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# COMMENT

## THE COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA

Sunny Huo†

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### I. INTRODUCTION

On December 29, 1993, the 5th Session of the Standing Committee of the 8th National People's Congress adopted the Company Law of the People's Republic of China ("Company

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Law").<sup>1</sup> The Company Law, China's first national law to govern the establishment and operation of corporations since 1949, went into effect on July 1, 1994.<sup>2</sup> This paper will present the following: (1) a brief discussion of the economic environment in China; (2) an overview of how the law treats two common types of corporate entities; and (3) an analysis of how the Company Law could help meet some of China's current and projected needs.<sup>3</sup> Throughout this paper, special attention will be given to the question of how the provisions of the Company Law could benefit or hinder foreign investors interested in setting up a corporate entity in the People's Republic of China.

## II. THE ECONOMIC ENVIRONMENT IN CHINA

### A. OVERVIEW

In the past decade, China experienced economic growth unmatched by any other nation. In 1993, China's economy ranked third in the world, following only the United States and Japan.<sup>4</sup> That same year, foreign investment in China exceeded two hundred billion U.S. dollars and in the first half of 1994, this amount increased by another 20%.<sup>5</sup> With China containing over a quarter of the world's population, there is little doubt that investors worldwide are keeping a close eye on the potential opportunities in China. However, in recent years, this interest has been shaken as more and more investors have become exposed to China's antiquated and unreliable legal system.<sup>6</sup> The Company Law was enacted first, to alleviate this problem by providing a piece of solid legislation aimed at restoring investor confidence and sec-

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1. Zhonghua Renmin Gongheguo Gongzifa [The Company Law of the People's Republic of China], translated in CHINA L. & PRAC., Mar. 9, 1994, at 55 [hereinafter Company Law].

2. David Ho, *China's New Company Law: Something Concrete to Go By*, E. ASIAN EXECUTIVE REP., Feb. 15, 1994, available in LEXIS, World Library, EASIAN File.

3. *Id.* The Company Law is divided into eleven sections: General Provisions, Limited Liability Companies, Companies Limited by Shares, Issuance and Assignment of Shares, Company Bonds, Accounting, Mergers, Dissolution, Branch Offices, Liability, and Supplementary Provisions. For the purposes of this paper, we will be focusing only on the provision relating to the establishment of Limited Liability Companies and Companies Limited by Shares. Due to space limitations, this paper will not discuss the provisions governing dissolution or merger of companies, wholly owned state enterprises, or branch offices of foreign firms.

4. Glenda Korporaal, *China—From Superboom to Boom*, AUSTL. FIN. REV., July 26, 1994, available in LEXIS, World Library, ALLWLD File.

5. Peter Siedlitz, *Political and Economic Reform Go Hand-in-hand*, BUS. TIMES, July 19, 1994, available in LEXIS, World Library, BUSTMS File.

6. See Mark Lawson, *China: Survey—Uncertainties in Laws Create Some Investor Hesitation*, AUSTL. FIN. REV., Sept. 14, 1994, available in LEXIS, World Library, ALLWLD File.

ond, to solve China's problem of establishing a legal framework for governing the operation of private business entities.<sup>7</sup>

## B. BEFORE THE COMPANY LAW

Prior to 1978, China did not need national legislation to govern the operation of private companies, since its planned socialist economy was comprised almost exclusively of state-owned enterprises managed as governmental agencies.<sup>8</sup> However, during the late 1970's, due to inadequate capital resources, inferior management techniques, and outmoded technology and equipment, these enterprises began experiencing financial difficulties.<sup>9</sup>

In response, China instituted a series of programs in 1978 that were designed to transform China's socialist economy into a market economy and also to encourage foreign equity investment into China. These programs were first tested in "special economic zones" such as Shanghai and Guangdong.<sup>10</sup> While the specific details of these reform programs fall outside the scope of this paper, they can be broken down into three stages. Initially, foreign investors were permitted to set up closely held, and closely monitored, "limited liability companies" by means of joint ventures with domestic entities.<sup>11</sup> Second, legislation was passed to allow companies to be wholly owned by foreign investors (wholly foreign owned enterprises or "WFOEs").<sup>12</sup> Third, in 1992, limited liability companies and stock companies were introduced by the Standards for Limited Liability Companies Opinion and its companion, the Standards for Companies Limited by Shares Opinion.<sup>13</sup> The Company Law represents a culmination of legislation produced in this third stage of Chinese legal evolution.<sup>14</sup>

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7. See Ho, *supra* note 2; Preston M. Torbert, *Broadening the Scope of Investment*, CHINA BUS. REV., May 1994, available in LEXIS, World Library, ALLWLD File.

