Private equity limited partnerships in China: A critical evaluation of active limited partners

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PRIVATE EQUITY LIMITED PARTNERSHIPS IN CHINA: A CRITICAL EVALUATION OF ACTIVE LIMITED PARTNERS

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Although current academic thinking tells us that private equity investors are generally passive in the management of funds, Chinese private equity market is dominated by funds whose investors are relatively active. The interference of limited partners in a fund’s management triggers internal conflicts between partners. This article examines the legal and practical reasons for this phenomenon. Based on extensive interviews with market participants, it is found that the agency problems, the legal weaknesses of limited partners under Chinese law and several regulatory constraints on China’s private equity industry have influenced the decisions of investors to pursue active strategies in funds. This article also examines the effectiveness of the control rule and a few of the common private contractual arrangements in addressing the agency problem in the context of Chinese private equity funds, and suggests strategies to mitigate the problem.

A. INTRODUCTION

The private equity fund has become a very popular equity investment vehicle in China.¹ Private equity funds are formed to pool the capital of different investors, including those of pension funds, private enterprises and wealthy individuals. In 2012, a total of 359 private equity funds disclosed an aggregate fundraising amount of 25.31 billion USD.²

¹ See Li Tangning and Fang Jiaxi, “Chinese Private EquityEntered Into a Golden Stage”, Economic Information Daily, 13 June 2011 (noting that private equity funds will become the third largest financing method in China, after bank loans and IPO).

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In China, the limited partnership has been the most popular business vehicle among private equity funds since it was adopted by the Partnership Enterprise Law of the People’s Republic of China (PEL) in 2007. The central concept characterising the limited partnership is that limited partners who make capital contributions to the firm have no right to participate in its management. However, general partners have the right to manage the firm, though they have to bear unlimited liability for the debts and obligation of the firm. Under Article 68 of the PEL, “a limited partner shall neither carry out partnership affairs nor represent the limited partnership when dealing with other parties.” However, the meaning of “management” has not been authoritatively determined in China or in other jurisdictions such as the US, UK, Singapore, New Zealand and Australia. The limited partnership-related statutes in jurisdictions such as US—Delaware and Singapore merely offer guidelines by providing a safe list of activities not considered as taking part in partnership management (also known as the “safe-harbour” list) in order to assist limited partners in demarcating the legitimate scope of their participation in the firm’s activities. The PEL also provides a list of the activities which limited partners will not be deemed as “carrying out the partnership affairs”.

In China, a typical private equity fund is raised and managed by a professional private equity firm comprising investment professionals, through a fixed-life limited partnership (termed a “private equity limited partnership”). The private equity firm generally acts as the general partner in the limited partnership, while the investors act as the limited partners. The general partners make and monitor the fund’s investment and carry out the day-to-day operation of the fund, with limited partners merely providing capital to the fund.

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3 See China Venture Capital Yearbook 2009 (Democracy and Construction Press, 2009), 252 (a survey shows that, among the newly raised private equity funds, limited partnership-type funds accounted for 51%).
4 The Partnership Enterprise Law was first adopted at the 24th Meeting of the Standing Committee of the 8th National People’s Congress on 23 February 1997. This law came into force on 1 August 1997 and was revised in 2006. On 25 January 2009, the rule for foreigners to set up partnership enterprises, including the limited partnership, in China was promulgated. It came into force on 1 March 2010. One of the major reasons for adopting the limited partnership in China is to encourage the investment of capital in high-technology enterprises and to facilitate the development of the venture capital market. Since 2007, there has been a tremendous increase in the use of limited partnerships in China.
5 KL Fletcher, Higgins and Fletcher, the Law of Partnership in Australia and New Zealand (The LBC Information Services, 1996), 267.
6 See Limited Partnership Act 1907 (UK), s 6(1).
7 See Limited Partnership Act 2008 (Singapore), s 6.
8 See Limited Partnership Act 2008 (New Zealand), s 20.
9 See Partnership Act 1958 (Australia), s 67.
10 Delaware Revised Uniform Limited Partnership Act (17 Del Code tit 6), §17-303(b).
11 See Limited Partnership Act 2008 (Singapore), First Schedule.
13 Partnership Enterprise Law 2006 (PRC), Art 68.
General partners’ management activities include, inter alia, raising new funds, selecting portfolio companies, managing portfolio companies and distributing profits.14

While we have seen a rapid growth of private equity funds in China, a handful of problems have arisen. A pervasive problem is that limited partners have a strong desire to control the fund and to challenge the decisions of general partners. General partners are thus widely described as “henpecked husbands” and limited partners are considered as “nagging wives”.15 This phenomenon challenges the current orthodox view that private equity investors are generally passive—ie that they do not wish to play a decisive role in the fund’s investment but are willing to delegate decision-making authority and other management responsibilities to the skilled fund managers.16

The interference of limited partners in the operation of funds would inevitably create internal conflict between the limited partners and the general partners, and may lead to the dissolution of the funds. Such a conflict would be more acute in bigger-sized funds which have a large number of partners. It would also be more serious during a financial crisis, when general partners have difficulties in raising funds. Therefore, how to ensure that limited partners do not meddle in the operation of funds has become an imperative issue in practice. This article critically examines the reasons of and suggests solutions to this special problem in the context of China.

The remainder of this article will proceed as follows. Sections B and C give brief overviews of the limited partnership regime and the private equity market, respectively, in China. Based on empirical findings,17 Section D high-

14 See generally, Zou Jing, Placement and Operation of Private Equity-Legal Practice and Cases (Law Press China, 2009).
15 See ibid, 53–59.
17 The author had conducted an empirical study during the period from August 2008 to May 2012. This study covers three parts. Part I is the author’s personal interviews, telephone interviews and e-mail consultations with 21 interviewees, including lawyers, partners, professionals and academics who specialise in private equity investment in China. The interviewees come from the six cities that are the major places of private equity investment in China, ie Beijing, Shanghai, Tianjin, Shenzhen, Chongqing and Guangzhou. For confidentiality reasons, this paper will not disclose the full identities of the interviewees. Part II comprises the feedback and observation from practitioners. This information was obtained from: (i) meeting minutes of various forums and conferences on private equity investment in China; and (ii) research reports published in the authoritative newspapers and yearbooks, eg the China Venture Capital Yearbook and the Zero2IPO Research Center net. Part III is a study of the limited partnership agreements. The limited partnership agreements are obtained from: (i) local law firms, ie Beijing Global Law Firm, Chongqing Zhonghao Law Firm, ShanghaiYuantai Law Firm and Shenzhen Huashang Law Firm; and (ii) relevant books on Chinese private equity funds, eg Li Shoushuang, China Private Equity Fund—Raising and Establishment (Law Press China, 2009); Zou Jing, Placement and Operation of Private Equity-Legal Practice and Cases (Law Press China, 2009).
lights various innovative internal governance mechanisms that are employed by Chinese investors and analyses the reasons why Chinese investors seek active control over a fund’s management. As will be shown below, this phenomenon reflects the familiar agency problems within the limited partnership regime. In particular, the fact that limited partners by default have no legal rights to participate in day-to-day operations of a fund, the lack of fiduciary duty on general partners and the lack of a comprehensive derivative action by limited partners may increase the possibility of an agent’s abuse of discretion in the context of Chinese private equity funds.

The second part of the article discusses to what extent the investors’ activism and the agency problem require special legal rules or contractual designs to resolve. In the limited partnership scholarship, the control rule which requires limited partners who participate in the management of the firm to bear personal liability for entity obligations is theoretically considered an effective rule to deter the interference of limited partners. Therefore, Section E specifically examines the necessity and feasibility of the control rule in the context of China. It concludes that, given the internal defects within the control rule and the alternative legal rules available under the PEL, there is no need to adopt this rule in China.

A limited partnership, because it involves a partnership agreement between limited partners and general partners to enter into a legally binding relationship, is essentially contractual in nature. In the private equity market, investors and fund managers will usually enter into a partnership agreement that outlines the parties’ respective rights and obligations. This foundational document contains express provisions and covers issues that set out the terms of the relationship between the fund manager and the investors, such as the distribution of profits and the compensation of fund managers. Thus, Section F examines a few of the express contractual terms that Chinese investors have used to overcome agent misbehaviour and provides suggestions to improve these contractual arrangements.

