provides a clear-cut rule on the available contribution methods of permitting contribution of any non-cash asset which can be monetarily valued and legally transferred and stipulates that cash contributions shall not be less than 30 percent of a company's registered capital. As a result of that, equity interest can be one kind of contributable asset.

Furthermore, the revised Company Law specifically uses the concept of "intellectual property" as a contributable asset, in lieu of the "industrial property rights and non-patented technology" which was used previously. As a result, intellectual property such as copyrights will now be allowed to be contributed under the revised Company Law.

To ensure certainty in the valuation of registered capital, the revised Company Law still requires that the value of non-cash contributions to be accurately evaluated and verified by qualified institutes - normally the evaluation is done by qualified appraisal institutes and the verification by an independent accounting firm.

Contribution of Non-Tangible Assets

In addition, it should be highlighted, instead of setting a limit on the percentage of non-tangible assets that may be contributed; the revised Company Law takes the opposite approach and provides instead that the cash contribution must be not less than 30% of the total registered capital of a company. Therefore, under the

revised Company Law investors may contribute as much as 70% of the registered capital in non-cash property such as tangible and non-tangible assets.

Introduction of the Single Shareholder Company

The New Company Law allows a domestic LLC to be established by a single shareholder. The requirements are more stringent, which include:

- Raising the minimum registered capital to RMB 100,000 (approx. USD 12,500) which must be fully contributed in a lump sum when the company is established;
- Specifying the nature of the one-shareholder company on its business license;
- Domestic residents may only establish one single-shareholder company. A single-shareholder company is not allowed to invest in, or establish, any other single-shareholder company.
- Requiring important decisions made by the shareholder to be in writing and the company to keep file of such documents upon their signing by the shareholder;
- Requiring the financial reports to be inspected and audited by an accounting firm; and
- The Shareholder will be jointly and severally liable for the debts of the company if he/she fails to prove that his/her assets are independent from the assets of the company.

It now also clearly allows the provision of upstream security by a company for securing the liabilities of its shareholders, the de facto controller of that company's shareholder or a third party. Such security provisioning is permitted provided it is approved by the board of directors and by

non-interested shareholders at a shareholders meeting.

Improved Shareholder's Rights

The new law introduces key provisions aimed at protecting minority shareholders' rights. Shareholders may request that the company repurchase their shares:

- When they oppose an acquisition or merger;
- When they oppose the disposal of major assets;
- Where the company fails to distribute dividends for five consecutive years (having earned profits for the five years) or;
- Where they oppose the renewal of the company's terms.

Shareholders can bring action against the directors, supervisors and/or senior managers for violation of laws, regulations or the company's articles of association. Shareholders holding 3 percent or more of the company's shares may put forward proposals to the board and shareholders holding 10 percent or more of the company's shares may petition the People's Court to liquidate the company in certain circumstances. In practice, these rights may be difficult to exert.

The new law provides practical means for shareholders to exert supervision over the company through rights to view and copy the company's articles of association, accounts and minutes of the board and shareholder's meetings. State Administration of Industry and Commerce loses its direction in this matter and is henceforth required to provide searching facilities to the public in a substantial step toward transparency.

Legal Representative

The provision under the old law requiring the Chairman of the Board of Directors to be the Legal Representative of the company has been omitted from the new law. The new law provides that the appointment mechanism of the chairman and vice-chairman of the Board of Directors shall be specified in the articles of association.

However for FIE's the specific laws stipulate that the chairman of the Board of Directors is the legal representative by default. It is expected, therefore, that corresponding amendments will be made to the laws following the incorporation of the new Company Law, however no amendments have been announced.

Piercing the Corporate Veil

The New Company Law allows the corporate veil to be lifted where the controlling shareholder of a company abuses the privileges of incorporation, which may result in the controlling shareholder being held personally liable for the company's debts. Shareholders using the independent corporate legal personality to evade liabilities and thereby damage the interests of the company's creditors will assume unlimited personal liability for their wrongful acts. It remains to be seen how this new rule will be applied in practice. Forthcoming implementing rules are expected to provide additional guidance to the People's Court.

The New Company Law introduces rules on conflicts of interests. A controlling shareholder, effective controller, director or senior manager of a company incurs personal liability when taking advantage of

a relationship with a third party which damages the interests of the company. Directors of listed companies are ineligible to vote on matters in which they have an interest.

It also introduces the concept of corporate social responsibility. This is a noble move that is in line with international trends in corporate law. It may prove difficult to implement in practice, however, and will be of little use unless the People's Court gives the concept definition and provides guidelines to directors.

Foreign investors should note that, in many respects, FIEs and domestically-invested companies are subject to different regimes and rules. Article 218 of the New Company Law states that, "where the laws governing foreign investment differ from the provisions of the New Company Law, the former shall prevail". Consequently the New Company Law applies to foreign investors and FIEs only in circumstances where legislation on FIEs is silent. For this reason, few of the benefits will actually flow through to foreign investors and FIEs.

The new PRC Company Law has been much awaited. This foundation of China's corporate legal infrastructure is aimed at delivering commercial and governance improvements. It has met with support for the steps already taken but some key aspects remain unresolved and already pressure exists for further reform.

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