8. Torbert, *supra* note 7.

9. See Torbert, *supra* note 7 (China decided to encourage foreign equity investment in the late 1970s); Li Wei, *China: 40 Firms Rescued*, SHANGHAI STAR, Aug. 9, 1994, available in LEXIS, World Library, ALLWLD File.

10. Torbert, *supra* note 7.

11. See sources cited *supra* notes 2, 7.

12. *Id.*

13. Zhonghua Renmin Gongheguo Fagui Huibian, translated in CHINA L. & PRAC., July 19, 1992, at 9-10.

14. Company Law, art. 229.

### III. THE COMPANY LAW

#### A. OVERVIEW

At the risk of oversimplification, the Company Law seeks to provide a nationwide standard of establishing and operating limited liability companies and companies limited by shares in China. By doing so, the Company Law should serve four secondary purposes: (1) provide a part of the overall legal framework that will be essential to transforming China's state-owned enterprises into independent entities; (2) encourage and promote the fledgling security exchanges of Shanghai and Shenzhen by setting the stage for the forthcoming National Securities Law; (3) attract active and passive foreign investment by restoring investor confidence in Chinese corporations; and (4) foster overall domestic growth.<sup>15</sup> On its face, the Company Law seems to be well-suited to accomplish these goals. Unfortunately, as is common with other pieces of Chinese legislation, the Company Law contains several pitfalls astute foreign investors may wish to keep in mind before relying on the Company Law.

#### B. LIMITED LIABILITY COMPANIES

Limited liability companies under the Company Law appear to be a good alternative for those investors who wish to set up and be in direct control of a relatively small corporate entity in China. Foreign investors should take note of the shareholder voting and profit sharing provisions under the Company Law since they are somewhat different from similar provisions under Western corporation codes. Also of interest to potential owners of limited liability companies are the anti-corruption provisions, since the majority of these rules will likely have a significant impact on overall company operations.

##### 1. *Setting Up Limited Liability Companies*

Setting up a limited liability company under the Company Law is a relatively straightforward process. The basic requirements are as follows: (1) The limited liability company shall have a minimum of two and a maximum of fifty "shareholders"; (2) the shareholders shall invest in the company through direct capital contributions; (3) the shareholders shall jointly formulate the articles of association that includes the company's scope of business; (4) the company shall establish a fixed site for production and operations prior to applying for registration; and (5) the

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15. Torbert, *supra* note 7.

company must conform to all other requirements of the Company Law.<sup>16</sup>

Of these five requirements, the most unusual requirement is the one governing capital contributions. Under the Company Law, limited liability companies must acquire a minimum level of registered capital before they can apply for a "registration of establishment."<sup>17</sup> This minimum level of registered capital, which is to be made up of the paid-in capital contributions from the individual shareholders, varies depending on the company's scope of business operations. For production or wholesale companies, the minimum amount is RMB500,000, for commercial retail companies, it is RMB300,000, and for technological development or consulting companies, the minimum is only RMB100,000.<sup>18</sup>

A shareholder's capital contribution must generally be in the form of currency, although contributions of physical objects, industrial property, nonpatented technology, and leaseholds are permissible.<sup>19</sup> Industrial property and nonpatented technology capital contributions may not exceed 20% of the total amount required except in the case of high or new technology.<sup>20</sup> In all cases of "contributions-in-kind," the asset must be appraised and verified in accordance with the relevant administrative regulations.<sup>21</sup> If it is later discovered that the actual value of such property was lower than the original appraisal, the shareholders will be held jointly and severally liable for the discrepancy.<sup>22</sup>

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16. Company Law, art. 8 (conformity requirement), art. 11 (scope of business limit), art. 19 (basic requirements), art. 22 (articles of association requirements), and art. 28 (penalty for noncompliance).

17. Company Law, art. 23 (capital contribution minimum requirement), art. 27 (application for registration requirements).