Section G discusses whether reputational constraint and two common strategies employed by limited partners (i.e. the disclosure requirement and limited partners’ defaulting in capital call) are effective in constraining the behaviour of fund managers in Chinese context. It is argued that, because of their limited effect in China, they do not entirely alleviate investors’ fear about a fund manager’s abuse of discretion.

Section H offers concluding remarks and suggests that, to constrain mismanagement by fund managers, Chinese investors should not assume direct involvement in management. Instead, the alignment of interests must be achieved through a portfolio of legal strategies, such as good contract designs, good internal governance and a transparent investment process.
B. OVERVIEW OF THE CHINESE PRIVATE EQUITY LIMITED PARTNERSHIP

1. The Structure of the People’s Republic of China (PRC) Limited Partnership and Its Popularity in Private Equity

The PEL forms the basis of partnership law in China. The limited partnership is a special type of partnership governed under the PEL. The PEL defines a limited partnership as a partnership formed by general and limited partners, where the general partners are jointly and severally liable for the debts of the partnership and the limited partners are only liable to the extent of their capital contributions. The general partners by default have legal rights to carry out the business of the firm, while the limited partners are not allowed to do so. The limited partnership is deemed to be valid from the date of issue of the partnership enterprise business licence. It has to comprise a minimum of two partners, with the total number not exceeding 50.

Prior to the revision of this particular statute in 2006, the general partnership was the only partnership vehicle allowed under the PEL. The PEL, which had originally been enacted to govern the general partnerships, now contains provisions in ch III relating to the regulation of limited partnerships. If there should arise any situation that has not been explicitly addressed in ch III, there is a fall-back clause in the PEL whereby the relevant provisions on general partnerships and general partners will then become applicable.


"The term ‘partnership enterprise’ refers to the general partnership enterprises and limited partnership enterprises which are established in China by natural persons, legal persons and other organizations in accordance with the law. A general partnership enterprise shall be formed by general partners. The partners shall bear unlimited joint and several liabilities for the debts of the partnership enterprise. Where the law provides specifically for how liability should be borne by general partners, such provisions shall prevail. A limited partnership enterprise shall be formed by general partners and limited partners. The general partners shall bear unlimited joint and several liabilities for the debts of the limited partnership enterprise. The limited partners bear the liabilities for its debts to the extent of their capital contributions."

Printer Enterprise Law 2006 (PRC), Arts 2, 67 and 68. Art 67 provides:“The partnership affairs of a limited partnership enterprise shall be executed by the general partners. The partners who execute the partnership affairs may request for determining their remunerations and the way of obtaining the remunerations in the partnership agreement.” Art 68 of the PEL states that “A limited partner may neither carry out the partnership affairs nor represent the limited partnership when dealing with other parties”.

"The date of issuance of business license of a partnership enterprise shall be the date of establishment of the partnership enterprise. Before the date of issue of a partnership enterprise business license, the partners shall not engage in the partnership business in the name of a partnership enterprise.”

Printer Enterprise Law 2006 (PRC), Art 61. It provides: “A limited partnership enterprise shall be established by not less than 2 but not more than 50 partners, unless it is otherwise provided by law. A limited partnership enterprise shall have at least one general partner.”
Although the PEL is silent on whether the limited partnership is a legal person, the limited partnership possesses certain attributes that are possessed by an independent legal entity. For example, the ability to sue or be sued in its own name, the capacity to own assets, the continuity of the partnership despite the departure or death of a limited partner and the postponement of recourse against the partners until a creditor has exhausted his remedies against partnership assets.

In China, a private equity fund can be organised as the limited partnership under the PEL. It can be established as a joint stock company or a limited liability company under the PRC Company Law 2005. It can also be organised as a trust-type fund under the Management Measures for the Trust Company 2007. In summary, there are three major advantages of the limited partnership in China’s private equity markets. First, the combination of limited liability and personal liability appear to align the interests of both investors and managers. It is attractive to the passive investors who prefer to entrust their capital to skilled fund managers. On the other hand, the personal liability imposed on the fund managers provides an effective safeguard for the investors, as well as the incentive to avoid the risk of negative net asset outcomes.

Secondly, the flexibility and privacy of the limited partnership meets the needs of both parties. Partners may negotiate the terms of the partnership

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24 Under PRC law, “legal persons” refers to organisations which possess the capacity for civil rights and independently enjoy civil rights and undertake civil obligations.


26 Partnership Enterprise Law 2006 (PRC), Art 20. It provides: “All the capital contributions made by partners, the proceeds and other properties acquired in the name of a partnership shall be the properties of the partnership enterprise”.

27 Partnership Enterprise Law 2006 (PRC), Art 80. It provides:

“When an individual limited partner is deceased or declared deceased, or when a legal person or any other organization limited partner is terminated, his heir or its successor to the rights may obtain the qualifications of the limited partner in the limited partnership enterprise.”

28 Partnership Enterprise Law 2006 (PRC), Arts 38 and 39. Art 38 provides: “A partnership enterprise shall pay for its debts with all of its properties”. Art 39 provides: “Where a partnership enterprise fails to settle any mature debt, the partners shall bear joint and several unlimited liabilities”.

29 There are two major types of companies under Chinese law: the joint stock company and the limited liability company.

30 This type of fund is regulated by the PRC Operational Guidelines for Private Equity Investment Trust Business of Trust Companies 2008 (The China Banking Regulatory Commission, Yinjianfa 2008 No 45). Before that, trust companies were not allowed to invest in private equity directly. In a typical trust-type private equity fund, a trust company acts as a “trustee” of the fund and conducts equity investment in portfolio companies with the pooled assets in the trust plan. A trust company would usually hire a professional investment company as the investment consultant, or directly conducts private equity investment on its own.


agreement flexibly. Also, the limited partnership offers the investor more privacy as compared to corporations in the sense that the accounts of the partnership and the partnership agreements are not generally disclosed publicly.

Thirdly, the partnership itself is not subject to taxation in China. Each partner is taxed individually on his share of the profits generated by the firm.\(^{33}\) In particular, to encourage more venture capital onshore, many cities and provinces provide various tax-privileged treatments to limited partnerships in their areas.\(^{34}\)

2. Private Equity in the Context of China

“Private equity” generally refers to an asset class consisting of equity securities in companies that are not publicly traded on a stock exchange.\(^{35}\) Venture capital can be deemed as a subset of the private equity asset class. Their major difference is that the former focuses more on companies at an early stage or high-tech start-ups while the latter invests in more mature companies.\(^{36}\)

Compared to the US, which has over 50 years of experience in venture capital investment since the 1960s,\(^{37}\) China has a much shorter history in this sector.\(^{38}\) The beginning of venture capital in China can be traced back to 1985, when the concept of venture capital was first mentioned in a government
document to reform and develop the science and technology sector. Nevertheless, most of the venture capital firms during the 1980s and 1990s were government backed and government directed. Moreover, owing to the sensitive nature of the term “private” in socialist China, the term “private equity” (simu guquan) was not widely used or accepted by the government for a long time, until recently.

The situation has changed dramatically in recent years. The government has gradually eased policy restrictions on equity investment, thus allowing more institutional investors to engage in private equity investment. For instance, since 2008, the National Social Security Fund, certain insurance institutions, commercial banks and trust companies have been gradually permitted to make equity investments.

Today, the phrase “quanmin PE”, meaning “everyone invests in private equity”, is a popular expression used to reflect the current industry trend in China. Professional firms, local governments, state-owned enterprises and even individual investors are actively participating in private equity investment, all in the expectation of making healthy returns on their capital.

Nonetheless, there are still no specific national laws or regulations governing the private equity funds in China, and there are no precise definitions of private equity and venture capital yet. Due to the legislative gap, the boundary between venture capital and private equity is getting blurred. Investors who used to invest in the venture capital sector are now inclined to make private equity investments in later-stage portfolio companies, especially pre-initial public stock offering (pre-IPO) companies, so as to gain quick returns.