18. *Id.* These minimums appear to serve three purposes: (1) by requiring companies to establish and maintain a minimum level of capital, the Company Law should reduce the likelihood of private companies failing due to undercapitalization, a problem that an increasing number of state enterprises are beginning to face; (2) by increasing the stability of private enterprises, the Company Law should also restore some investor confidence in the volatile Chinese market; and (3) astute readers may note that China has set the minimum capital contribution requirements for scientific research-based companies to be one-fifth of that for production companies. There is little doubt that both this provision, as well as the exemption to the 20% limit for similar companies in Article 24, were motivated by China's desire to obtain high tech manufacturing and other goods. It is not difficult to see why China desires such items since the current lack of high technology is one of the main reasons why it has difficulty competing effectively with its Western counterparts. Capital contribution limits for types of businesses not listed under Article 23 are to be determined by forthcoming regulations. See generally Torbert, *supra* note 7.

19. *Id.* art. 24.

20. *Id.* See generally discussion *supra* note 18.

21. Company Law, art. 24.

22. *Id.* art. 28.

## 2. *Rights and Liabilities of Shareholders*

The rights and liabilities of limited liability company shareholders depend almost exclusively upon the amount of their initial capital contributions. These rights boil down to the following: (1) shareholders are shielded against liability to the company exceeding the total amount of their capital contribution; (2) the profit share each shareholder is entitled to receive is determined by the ratio of the shareholder's capital contributions; (3) shareholders shall have the preemptive right to subscribe to any new increases in the company's capital on a priority basis determined by their contribution shares; and (4) shareholders shall have voting rights at regular and extraordinary shareholder meetings in proportion to their capital contributions.<sup>23</sup>

The Company Law allows two types of shareholder meetings: (1) regular meetings, which are provided for under the company's articles of association, and (2) extraordinary meetings, which may be convened by a shareholder or a group of shareholders who represent at least 25% of the total voting rights.<sup>24</sup> Both types of shareholder meetings have the power to decide on the business strategies and investment plans of the company, to appoint and replace directors and supervisors, to consider and approve reports from the board of directors of the supervisory board, and to consider and approve the company's annual budget and final accounts.<sup>25</sup> The minimum number of votes required to pass an issue is normally governed by the procedures set forth in the articles of incorporation except in the case of the company's dissolution or in the case of an increase or decrease in capital where the Company Law requires a two-thirds majority vote.<sup>26</sup> It should be noted that the Company Law does not specifically provide for the use of proxies at shareholder meetings.<sup>27</sup> Whether or not such provisions may be incorporated into the articles of association is unclear, although there does not seem to be any specific prohibitions in the Company Law against including such a provision.<sup>28</sup> Regardless of the case, foreign investors who do not have the time to attend shareholder meetings in China on a regular basis should probably take care to contract for such proxy rights.

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23. *Id.* art. 3 (liability shield), art. 33 (rules governing profits and priority; note that while the Company Law states that the shareholders shall subscribe to new shares according to a priority basis, it does not describe how the priority system works), and art. 41 (rules governing voting rights).

24. *Id.* art. 43 (regular and extraordinary shareholder meeting).

25. *Id.* art. 38 (functions of the shareholder meeting).

26. *Id.* art. 39.

27. *See id.* art. 41.

28. *Id.* *See generally* *Id.* art. 22.

Potential investors should also be aware that under the Company Law, once a company registers and receives its business license, none of the shareholders may withdraw their capital contributions.<sup>29</sup> However, shareholders may still assign their capital contributions to other shareholders without limitation.<sup>30</sup> Assignments can also be made to nonshareholders if consent is obtained from more than one-half of the existing shareholders.<sup>31</sup> Withholding consent to such transfers can be quite costly since under the Company Law, shareholders are deemed to have consented to a proposed assignment if they do not exercise their preemptive right to purchase the amount of contribution in question.<sup>32</sup>

### 3. *Anti-Corruption and Company Supervision*

In addition to the minimum capital contribution requirements, the limited liability company section of the Company Law also includes several anti-corruption provisions designed to enhance the independence and stability of all such corporate entities.

First, for companies with relatively large scopes of business, a supervisory board must be set up to oversee general operations.<sup>33</sup> These boards have the power to examine the company's financial affairs, supervise the actions of directors and managers to ensure that they are not in violation of the law, call extraordinary shareholder meetings, and attend board of director meetings as nonvoting attendees.<sup>34</sup> The members of these boards ("supervisors") may not also concurrently serve as directors, managers, or as any other persons in charge of the company's financial affairs.<sup>35</sup>

In addition, regardless of the size of the company, no person can serve as a director, manager, or supervisor if that person has (1) no capacity or limited capacity for civil actions; (2) been convicted of corruption or other crimes;<sup>36</sup> (3) served in a similar capacity in a company that has gone insolvent;<sup>37</sup> (4) been the legal

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29. Company Law, art. 34.

30. *Id.* art. 35.

31. *Id.*

32. *Id.*; see also Torbert, *supra* note 7.

33. Company Law, art. 52.

34. *Id.*

35. *Id.*

36. *Id.* art. 57. An exception to this requirement exists where five or more years have elapsed since the *expiration of the criminal sentence* (emphasis added).

37. *Id.* An exception to this requirement exists where at least three years have elapsed since the date the *insolvency liquidation was completed* (emphasis added).



representative of a company that has had its license revoked;<sup>38</sup> or (5) a large amount of individual debt which has become due and is still outstanding.<sup>39</sup> Anyone serving as a current state official would also be barred from serving as a director, manager, or supervisor of a private company.<sup>40</sup> A director, manager, or supervisor who accepts a bribe, seizes company property for personal gain, misappropriates company funds, misuses company assets, engages in a personal business that is harmful to the company's interests, enters into a contract with the company that was not expressly authorized by the articles of association, or discloses company secrets, will be held personally liable for any losses which result.<sup>41</sup> Unlike previous Chinese laws that tended to lack enforcement mechanisms, the Company Law devotes a section exclusively to liability and penalties for violations of these and other provisions.<sup>42</sup>

Finally, under the Company Law, all limited liability companies have a duty to seek the opinion of their labor unions before deciding on any issue involving wages, welfare benefits, production safety, labor insurance, or other similar concerns.<sup>43</sup> Opinions are sought by inviting labor union representatives to attend meetings involving such issues as nonvoting representatives.<sup>44</sup> While these provisions relating to the company's duty are clear under such circumstances, the Company Law does not explain how conflicts between the labor unions and the company are to be resolved. Perhaps of greater concern is that the Company Law leaves out many details as to what results if a company decided to proceed with a decision even though it was opposed by the labor unions.

#### 4. *Synopsis*

In summary, limited liability companies seem best suited for those investors willing to spend a fair amount of personal time or resources monitoring the operations of their Chinese companies. Since proxies are not permitted under the Company Law and control of these corporate entities depends almost exclusively on the ratio of the shareholders' capital contributions, those investors who put in a significant percentage of the total capital will probably wish to be readily available to take part in the proceed-

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38. *Id.* An exception to this requirement exists where at least three years have elapsed since the date the *business license was revoked* (emphasis added).

39. *Id.*

40. *Id.* art. 58.

41. *Id.* arts. 59-63.

42. *Id.* arts. 206-28.

43. *Id.* arts. 55-56.

44. *Id.*

ings. For those investors who prefer a more passive means of investing in China, as well as those investors who seek to operate on a larger scale, the second half of this paper will likely to be of more interest.

### C. COMPANIES LIMITED BY SHARES

While there is no upper capital limit for limited liability companies, investors who wish to establish relatively large scale operations in China should consider setting up a company limited by shares. Investors familiar with C-corporations under common U.S. corporate codes should find the structure of companies limited by shares under the Company Law quite familiar.

#### 1. *Establishing Companies Limited by Shares*

The basic requirements for setting up a company limited by shares are as follows: (1) the company must have the statutory minimum number of promoters; (2) the company must be able to raise the statutory minimum amount of capital through the subscription of shares; (3) the share issuance must conform with relevant Chinese regulations; (4) the company must have formulated its articles of association; (5) the organizational structure of the company must comply with relevant Chinese laws; and (6) the company's site for production and operation must be prepared prior to application for registration.<sup>45</sup>

Under the Company Law, companies limited by shares can be established by sponsorship, which requires the promoters to subscribe to all of the shares being issued or through a share offer, where the promoters must subscribe to a minimum of 35% of the total number of shares offered with the balance being offered to the public.<sup>46</sup> In either case, a company limited by shares must have at least five promoters, more than half of whom must be domiciled in China.<sup>47</sup> State-owned enterprises that are being restructured as companies limited by shares are exempt from this rule so long as the company is being restructured by means of a share offer.<sup>48</sup> Promoters will be jointly and severally liable for all

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45. *Id.* art. 73.