C. THE LIMITED PARTNERS AND GENERAL PARTNERS CONFLICT IN CHINESE CONTEXT

1. Innovative Governance Strategies

One of the default rules of the limited partnership regime is that the management powers of the firm are generally vested with general partners whereas

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39 The document is entitled: “the Decision to Reform the Chinese Science and Technical System”. After that, the government provided several regulatory guidelines to accelerate the development of venture capital in China.

40 See Research Report on China Private Equity (China Financial & Economic Publishing House, 2007), 69. The development of venture capital during the initial stage (1985–97) was triggered by the incremental economic reform in China. Due to the lack of a mature capital market, a clear legal infrastructure and a supportive institutional framework, the venture capital sector has not seen a rapid development.

41 The government and officials have tended to use the term “venture capital” (chuangye touzi or fengxian touzi) instead of “private equity” in the last decade.

limited partners are not allowed to participate in the management of the firms (see Figure 1).

Nevertheless, the situation is different in China. In particular, many Chinese limited partners participate in the decision-making process of the fund and have de facto control over the fund. For example, in the so-called “proprietary funds” (zhuanxiang jijin) which are established by the limited partners, limited partners are responsible for making investment decisions. In the so-called “project funds” (xiangmu jijin), limited partners are entitled to select portfolio companies first and raise capital thereafter. Some limited partners are even allowed to act as investment managers in these funds.

The vast majority of Chinese private equity funds have various kinds of advisory/investment committees in place as their internal governance mechanisms. Typically, an investment strategy committee (touzi juece weiyuanhui), comprising both limited and general partners, is commonly formed to review and approve investment proposals, and members in the committee have the right to veto the investment proposals.

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46 Yang Yongxiang and Xu Xiaocheng, “Limited Partners in China” (2008) 8 TopCapital 1 (noting that, in a private equity fund set up by the Shenzhen Oriental Fortune Capital, the investment
The so-called partners' meeting (hehuoren huiyi, also called the “joint meeting” (lianhe huiyi)), which is composed of all partners, is also commonly employed by Chinese funds. The function of this meeting varies from fund to fund. In some funds, partners have the right to approve investment proposals in this meeting. The East Ocean Venture Capital Limited Partnership (Wenzhou Donghai Chuangye Touzi Youxian Hehuo Qiye) was one such example. The partners’ meeting, consisting of nine limited partners and one general partner, was the highest decision-making body in the firm. According to the partnership agreement, every investment proposal must be approved by at least two-thirds of the members. Contribution votes were distributed among members in accordance with their respective share in paid contributions, where a paid contribution of 5 million RMB (equivalent to 80,000 USD) was entitled to one vote. As the general partner’s capital contribution was less than 1% of the total committed contribution, he had no controlling power in the fund, so de facto control laid with the limited partners. Due to severe internal conflict over investment, this partnership was eventually dissolved.

A typical Chinese private equity fund’s governance structure is presented in Figure 2. Typically, the investment committee reviews and approves investment proposals, while the annual partners’ meeting resolves issues such as the admission of new partners, the transfer of shares, liquidation, etc. General partners are allocated with ordinary operation and administrative functions.

2. A Desirable Governance?

Chinese practitioners have mixed views on limited partners’ involvement in the decision-making process. Some limited partners take the view that it provides them with an effective and less costly way to supervise the fund and support the general partners with their professional insights. However, they have been accused of being too shortsighted, as they are only willing to invest in pre-listed companies for stellar returns within a short timeframe.
The division of investment powers between limited partners and general partners on the investment committee is to some extent subject to the bargaining powers between the two parties. To meet their specific business needs, it is ultimately for the parties to design the governance structures of the fund. Nevertheless, it is argued that decision-making by limited partners is likely to be inefficient. First, it is difficult for all partners to reach agreement on every issue. Once they fail, it may hinder the investment’s progress or lead to suspension of the fund. Moreover, as observed by Davis, there is no reason to suppose that those who are skilled in investing money are the best people to manage the firm in which the money is invested.\textsuperscript{53} Further, if limited partners are given access to detailed investment information and financial data, any disclosure of this confidential information may be detrimental to the pre-listed portfolio companies.\textsuperscript{54}

Considering the inconsistency in investment committee practices in China, it is suggested that the composition, functions and procedures of these investment committees must be standardised across the private equity industry. The roles and responsibilities of the committee as well as its members must be specified in the partnership agreement. For example, to prevent limited partners from meddling, there should be an explicit provision in the partnership agreement specifying that the function of the advisory committee will be supervisory only. Members of the committee should not be able to force the fund manager


\textsuperscript{54} \textit{Ibid.}
to follow their advice or decision. The committee should only be able to review and approve issues such as transactions involving conflicts of interest and waivers of restrictions in the partnership agreement.

In particular, the advisory committee (guwen weiyuanhui) (also known as the advisory board in the US and UK) may be a preferable monitoring mechanism for limited partners, under which limited partners in this committee are able to provide investment or technical advice but are not entitled to any voting rights over investment.

D. Why Active Limited Partners Predominate?

This section examines the possible contributory factors which influence the decisions of limited partners to pursue active strategies in Chinese private equity limited partnerships.

1. Constraining Agent Misbehaviour

Agency problems typically arise in the context of an agency relationship under which the principals engage the agents to perform functions on their behalf. Such a relationship involves delegating some decision-making authority to the agent. As the agent will not always act in the best interests of the principal, the principal has to incur monitoring expenditures to limit divergences from his interest.

The agency problem also exists in the limited partnership. Limited partners generally are concerned that general partners may pursue their own self-interest at the expense of the interests of limited partners, while general partners want to maximise assets under the management and the resulting management fees and carried interests. Particularly, in the private equity context, given the uncertainty of this high-risk market and the information asymmetries, the general partners are in a position to take advantage of the limited partners. In order to ensure that their interests would not be infringed upon, limited partners have to spend monitoring costs to limit divergences from their interest. However,
the structure of the limited partnership under which the management powers are vested with general partners only creates obstacles for limited partners to monitor how their investment is deployed.60

2. The Legal Weakness of Chinese Limited Partners

(a) Partnerships without Fiduciary Duty

In common law jurisdictions, fiduciary duty is considered the basic principle underlying the intra-partnership relations.61 However, Chinese law does not have an equivalent concept of fiduciary duty on partners; there are only a few broad principles regulating general partners' conduct.62 Also, a national credit reporting system has not been established in China and there is no efficient punishment mechanism for partners who do not act in good faith under Chinese partnership law.

Arguably, the lack of fiduciary duty regime increases the attractiveness of an active strategy to limited partners. Assuming a general partner is subject to comprehensive fiduciary duties and the defaulting general partner is exposure to significant risk of sanction, limited partners may have less desire to supervise the fund through direct involvement in the decision-making process.63

Taiwan is a traditional civil law jurisdiction without a comprehensive concept of fiduciary duty. The Taiwanese venture capital market is also dominated by funds whose investors are active in decision-making and other aspects of the fund's business.64 As observed by Gulinello, the slow development of fiduciary duties in Taiwan helps to explain the predominance of active-investor funds.65

(b) No Comprehensive Rule on Limited Partners’ Derivative Action

The limited partner’s right to bring a derivative action is also an important tool available to limited partners to protect their interests in the limited part-

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61 See G Morse, Partnership Law (Oxford University Press, 6th edn, 2006), 160; Yeo Hwee Ying, Partnership Law in Singapore (Butterworths Asia, 2000), 167.
62 They are: (i) the managing general partner shall regularly report to the other partners on the process of partnership activities, the business and financial status of the partnership; (ii) general partners shall not carry on any business competing with that of the partnership; and (iii) general partners shall not engage in activities which may harm the interests of the partnership enterprise.
63 Gulinello, supra n 16, 352. See also, CJ Gulinello, “The Revision of Taiwan’s Company Law: The Struggle Toward a Shareholder-Oriented Model in One Corner of East Asia” (2003) 28 Delaware Journal of Corporate Law 75, 104–06.
64 Gulinello, supra n 16, 268.
65 Ibid, 352.
nership. The US courts have recognised this right since the mid-1960s, and it is now available in many US states. Under the Delaware Revised Uniform Limited Partnership Act, limited partners have a right to bring a derivative action in the name of a limited partnership to recover a judgment in its favour if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed. The derivative action mechanism is also frequently used to launch actions against errant general partners who breach their partnership duties.