46. *Id.* art. 74 (generally), art. 82 (establishing a company by promotion), art. 83 (promoter 35% requirement), art. 89 (share offer must be through a lawfully established securities house), and art. 90 (subscription monies shall be collected by a bank acting on behalf of the company).

47. *Id.* art. 75. The reader should note that the Company Law does not specify whether or not this requirement can be met by promoters who are domiciled in Hong Kong or Taiwan. Presumably, this issue will be clarified by subsequent legislation. See also Torbert, *supra* note 7.

48. *Id.* art. 81.

expenses and debts incurred in trying to set up a company if the company ultimately cannot be properly established.<sup>49</sup>

Unlike limited liability companies, the minimum registered capital requirement of a company limited by shares does not vary depending on the company's scope of business. All companies limited by shares must have a minimum registered capital of at least RMB10,000,000.<sup>50</sup> Treatment for capital contributions in-kind by promoters is the same as that described in the provisions governing similar contributions by limited liability company shareholders.<sup>51</sup>

## 2. *Operation of Companies Limited by Shares*

The rules governing shareholder meetings, board of directors' meetings, and supervisory boards for companies limited by shares, are similar to those governing limited liability companies, although the anti-corruption provisions for the former seem to be slightly more stringent.<sup>52</sup> For example, although regular shareholder meetings for companies limited by shares are only held once each year, an extraordinary meeting will be convened automatically if the net losses of the company reach an equivalent of one-third of the total share capital.<sup>53</sup> Proxies will be permitted at these, as well as all other types of shareholder meetings.<sup>54</sup> Similar to limited liability companies, companies limited by shares must also obtain the opinion of their labor unions before proceeding on issues involving labor issues.<sup>55</sup>

## 3. *Share Transfer Restrictions*

Shares must be issued in the form of share certificates with all shares of the same type carrying identical rights and benefits.<sup>56</sup> Companies may also issue registered and bearer shares, provided such shares comply with the requirements under the Company Law.<sup>57</sup> All three types of shares entitle the shareholder to the right of one vote per share held.<sup>58</sup> Investors familiar with the U.S. corporate securities system should note that

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49. *Id.* art. 97.

50. *Id.* art. 78. The Company Law provides that certain administrative regulations may require a higher minimum registered capital amount although it does not describe in detail what those regulations are.

51. *Id.* art. 80.

52. *Id.* arts. 102-28.

53. *Id.* art. 104.

54. *Id.* art. 108.

55. *Id.* arts. 121-22.

56. *Id.* art. 129 (certificate form) and art. 130 (all shares must have the same rights).

57. *Id.* art. 134.

58. *Id.* art. 106.

under the Company Law, a company cannot issue other types of shares, such as preferred shares, without prior approval from the State Council.<sup>59</sup>

In the case of a company limited by shares established by sponsorship, shares may not be transferred to the public for a period of at least three years.<sup>60</sup> For companies set up through promotion, the same three-year restriction applies to the 35% minimum held by the sponsors, and the balance may not be offered to the public until approval has been obtained from the securities administration department of the State Council.<sup>61</sup> The Company Law also prohibits directors, supervisors, and managers from transferring their shares to another party while they remain in office.<sup>62</sup> Companies limited by shares may not repurchase their own shares except in the case of mergers or for the purpose of canceling the shares entirely.<sup>63</sup>

#### 4. *Listed Companies*

Listed companies are joint stock companies which have obtained approval from the State Council to list and trade their shares on an authorized security exchange.<sup>64</sup> To obtain approval, a company must first satisfy the following requirements: (1) the company's total share capital must equal or exceed RMB50,000,000; (2) the company must have been in business for more than three years before it filed an application for approval; (3) the company must show it was profitable during those three years; (4) the company must not have committed any "serious illegal acts" within those same three years; (5) the company must have at least 1,000 shareholders who hold at least RMB1,000 worth of shares each; (6) the shares to be issued to the public must represent at least 25% of the company's total shares (however, if the company's total share capital does not exceed RMB400,000,000 or if its total share capital does exceed RMB400,000,000 the issue must equal at least 15% of the total

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59. *Id.* art. 35.

60. *Id.* art. 147.

61. *Id.* art. 84.

62. *Id.* art. 147. Despite this restriction, the provisions of the Company Law do not seem to prevent an individual from resigning from office and then offering his or her shares to the public on the next day. See generally Torbert, *supra* note 7.

63. *Id.* art. 149.

64. At present, shares can only be traded as "A shares" on the Shanghai and Shenzhen Stock Exchanges (denominated and traded in renminbi ("RMB")), "B shares" on the Shanghai Stock Exchange (denominated in RMB but traded in US\$) and Shenzhen Stock Exchange (denominated in RMB but traded in HK\$), or as "H shares" on the Hong Kong and U.S. Stock Exchanges (denominated in RMB but traded in foreign currency). *China: World Equity Markets - China*, EUROMONEY SUPPLEMENT, June 29, 1994, available in LEXIS, World Library, ALLWLD File.

shares); and (7) the company must meet all other conditions specified by the State Council.<sup>65</sup> Listed companies must publish an accounting and financial report every six months. If the State Council's department for the administration of securities discovers that the listed company no longer satisfies any of these requirements, the company will have its listing suspended.<sup>66</sup>

It is not clear how these provisions will govern overseas listings of Chinese companies. While the Company Law states that shares may be offered to investors outside China during the initial share offer, and that such securities may also be listed on overseas stock exchanges, it remains obscure as to the details of how such offers are to be made.<sup>67</sup> This ambiguity is of special concern to Chinese companies because there is a large potential for conflict between these "special regulations" to be drafted by the State Council and the rules governing foreign stock exchanges.<sup>68</sup> It should be noted that although the Company Law does not provide an answer to this dilemma, work is currently underway in the Chinese legislature on a National Securities Law that may resolve some of these problems.

## 5. *Synopsis*

The provisions governing companies limited by shares are strict and fairly ambitious. Like the sections governing limited liability companies, these provisions were apparently drafted to enhance and ensure the stability and profitability of a company limited by shares, particularly if the corporation is also a listed company. Examples of some of these protective measures include the restrictions imposed on promoters regarding their ability to transfer their shares, the duty of fidelity imposed on directors and other officers, and the three-year profit/loss monitoring period for listed companies. Until the National Securities Law is in effect, however, foreign investors who wish to invest in Chinese stock companies that are listed overseas will have to rely on existing regulations and legislative opinions.

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65. Company Law, art. 152.

66. *Id.* art. 156 (publication requirement), art. 157 (violation penalty) (note that a company that has suffered losses for three consecutive years will also be in violation of Article 157), and art. 158 (if the violation is not remedied within the set time, the company's listing will be terminated).

67. *See id.* art. 85 (shares to be offered outside China must first be approved by the State Council's department for the administration of securities) and art. 155 (shares may be listed outside the P.R.C. but such listings will be governed by as of yet unidentified "special regulations").

68. Ho, *supra* note 2.

#### IV. EFFECT OF THE COMPANY LAW

Although there is an inherent risk in trying to predict the effect of most, if not all, Chinese laws, it is not difficult to see how the Company Law could have considerable impact on changing China's overall business law environment.<sup>69</sup>

##### A. PREVIOUS LEGISLATION

As stated earlier in this paper, the Company Law governs only limited liability companies, companies limited by shares, branch offices of foreign corporations, and certain "subcategories" of each.<sup>70</sup> Article 18 of the Company Law states that legislation governing the operation of WFOEs and joint ventures shall remain unaffected by the Company Law and such entities should still abide by the terms of these previous rules.<sup>71</sup> As for limited liability companies and companies limited by shares, however, the Company Law should now be considered the authority. All companies established under previous legislation will have to undergo "self-evaluation" to ensure that they comply with the terms of the new Company Law.<sup>72</sup> The procedures governing self-evaluation remain to be drafted and until such time as they are ready, companies incorporated under previous legislation may continue to operate normally.<sup>73</sup>