Article 68(7) of the PEL provides legal standing for the limited partner to pursue a legal action in the name of the limited partnership to safeguard the interests of the limited partnership where the general partners decline to exercise their rights to sue. However, the PEL does not provide a regulatory framework governing the derivative action, nor does it set forth the requirements and procedures for bringing such an action. There is some doubt as to whether this single legal provision would work effectively as a way to protect the interests of the limited partners.

3. Qualified Limited Partners are “Limited”

A typical characteristic of the Chinese private equity market is that, unlike its US counterpart, where the majority of funding comes from pension funds, endowments and the insurance industry, the major limited partners of Chinese private equity funds are wealthy individuals and families. A 2012 survey shows that 50.2% of Chinese limited partners were wealthy individuals and families and 17.2% were private enterprises. The rest were venture capital/private equity institutions, financial institutions and various funds such

66 In partnership law, derivative action does not exist in general partnerships. In fact, there is no need to have such a judicial mechanism because every partner in a general partnership has equal rights and obligations. General partners are not passive investors like minority shareholders in the corporation.
68 At the time of writing, the 1976 version of the Uniform Limited Partnership Act has been adopted by 49 states and the 2001 version of the Uniform Limited Partnership Act has been adopted by 15 states. These Acts provide specific provisions on the limited partner’s derivative action. See NCCUSL’s Legislative Fact Sheet, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-6-ulpa.asp, accessed on 12 January 2012.
69 See Delaware Revised Uniform Limited Partnership Act, § 17-1001; see also Uniform Limited Partnership Act, § 17-1001; see also Uniform Limited Partnership Act, § 1002 (2001) and Revised Uniform Limited Partnership Act, § 1001 (1985).
72 Lee, supra n 56, 260.
as government-guided funds (zhengfu yindao jijin), pension funds and university funds (see Figure 3).73

There are various reasons for the domination of individual investors in China’s private equity industry. Significantly, with rapid economic development of the nation, the number and wealth of high-net-worth individuals keep growing. In 2011, individual investors were expected to have 18 trillion RMB to invest.74 Also, because many institutional investors were not permitted to make equity investment due to past policy constraints,75 individual investors and wealthy families became the main source of private equity funding.

Arguably, the domination of individual investors contributes to the active-investor strategy in Chinese funds. First, economic scholars have advocated widely that individual investors are generally less risk-tolerant than institutional

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75 For instance, insurance companies were not permitted to make private equity investment in China until 2010.
investors.\footnote{See generally J Coval, D Hirshleifer and T Shumway, “Can Individuals Investors Beat the Market”, Harvard NOM Working Paper No 02-45 (2002) (noting that institutional investors normally tend to describe risks in quantitative terms while individual investors calculate the risk on the basis of the amount of money being lost by them; the former have better means of information which makes them more comfortable in investing in new areas, while the latter normally hesitates to invest in those areas which they do not have any knowledge or familiarity).}{In China, a number of individual investors belong to the first-wealth generation (fuyidai), which emerged after the economic reform of the 1990s. It is conceivable that they are reluctant to fully entrust their money to third parties for investment and tend to control the fate of their capital by choosing portfolio companies themselves.\footnote{This opinion is also expressed by Mr Hu Xucang (former general partner of the East Ocean Venture Capital Limited Partnership) in an interview regarding the dissolution of the East Ocean Venture Capital Limited Partnership. See Yuan, \textit{supra} n 49.}

Secondly, as Chinese law has long mandated the use of the limited liability company in the private equity sector,\footnote{Two major restrictions in Chinese law mandate the use of the limited liability company: (i) under the previous PEL 1997, legal persons, including various corporate forms were not permitted to establish partnerships; and (ii) Chinese partnerships were subject to double taxation until 2003 when the tax authority changed the tax policies. Therefore, partnerships did not enjoy substantial tax advantages as compared to corporations.}{investors are used to employing the corporate form as the investment vehicle. As a result of path dependence, investors have not fully appreciated the structure of the limited partnership. Some investors interviewed claimed that they should be entitled to respective managerial rights according to their capital contribution to the fund, like shareholders in corporations.\footnote{See “The Disputes between Chinese Limited Partners and General Partners”, \textit{Southern Metropolis Daily}, 9 March 2010; “Chinese Venture Capital Dilemma: Henpecked General Partners”, \textit{Economic Weekly}, 15 March 2010; Chen, \textit{supra} n 43.}}

4. Lack of Competent General Partners

The default rule of the limited partnership whereby only general partners have managerial powers makes the general partner’s expertise an essential requirement in the success of the firm. As observed by Gulinello, the number of qualified fund managers may influence the number of active or passive investor funds. If there are fewer qualified managers, there may be more funds with active investors whose expertise and industry connections supplement the performance of less qualified fund managers. Conversely, a greater number of qualified fund managers would result in more passive-investor funds.\footnote{Gulinello, \textit{supra} n 16, 308.}

Due to the short history of China’s private equity industry, there is a shortage of competent and experienced general partners with good track records. Recent statistics reveal that only 5% of the total investigated fund managers have more
than 10 years’ experience in the private equity sector and 40% of them have experience of less than 2 years.81

E. Is the Control Rule a Solution?

Under Chinese law, there are two basic themes regulating partnership relationships—the PEL and the partnership agreement. The next issue to examine is to what extent special legal rules in the partnership or contractual designs in the partnership agreement are required to solve the active-investors problem in China. In legal scholarship, the control rule has long been justified as a prophylactic mechanism against the improvidence of the limited partners.82 It forbids limited partners from participating in the management of the partnership and makes a limited partner personally liable for the obligations of the firm if he does take part in the control of the partnership’s affairs.83 This raises the question: is there a need to adopt the control rule in China and is it an effective rule to mitigate conflict between limited partners and general partners?

1. Is There a Need for the Control Rule in China?

The control rule exists in many jurisdictions, such as France,84 Delaware,85 New Zealand,86 Singapore87 and the UK.88 However, Chinese law does not provide such a rule. Rather, the PEL merely provides a list of activities not viewed as taking part in partnership management (also known as the “safe-harbour activities” list) in order to assist limited partners in demarcating the legitimate scope of their participation in the fund’s activities.89 These activities include:

“(1) participation in a collective decision to admit or remove a general partner; (2) making a proposal relating to the business management of the limited partnership firm; (3) participation in the selection of an accounting firm to audit the limited partnership firm; (4) receiving an audited financial report of the limited partnership firm; (5) inspection of accounting books and other financial information of the limited partnership business which involve self-interest; (6) commencement of legal

81 Supra n 45, 22–23.
84 French Commercial Code, Art L222-6.
85 Delaware Revised Uniform Limited Partnership Act, § 17-303.
86 Limited Partnership Act 2008 (New Zealand), s 30.
87 Limited Partnership Act 2008 (Singapore), s 6.
88 Limited Partnership Act 1907 (UK), s 4 (2). Nevertheless, neither Germany nor Japan provides an equivalent control rule in their limited partnership regimes.
89 Partnership Enterprise Law 2006 (PRC), Art 68.
proceedings against an accountable partner when the limited partnership’s interests have been infringed; (7) initiation of legal action in one’s own name to safeguard the limited partnership’s interests where the partner responsible for the conduct of partnership affairs has neglected the exercise of his rights; and (8) providing guarantee for the limited partnership.97

However, it is not clear whether the list is exhaustive and it is uncertain whether a limited partner will lose limited liability if he participates in activities not included in the list.90