It should be noted that while some commentators on the Company Law fear that the Article 18 "exemption" may pose a potential "grandfathering" problem when read in conjunction with the "conformity" requirements of Article 229, such a problem does not truly exist if one reads the two Articles closely.<sup>74</sup> Article 18 states that in the case of joint venture companies and foreign investment enterprises, such entities shall comply with the provisions of the previous laws.<sup>75</sup> Under Article 229, all com-

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69. It should be noted that at the time of this writing, not all of the implementing regulations of the Company Law have been drafted. It is uncertain how these regulations may change the provisions of the Company Law although at least one set of regulations have already set forth several exceptions to certain provisions of the Company Law governing notice for shareholder meetings and voting quorums. See *generally* Company Law, arts. 34-49, 102-23.

70. These subcategories include provisions governing the operations of wholly owned state enterprises (limited liability companies) and the restructuring of state enterprises as companies limited by shares. See Torbert, *supra* note 7.

71. Company Law, art. 18.

72. *Id.* art. 229; *Id.* at 55 (Editor's Notes).

73. *Id.* art. 229.

74. Torbert, *supra* note 7.

75. The text of Article 18 reads as follows: "This Law shall apply to limited liability companies with foreign investment. Where laws concerning Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures, and foreign investment enterprises have different provisions, such provisions shall apply." Company Law, art. 18.

panies established under previous laws may continue to operate normally provided that they conform with the provisions of the Company Law. At least one commentator has noted that these provisions could be interpreted as allowing existing foreign investment enterprises ("FIEs") to retain their preferential tax treatment while at the same time denying all future FIEs of similar benefits.<sup>76</sup> This interpretation does not seem valid since there is no language in Article 18 which distinguishes between existing and future FIEs. As such, it is hard to see how there could be a grandfathering effect since Article 18 seems to apply equally to those companies created before the Company Law went into effect, as well as to those created afterwards. In other words, Article 18 should not be considered a grandfathering provision but rather a large loophole to the Article 229 requirement. Shrewd investors may realize that if Article 18 could be interpreted in the manner just stated, they will effectively have the freedom to choose between incorporating their companies under either the Company Law or the existing foreign investment enterprise laws.<sup>77</sup> While it is difficult to imagine why the Chinese legislature may have drafted the Company Law this way, more unusual things have happened in the Chinese legal system.

## B. MEETING FOREIGN CONCERNS

Although China has experienced tremendous economic growth in the past decade, international trade between China and her trade partners has declined recently due to the many problems inherent in the Chinese system. China's western counterparts have set forth four conditions that need to be met if trade relations are to continue to grow into the next decade: (1) China must increase the transparency of her trading and business laws and regulations; (2) China must make a firm commitment towards reducing tariffs and removing nontariff barriers across the board; (3) China must establish a specific timetable for allowing market access by service organizations such as banks, insurance companies, and various "consulting" enterprises; and (4) China must improve protection for intellectual property rights

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76. Torbert, *supra* note 7.

77. It is not yet clear what effect the Company Law will have on tax holidays, preferential tax rates, and other tax benefits currently enjoyed by foreign investment enterprises. Since the Company Law does not mention these benefits for "enterprises with foreign investment," there is a strong likelihood that it will be interpreted not to provide these incentives for companies established under the Company Law. If such were the case, most investors would probably avoid setting up corporate entities through the Company Law since the Article could allow them to establish companies under previous legislation that could still enjoy the tax benefits. See generally Torbert, *supra* note 7.

and make real progress in reducing the level of widespread infringement.<sup>78</sup>

While the scope of the Company Law encompasses the first three of these conditions, the Company Law by itself can only provide answers to the first two. Insofar as increasing the transparency of Chinese investment laws, the Company Law is clearly a step in the right direction. Up until the time the Company Law was passed, Chinese legislation in the area of corporate law has been vague and not entirely reliable. The Company Law's immediate predecessors, the Standards for Limited Liability Companies Opinion and the Standards for Companies Limited by Shares Opinion were only legislative opinions that lacked the force of law. By incorporating these provisions into a law issued by the country's highest legislative body, the Company Law will provide foreign investors a fairly substantial framework to use in determining how they wish to proceed.<sup>79</sup>

Next, although the Company Law does not specifically address the issue of international trade, it is fairly clear from its provisions that the Chinese government is taking a firm step towards lowering the barriers to foreign investment. The Company Law provides foreign investors with two clear means of establishing and operating a corporate entity in China. Although the Article 18 loophole could present a problem in trying to determine what the tax benefits for FIEs may be under the new system, the provisions of the Company Law, on the whole, seem to provide a stable, if uninspiring, set of options for large and small business ventures alike.

One possible barrier to the entry of foreign investment is the capital contribution minimum requirements for establishing both limited liability companies and companies limited by shares. Given the scale of most foreign business ventures into China, however, foreign investors should rarely find these requirements to be of real concern. In fact, these requirements may even benefit foreign investors since they would reduce the number of undercapitalized companies in China and thereby help renew public confidence in Chinese corporate entities.

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78. Tony Walker, *China: China's Stance Has Little to Do With Free Trade—Beijing Observed*, AUSTL. FIN. REV., Nov. 8, 1994, available in LEXIS, World Library, ALLWLD File.

79. The reader should keep in mind two caveats to this rather general conclusion. First, as pointed out at various points throughout this paper, several provisions of the Company Law are relatively unclear and may still be subject to subsequent interpretation by the forthcoming implementing regulations. Second, China has had a long history of arbitrary enforcement of its own laws, especially in the area of business law. Whether or not the Chinese government will fully comply with these particular interpretations of the Company Law is a question which still remains to be answered.



Consulting and service companies are clearly permitted under Article 23 of the Company Law. As for banking and securities firms, the Company Law by itself appears to have little effect in changing the Chinese government's attitude towards allowing private companies greater access to such markets. Article 11 of the Company Law requires a company to specify its scope of business activities in the articles of incorporation and to register it with the relevant authorities.<sup>80</sup> In general, China has been reluctant to approve of anything other than extremely narrow scopes of business.<sup>81</sup> As such, even though the Company Law does not itself specifically limit the scope of a company's business operations in China, such entities will still have to cope with the difficulties of dealing with the government's registration agencies. Even if a company were granted a broad license to carry out its business, special regulations still prohibit activities dealing with banking or securities without express authorization. Since any business activity not specifically provided for by the company's business license and registration remains a technical violation of Chinese law, foreign investors will still have to apply for specific authorization with the government agencies for such activities despite the implementation of the Company Law.

In addition to meeting some of the conditions listed above, the Company Law should also help China's position in the international arena by encouraging overall domestic economic growth. The Company Law's influence may be felt on several levels. First, China is currently facing the dilemma of trying to transform her socialist economy into a market economy. By establishing a solid legal foundation for transforming state-owned enterprises into joint stock companies capable of making public offerings, the Company Law could provide alternative sources of capital for companies that were previously wholly dependent upon the state for financial support. Second, the Company Law contains a number of anti-corruption measures that have not been previously codified by the Chinese legal system. Some commentators argue that these restrictions might harm China's economy by preventing some of its most skilled individuals from participating in company management, especially in light of the recent rash of state-owned enterprises being forced into bankruptcy. In general, however, it seems that such restrictions will probably help promote investor confidence by keeping out directors who have had a history of company failures while at the

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80. Company Law, art. 11.

81. Torbert, *supra* note 7. This practice runs counter to the American and European approach that tends to permit companies to have broadly defined scopes of business.

same time creating business opportunities for new, and perhaps less politically entangled, talent.

In summary, while the Company Law has a limited scope of effect and still remains subject to interpretation by subsequent implementing legislation, the overall legal structure set up by the Company Law should serve the basic needs of the Chinese business environment fairly well. Unfortunately, by itself, the Company Law will probably not be sufficient to solve all the problems between China and its international trade partners.

## V. CONCLUSION

The Company Law is a landmark piece of legislation no matter how one interprets it. For the first time in five decades, investors in China will have a solid law, issued by the highest legislative authority in the country, to rely upon in making their business decisions. However, this is not to say that the Company Law will provide a complete answer to the Chinese puzzle. Numerous ambiguities and potential problems still exist both within the Company Law as well as within the basic Chinese legal system. Despite these difficulties, however, the passage of the Company Law should be taken as a sign that China is moving in the right direction.