In essence, the control rule relates to a trade-off between limited liability and management rights in a limited partnership. Such a trade-off was developed in the form of a commenda in medieval Europe to meet the business needs of maritime traders at that time.91 Because the commenda usually lasted only for a single or round-trip voyage92 and the assets were at sea or in foreign ports for the period of the overseas venture, passive partners had to give up the control of the assets.93

The control rule liability was later derived from the French société en commandite simple under nature law theory.94 In the French Ancien Régime, nobles who engaged in commercial activities would risk the loss of noble status.95 The société en commandite simple was thus created so that noblemen were able to make investment without letting outsiders know their names and without having to engage in the business.96 French merchant courts then frequently extended limited liability to a partner when they found it morally unjust to impose full liability on a partner who played no role in management.97 Likewise, the court imposed unlimited liability for those who participated in the management and incurred debts to the firm.98

90 The safe-harbour list under the PEL is much shorter and more restrictive than its counterparts in Delaware, Singapore and New Zealand.
91 The commenda had been a common device used for financing maritime trade during the tenth and the eleventh centuries. By the fifteenth century, the commenda had evolved to the società in accomandita for the purpose of short-term terrestrial use. For the history of commenda see Hansmann et al, “Law and the Rise of the Firm”, (2006) 119 Harvard Law Review 1335.
92 Hansmann et al, ibid, 1372.
93 Ibid, 1373.
94 AD Kessler, “Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership” (2003) 32 Journal of Legal Studies 511, 519 (noting that France transplanted the commenda and sanctioned the société en commandite simple in the Commercial Ordinance of 1673 and later regulated the business form in the French Commercial Code 1807; however, the Commercial Ordinance of 1673 did not provide comprehensive definition of the società en commandite simple, but left the task to contemporary jurists).
97 Kessler, ibid, 523–24.
98 RC Van Caenegem, An Historical Introduction to Private Law (Cambridge University Press, 1992), 118 (noting that these “moral necessities” were factors that were largely influenced by the
In the early nineteenth century, the French société en commandite simple was transplanted to the US.99 The New York 1822 statute copied the French law and likewise prohibited limited partners from participating in control on the penalty of being held liable as general partners.100 However, the control rule is an anachronism in the US partnership history101 because, unlike the société en commandite simple, which was enacted to meet the specific needs of noblemen, there was no such social demand in 1822 New York. There is also little reason to believe that such a rule would be useful in today’s US society, since there exists a variety of business forms providing a full liability shield to investors, such as limited liability companies and the limited liability partnership. In 2001, the Uniform Limited Partnership Act (ULPA) abolished the age-old control rule.102

In the context of China, there seems to be no legislative need to introduce the control rule. First, the control rule provides creditors with a method to recover from the limited partners if they participate in the firm and cause loss to the firm’s creditors. However, not every creditor of a firm has expectations regarding limited partners’ liability, such as tort creditors, who become creditors of a firm involuntarily and sophisticated institutional creditors.103

Secondly, creditors of the partnership would not necessarily be harmed if the limited partner did take part in the control of the firm.104 Particularly, if highly leveraged debt financing is not used in the fundraising processes, it is unlikely that the fund’s creditors would be subject to excessive liability of a large magnitude.

Thirdly, the control rule gives general partners a potent weapon in negotiations over partnership terms, and limited partners would be disadvantaged if

100 The statute required that “no special partner shall transact any business on account of the partnership” and those who participate in managing the business would be “under the penalty of being liable as a general partner”, Laws of New York, § 5 (1822), cited in Kessler, supra n 94, 541.
102 As a result, a limited partner will no longer be held liable for limited partnership obligations “even if the limited partner participates in the managerial and control of the limited partnership”. See Uniform Limited Partnership Act Prefatory Note (2001).
103 Institutional creditors are sophisticated, thus is possible for them to know whether a partner is a general partner or a limited partner by examining the partnership agreement and certificate. Trade creditors might seek for credit agency ratings to ensure the debtor’s liability in practice instead of expecting the debtor to have unlimited liability for the debts of the firm. Basile, supra n 101, 1224–26.
104 Basile, ibid, 1224.
they attempted to manage the firm.\textsuperscript{105} This may weaken the quality of management since the risk of personal liability for participation in management may deter the limited partners from monitoring the general partners.\textsuperscript{106}

### 2. Inherent Defects within the Control Rule

There are also inherent defects within the control rule. First, although this rule is generally accompanied by a lengthy safe-harbour list of activities which are not to be regarded as amounting to participation in control, there is reasonable doubt as to whether this list is complete enough to cover all situations in different business environments.\textsuperscript{107} It is always left for the courts to decide whether a specific activity is deemed as control or management. However, US courts have not yet been able to provide a satisfactory interpretation of the rule.\textsuperscript{108}

Moreover, the test for finding a limited partner liable under control rule liability is unclear in legislation and judicial practice, and varies from jurisdiction to jurisdiction. In the US, the early test for finding a control rule liability was “whether [the partner] ‘interfered’ with the general management of the partnership business”.\textsuperscript{109} The 1985 amendments to the ULPA require the creditor to possess “reasonable belief” of the participation in control. Delaware\textsuperscript{110} requires that the control rule liability be dependent on the knowledge of the third party of his participation in management.\textsuperscript{111} In Singapore, the liability of the limited partner is not contingent on the knowledge of the third party dealing with the partnership.\textsuperscript{112} The UK Law Commissions also proposed this, and argued that the conceptual basis for the control rule liability is simply the limited partner’s lack of managerial responsibility.\textsuperscript{113}

Given that the control rule is a complicated statutory rule which requires substantial judicial interpretation for qualified implementation, it is doubted

\textsuperscript{105} \textit{Ibid.}, 1222.  
\textsuperscript{106} See Bishop, supra n 83, 711.  
\textsuperscript{107} Basile, supra n 101, 1221.  
\textsuperscript{108} \textit{Ibid.}, 1228.  
\textsuperscript{109} \textit{Ibid.}, 1202.  
\textsuperscript{110} Delaware Revised Uniform Limited Partnership Act, § 17-303; Limited Partnerships Law (Jersey), Art 19(4).  
\textsuperscript{111} To establish a control rule liability, the third party must prove that (i) he believed the contracting party was a general partner at the time of transaction; (ii) he acted in good faith in “reasonable reliance on such belief” and “on the credit of such a person”; and (iii) he extended credit to the partnership. See Delaware Revised Uniform Limited Partnership Act, §17-304(a) (2006). This approach limits the circumstances under which the exercises of control could lead to imposition of liability on limited partners. See UK Law Commission and Scottish Law Commission, “Limited Partnerships Act 1907: A Joint Consultation Paper”, Consultation Paper No 161/ Discussion Paper No 118 (2001), 34.  
\textsuperscript{112} Limited Partnership Act 2008 (Singapore), s 6(2).  
that the test established for the control rule liability would be feasible in China. As there is a shortage of competent judges and the expertise of judges varies from place to place, it seems inappropriate to rely too much on judicial interpretation of the control rule.

3. Alternative Rules in Chinese Law

The fact that Chinese partnership law provides alternative rules which serve similar functions to the control rule also suggests that there is no need to adopt the control rule in China. Specifically, the PEL provides a rule that is similar to the estoppel rule under common law. If a limited partner carries out partnership business without authority to do so and causes loss to the partnership and other partners, the limited partner is liable for the loss caused. Also, if a third party reasonably believed that the contracting party was a general partner and conducted transactions with that partner, the limited partner would bear the same liability as a general partner in the partnership. To establish liability under this rule, the third party bears the burden of proving that he reasonably believed that a limited partner was a general partner; and he accordingly proceeded to conclude a transaction with the limited partner.

In view of the three reasons given, the control rule seems an unnecessary and unviable mechanism to deter limited partner’s intervention in the operation of the firm in China.

F. Explicit Contract as a Solution

The PEL gives partners who anticipate internal conflicts considerable latitude to rearrange internal governance through formal contracting. Essentially, the limited partnership agreement is the fundamental legal document that outlines


115 For discussion of the estoppels rule in the limited partnership, see Bishop, supra n 83, 701, 704.

116 Partnership Enterprise Law 2006 (PRC), Art 98. It states: “Where any partner, who does not have the power to execute the affairs of the partnership affairs, illegally executes such affairs, if its (his) act causes any losses to the partnership enterprise or to other partners, it (he) shall bear compensation liabilities”.

117 Partnership Enterprise Law 2006 (PRC), Art 76:

“Where it is reasonable for a third person to believe a limited partner as a general partner and make a transaction with him, this limited partner shall bear the same liabilities for this transaction as a general partner shall do. Where a limited partner makes, without authorization, a transaction with any other person and causes any losses to the limited partnership enterprise or to other partners, he shall be liable for compensation.”
the parties’ respective rights and obligations for a private equity limited partnership. It sets out the terms of the relationship between the general partners and the limited partners. This part examines whether Chinese limited partners are able to create powerful contractual incentives for reducing agency costs.

Lee observed that private equity partnership agreements usually contain provisions that address three core categories of issues: (i) distribution of income to investors; (ii) liquidation of the fund; and (iii) compensation of fund managers.118 These covenants also exist and are widely used in Chinese private equity funds. As observed from the examined Chinese limited partnership agreements, the major contents of a typical agreement included: (i) covenants relating to general partners; (ii) covenants relating to limited partners; (iii) covenants restricting the types of investment; (iv) covenants relating to capital contribution; and (v) covenants relating to distribution.119

Given the diversified market practice and economic conditions over the vast geographical territory, the commercial terms between the investors and fund managers vary from fund to fund in China. For example, the general level of compensation to general partners differs considerably between domestic funds and foreign funds.120 Therefore, this section does not seek to examine all the legal terms followed by Chinese funds, but is intended to highlight the common arrangements in partnership agreements that are used to align the interests of investors with fund managers.

1. General Partners’ Remuneration

It is widely accepted that the structure of a manager’s compensation depends primarily on agency costs and information asymmetry problems.121 Academic studies have also submitted that the reward strategy does not need an elaborate legal framework for its implementation but can be embodied in a mutual contract.122 We have seen internal conflicts of interest over general partners’ remuneration in practice.123 We now discuss whether this strategy works effectively as an alignment of interests in the Chinese context.

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118 Lee, supra n 56, 275.
119 The author examined 10 limited partnership agreements. These agreements were collected from Beijing Global Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm and Shenzhen Huashang Law Firm.
120 Supra n 45, 4 (noting that the general level of compensation for managers is comparatively higher in foreign venture capital and private equity firms than Chinese domestic firms).
122 See Davis, supra n 53, 204.
123 See generally supra n 45.
(a) Management Fees

The remuneration of general partners usually consists of two major parts: management fees (jījīn guǎnlìfèi) and carried interests (tōuzī shòuyì fènchéng).124 The management fee is an annual payment made to the general partners to cover the firm’s normal operations, such as transaction costs, office rental, staff compensation and travel expenses.125 In China, the most common form of management fees are the fixed fees calculated based on the total capital contribution to the fund.126 Management fees vary according to the size and scope of the fund. The average rates of such fees in Chinese funds range from 1.5 to 3% of the total committed capital contribution to the fund, which is in line with international practice.127

However, such a fixed fee provision may not necessarily incentivise the fund manager to maximise the value of the investment in some Chinese funds. As the management fee is calculated based on the share of capital commitments,128 fund managers would pay more attention to the size of the fund than the fund’s performance.129 They would seek to select bigger projects or to increase the size of the fund, but not necessarily to perform well in managing investments. In practice, some managers have manipulated the estimated value of the portfolio companies in order to charge higher management fees.130

On the other hand, a management fee should by default be paid periodically (and typically annually) to general partners.131 However, there is evidence to indicate that some Chinese limited partners are not willing to pay such fees to general partners.132 There also exists the so-called “nil management fee” (míanfei zhì) regime, under which limited partners are not required to pay management fees.133 Arguably, this arrangement would inevitably cause grievances among general partners and would not incentivise the general partners in the operation of the funds.

It is suggested that the above problems may be mitigated by additional provisions in the partnership agreement. For instance, the size of the fund and the

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124 Supra n 45, 4.
125 See P Gompers and J Lerner, “An Analysis of Compensation in the US Venture Capital Partnership” (1999) 51 Journal of Financial Economics 3, 20 (noting that fixed fees can be specified as a percentage of the committed capital, the value of fund’s assets, or some combination or modification of these two measures; management fees can also be calculated as a flat fee or as a declining percentage of managed capital).
127 Supra n 45, 3 (noting that management fees for small size funds generally range from 2 to 2.5%, while the rate for bigger funds is 1.75–2%). See also supra n 51, 168.
128 See supra n 51, 160–70.
129 Ibid. Such a situation is also observed in the US. See Lee, supra n 56, 284.
130 Supra n 51, 168–70.
131 See Gompers and Lerner, supra n 37, 101; Gompers and Lerner, supra n 125, 14–21.
132 See generally supra n 51, 170–71.
number of investors admitted may be limited to specific amounts. Also, a specific fee formula may be used as a guide to explain clearly at the outset of the fund raising how management fees are calculated, so that limited partners would be more willing to make the payment of management fees to the general partners.  

(b) Carried Interest

Carried interest (also known as “carry” (fudai quanyi/shouyi ticheng)) is designed as an incentive to maximise managers’ performance, whereby managers are rewarded according to a related share of the profits from the fund investments. There are two methods for calculating the carried interest in Chinese private equity funds: one is the fixed carry, based on the net profits of the fund investment; the other is the floating carry, whereby fund managers receive a certain percentage of the fund profits if they are able to achieve a minimum rate of return, ie a “hurdle rate” (shouyi menkan).  

The allocation of carried interest varies with the type of fund and the demand from the limited partners. The international standard is that carried interest of typically up to 20% of the profits is paid to general partners while the remaining 80% is paid to limited partners.  

Statistics show that the average rate of the carry ranges from 5 to 15% of the profits in the Chinese funds that have been investigated. Also, it is common that general partners receive a share of profit only if they are able to meet the hurdle rate.  

The international consensus is that alignment of interest would be best achieved when general partners’ wealth creation is primarily derived from carry and returns generated from a substantial equity commitment to the fund.  

While it is difficult to identify an appropriate indicator or formula for a general partner’s carry, there are ways to improve the alignment of interests.

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134 See Institutional Limited Partners Association (ILPA), ILPA Private Equity Principles (version 1.0) (ILPA Principles), 5. ILPA issued the ILPA Principles to promote the best practice of private equity partnership. Available at www.ilpa.org.

135 See supra n 73, 16–17.

136 Gompers and Lerner, supra n 37, 101; supra n 45, 17.

137 Supra n 51; supra n 49, 18 (noting that many Chinese funds set the hurdle rate at 8%).

138 See, eg Gilson, supra n 121, 1089.

139 Ibid, 16.

For instance, the calculation of carried interest should be subject to regular independent auditor review. Also, best practice should be promoted in the market so that the carried interest is distributed predominantly to the professionals who contributed to the success of the fund.

(c) Carry Clawback

The clawback mechanism is another important component of fund manager incentive compensation. Under this mechanism, distributions (including the management fees and carry) to the general partners have to repay the earning received from early successes of the fund if the overall performance of the fund is poorer than expected.142

Many Chinese funds employ the clawback mechanism to respond to agency costs and realign the interests of limited partners with general partners. Nevertheless, there is concern on how to retrieve an early payment from the general partners, especially when the credit profile of the manager is low. Also, since the clawback payment will trigger potential tax liabilities on general partners in China, it is conceivable that they would not be willing to return the carry received and may misuse such a payment by the end of the fund.143

To alleviate such a problem, general partners are generally advised to have an escrow account with substantial reserves (a certain percentage of the carry distribution) to cover any potential clawback liabilities. Also, the clawback period must extend beyond the term of the fund, including liquidation.144 Limited partners may also consider including specific provisions to enforce clawback payment in the partnership agreements.

2. General Partners’ Contribution

Requiring a general partner to have a substantial equity interest in the fund is a common incentive used for alignment of interests. General partners are usually required to contribute 1% of the committed capital,145 though this amount may vary, depending on the net worth of the fund manager.146 This requirement is said to serve as an incentive to ensure that general partners have something to lose if there is poor or reckless performance.147

142 Gilson, supra n 121, 1089–90; Lee, supra n 56, 286.
143 See Shi, supra n 51, 179.
144 ILPA Principles (version 2.0), 5.
146 See J Lerner et al, Venture Capital and Private Equity: A Casebook (John Wiley & Sons, 4th edn, 2009), 73 (explaining that, while a 1% contribution is average, general partners’ contributions can vary).
147 Lee, supra n 56, 287.
Under Article 16 of the PEL, the general partner may offer contributions in the form of cash, tangible goods, intellectual property, land use rights or other property rights and service.148 Many Chinese general partners are also required to make a cash contribution to the fund. Some are even required to contribute up to 50% of the total investment, which is much higher than international practice, which requires 1% committed capital only.149

A high contribution requirement for general partners has created problems in practice. For example, general partners who have insufficient capital have to give up part or all of their management fees to meet the contribution requirement.150 Also, due to the lack of an effective monitoring mechanism and the fact that limited partners do not tend to review the capital accounts regularly, there are situations where general partners do not commit to the contribution requirement and intentionally conceal the fact to the limited partners.151

These situations may be improved by specifying in the partnership agreements that a certain percentage of the amount contributed by the general partners should be in cash and should not be contributed through the waiver of management fees. Also, general partners should be required to send written notices to all limited partners after the cash contribution has been committed. Clear default liability must also be specified in the agreements.

3. Co-investment Rights

The right to co-investment (gentou) is another popular constraint to general partners in private equity transactions. Generally, some (though not necessarily all) investors (or managers) are invited to co-invest their own money alongside the fund in a target company.152 A survey shows that more than half of Chinese private equity institutes allow the managers to co-invest in target companies.153 Many domestic funds even make it mandatory for general partners to co-invest into portfolio companies.154 Some general partners are required to co-invest up to 10–20% of the total investment.155 For half of the fund managers consulted, their return from co-investment accounts for 40–50% of their total remuneration.156

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148 Partnership Enterprise Law 2006 (PRC), Art 64 provides that “A limited partner may make capital contributions in money, in kind, or intellectual property right, land use right or other properties. No limited partner may make capital contributions in labor services.”

149 Supra n 51, 96.

150 Ibid. 96–97.

151 Ibid.


153 Supra n 45, 28.

154 Ibid.

155 Interview with a managing director at a Shanghai-based private equity fund-of-funds manager focused on China.

156 Supra n 45, 28.
However, most foreign funds (up to 68.8% of the foreign funds investigated) do not grant co-investment rights to their managers. Among those managers who employ such rights in foreign funds, the return from their co-investment accounts for less than 10% of their total income. The major concern for foreign funds in allowing general partners to have co-investment rights is that it may trigger conflicts of interest. In particular, there may be conflicts in a general partner’s allocation decisions when they have a particular interest in the portfolio company: the general partners may reserve the most promising new opportunities for themselves rather than share them with their investors. Meanwhile, when gains from co-investment constitute the major part of general partners’ remuneration, general partners would conceivably devote more time to the co-invested projects while neglecting the overall interest of the existing fund they serve.

In principle, Article 32 of the PEL does not allow general partners to participate in any business which is in competition with the existing partnership business, and requires the default partners to return the proceeds gained from the competing business to the partnership and to compensate the partners and/or partnership for any loss suffered as a result of this competing transaction. However, the statute does not specify clearly how to calculate the proceeds and loss, and there is no judicial interpretation of this provision. Thus, a common practice has evolved which is not in line with the law.

Parties may pre-empt such potential conflicts by prescribing the restricted transaction and specifying the maximum number of co-invested projects in the partnership agreement. General partners must be prohibited from acting as a general partner for a fund with equivalent investment objectives and strategies until the fund is invested. The general partner should disclose to the limited partners the number of projects that are co-invested.

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157 Ibid.
158 Lu Hui, “The First Detected Venture Capital Bribery Case in Shanghai”, Xinwen Wanbao, 7 May 2012 (reporting that the CEO of the China Fuxing Venture Capital was arrested for co-investing in underlying deals secretly with low prices in 2012).
159 Partnership Enterprise Law 2006 (PRC) Art. 32. It provides that:

“No partner may, solely or jointly with others, operate any business competing with this partnership enterprise. Unless it is otherwise stipulated in the partnership agreement or unless it is unanimously agreed by all partners, no partner may have any transaction with this partnership enterprise. No partner may engage in any activity which may ham the interests of this partnership enterprise.”

Art 99 states that:

“Where any partner engages in any business competing with this partnership enterprise or makes transactions with this partnership enterprise as in violation of the provisions of this Law or the stipulations of the partnership agreement, the relevant proceeds shall attribute to the partnership enterprise. If any loss is caused to the partnership enterprise or to other partners, it (he) shall bear compensation liabilities.”

160 ILPA Principles (version 2.0), 6.
4. Duties of General Partners

It has been observed that there is scant provision specifying the duty of general partners owed to the limited partners in the investigated partnership agreement.\textsuperscript{161} Some interviewees consulted also admitted that they do not apprehend the connotation of fiduciary duty, not to mention the specific fiduciary duty in common law.\textsuperscript{162} Conceivably, lay investors may not comprehend what duties or obligations a partner should have.

In common law, the comprehensive fiduciary duties of partners map well onto the agency problem within the partnership. However, there is no fiduciary duty under Chinese law, and it is unlikely that the Chinese legislature would transplant the whole concept of fiduciary duties, given its civil law tradition. It is also impossible to specify all of the duties of partners in the PEL. Therefore, it is submitted that parties should consider formulating their contractual duties and default liabilities to avoid the default outcome. In particular, by clearly specifying what general partners may or may not do in the investment process, limited partners would have less need to actively monitor the fund. For instance, parties may conclude in the agreement provisions such as: a general partner should disclose events affecting his ability to meet his obligation to the fund and to discuss such events with the advisory committee. A general partner should not be exculpated for liabilities arising from a material breach of the partnership agreement.

5. Summary of Explicit Contract

Unlike the US—Delaware and UK jurisdictions, which provide for separate specific limited partnership acts, PRC limited partnerships are regulated under Chapter III of the PEL, which contains only 25 provisions. There are still various issues which require serious attention by limited partners and general partners. Moreover, given the limited experience and lack of awareness of private equity in China, it is unlikely that newly established funds, especially small domestic funds, will have a well-tailored partnership agreement specifying every existing or potential issue of the fund. Further, although a number of the principles set forth by the International Limited Partnership Association (ILPA) have been applied in a number of partnership agreements that have been examined, the connotation and rationale for several technical terms have not been fully apprehended by local investors.\textsuperscript{163}

\textsuperscript{161} Supra n 119.

\textsuperscript{162} Telephone interview with Mr Feng (associate, Chongqing Zhonghao Law Firm) on 27 October 2009; telephone interview with Mr Lin (legal adviser, a Shanghai private equity firm) on 27 October 2008.

\textsuperscript{163} See supra n 119.
Therefore, it is suggested that explicit contracts should be utilised in a more extensive way to balance the protection of non-managing limited partners with the flexibility and incentives necessary for general partners. Also, there is a long way to go before practitioners work in concert to develop the same set of expectations when entering into any particular private equity limited partnership agreement.

G. Reputation and Other Strategies by Investors

1. Reputation

Many have argued that reputational sanctions play a vital role in deterring mismanagement of managers in the context of private equity.\(^{164}\) A typical private equity fund usually has a ten-year lifespan. In order to raise subsequent funds from the previous investors and to attract new investors, general partners will avoid abusive behaviour.\(^{165}\) A poor fund performance, however, will blemish their reputations as good stewards of investor capital. This will eventually hurt general partners’ efforts to raise capital for a new fund.\(^{166}\)

Nonetheless, while ordinary investors in private equity funds appear to rely heavily on reputational constraints to protect the fate of their investment, the situation may be different in the context of China.

First, recent evidence has indicated that Chinese investors in large joint venture funds (hezi jijin) are more likely to be motivated by issues beyond the reputation of general partners, like local tax incentives, local legislations, political pressure and local economic development plans. Also, government-guided funds (zhengfu yindao jijin) are formed by the government to direct a certain portion of funding to be invested in targeted local industries, such as the fields of science and technology, and green and cultural innovation.\(^{167}\) Local governments may require general partners to invest in certain preferred industries, or may provide tax waivers to certain general partners if they invest in these areas. As such, the large institutional investors are motivated, not by reputational constraint of the general partners, but by local development plans and political pressure to deploy their assets in certain industries and places.\(^{168}\)

Secondly, as discussed in the last section,\(^{169}\) many Chinese general partners are required to commit a high cash contribution rate to the funds. This evidence seems to support the view that Chinese limited partners do not rely

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\(^{164}\) See supra n 31, 395; Sahlman, supra n 60, 502.

\(^{165}\) Gilson, supra n 121, 1074–75.

\(^{166}\) Ibid.

\(^{167}\) See supra n 14, ch 5.2.

\(^{168}\) Cf the experience of the US private equity funds on this matter. Lee, supra n 56, 290–91.

\(^{169}\) Supra text accompanying nn 145–51.
heavily on reputation constraints. Put differently, if the relationship between limited partners and general partners was indeed based on reputation, such a monitoring device would not be needed or used extensively.170

Thirdly, the recent credit crunch, hedge fund scandals and numerous hedge fund collapses suggest that it is no longer possible to rely primarily on a manager’s reputation or historical track record.171 Due to the lack of a national personal credit reporting system and the lack of personal bankruptcy law in China, the effectiveness of any reputation constraint is weakened. Recently, the number of cases relating to fraudulent fundraising and false valuation of portfolio projects have increased rapidly in China.172 Also, given the information asymmetry between fund managers and investors, it is inevitably difficult for investors to access any real, accurate information about an investment or the precise success rate of the fund’s previous transactions. Thus many investors have to rely on relationships (guanxi) to look for promising projects.173 All of these factors suggest that an investor is unlikely to rely primarily on a manager’s reputation.

To nurture a trusting environment in the Chinese private equity industry, it is submitted that a sound credit system, through a comprehensive online personal credit system, ought to be established.

2. Disclosure

Academia has advocated the importance of mandatory disclosure as a legal strategy designed to protect investors in corporations.174 In the private equity context, fund managers often prefer to suppress negative information about their firms to gain high management fees. Also, whereas public-traded corporations are subject to a mandatory disclosure mechanism, private equity firms as general partners are not so bound. Nevertheless, disclosure is just as important for investors in private equity limited partnerships. Practitioners have expressed the same desire for a greater transparency within the funds.175

170 In fact, many limited partners consulted admit that the reason why they require general partners to make substantial capital contribution is to ensure that the general partners are loyal to the funds, and they employ such a mechanism to share the risk of investment with general partners if there is poor performance.


173 Telephone interview with Mr Feng (associate, Chongqing Zhonghao Law Firm) on 27 October 2009; telephone interview with Mr Liu (legal adviser, a Shanghai private equity firm) on 27 October 2008.


175 Telephone interview with Ms X (associate, Beijing Global Law Firm) in January 2012; telephone interview with Mr Y (partner, Shanghai Yuantai Firm) in January 2012.
Article 68(5) of the PEL permits a limited partner to “inspect accounting books and other financial information of the limited partnership business which involve self-interest” and recognises that it is not considered as participation in management. However, it is unclear what part of the business involves “self-interest” and whether it constitutes a prerequisite for the right of inspection. Due to the ambiguity of this provision, we have seen some limited partnership agreements imposing obstacles for limited partners to inspect the accountings of the partnership.\textsuperscript{176}

It is suggested that greater disclosure of financial and operational information, such as detailed financial information and valuation regarding the portfolio companies, annual and/or quarterly information for portfolio companies, and fund information should be made available to limited partners so that they would have less concern about potential mismanagement by the general partners.\textsuperscript{177} Fees charged to the fund or any portfolio company by an affiliate of the general partner should be disclosed and classified in each audited financial report.\textsuperscript{178} Also, the general partner should disclose events affecting his ability to meet his obligation to the fund, and should discuss such events with the advisory committee. The general partner should also disclose to the limited partners the number of co-invested projects. Arguably, limited partners would have less desire to intervene in the management of the fund if an ideal disclosure mechanism were in place.

3. Default in Capital Calls

One may also submit that the prospect of aggrieved limited partners exiting from the fund deters mismanagement on the part of general partners. In fact, failing to answer a capital call and stopping capital commitment are common governance devices used by Chinese limited partners. There has recently been an increasing trend of limited partners defaulting in capital commitment due to cash flow problems.\textsuperscript{179}

Nevertheless, it is argued that limited partners’ default option is not a desirable way to deter mismanagement because significant ramifications could follow, such as dissolution of the fund, negative reputation concerns and breach of investment agreement. Moreover, failing to answer a capital call is expensive because it subjects a fund to liquidity shocks.\textsuperscript{180}

Further, walking away from the fund is not an optimal solution for aggrieved limited partners in the Chinese regime. According to the PEL, in the event that

\begin{itemize}
  \item \textsuperscript{176} \textsuperscript{Supra} n 119.
  \item \textsuperscript{177} ILPA Principles (version 2.0), 16.
  \item \textsuperscript{178} \textit{ibid.}, 12.
  \item \textsuperscript{179} He Shasha, “Chaotic Phenomena in Private Equity Markets” (2012) 1 TopCapital 58.
\end{itemize}
the limited partnership is left with only general partners, the limited partnership must be converted into a general partnership. Moreover, if all the limited partners do not wish to carry on business in conformity with the partnership agreement and threaten to dissociate from the partnership, the remaining general partners have to dissolve the limited partnership first before converting it into a general partnership. 181 This would incur unnecessary formation and dissolution costs, and would have significant implications on the business of the limited partnership. 182

H. Conclusion

This article has identified a special feature of Chinese private equity limited partnerships in that the limited partners are very active in the management of the funds. In essence, the predominance of active limited partner funds reflects the limited partners’ particular concern about the agency problem within China’s young and vibrant private equity market.

As the limited partnership is a brand new business vehicle in China, it remains to be seen how it will develop in the future. Also, how effectively the contractual design and the legal rules will work in the future depends on the maturity of the market as well as the practitioners involved. Thus, the fact that Chinese limited partners tend to rely heavily on internal governance mechanisms for protection rather than complex contract designs does not indicate that the contractual design or reputational constraints do not and will not work in the context of China. This is a temporary sign of a still-evolving market, and the general unfamiliarity and uncertainty of Chinese limited partners towards this new business vehicle.

Given the contractual nature of partnerships and the existing inconsistency in contractual designs in practice, it is suggested that the usage of contractual designs must be strengthened in China. In particular, local Chinese funds may learn from the overseas experience in specifying the roles and responsibilities of the advisory committee as well as of their individual members. In August 2012, the first Self-regulations of Private Equity and Venture Capital Committee of the Investment Association of China was issued. This regulation includes 108 articles involving issues including the establishment of funds, fundraising, investment, portfolio management, investment exit, good faith management, disciplinary measures and social responsibility. 183 It also provides

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codes of conduct and norms for the development of funds. It is believed that the adoption of the prudent disciplinary measures in practice would contribute to the sound development of the private equity industry in China.

On the other hand, knowing parties’ inability to write complete contingent contracts, one should not solely rely on contractual designs to solve the internal problem of private equity funds. Instead, alignment of interests must be achieved through a portfolio of legal strategies, including good governance of funds, transparency of the evaluation and investment process, and comprehensive partnership rules.

Last but not least, to achieve a sustainable development of the private equity industry, we need further development of appropriate legal infrastructure by administrative bodies, a business-friendly regulatory environment and greater commercial sophistication among Chinese courts.