Limited Partners’ Derivative Action: Problem and Prospects in the Private Equity Market of China

Lin Lin, National University of Singapore

Available at: https://works.bepress.com/lin-lin/6/
The article inquires into the theories and operation of the limited partner’s derivative action in the context of China. The revised Partnership Enterprise Law provides a new remedy for the limited partner to pursue an action in its own name to safeguard the interests of the limited partnership. However, the law does not set forth a basic legal framework for bringing such an action. By identifying the special features of the private equity market of China and the deficiency of other remedial mechanisms to the limited partners, this article discusses the needs of the derivative action in the private equity limited partnerships. It also proposes special rules that are in line with the Chinese market condition.

Introduction

The limited partnership has become the most popular and common business vehicle in the private equity sector of China since it was adopted in the revised Partnership Enterprise Law of People’s Republic of China (PEL) in 2007. In a typical Chinese private equity limited partnership, fund managers serve as the general partners and investors serve as the limited partners. The general partners exercise control over the day-to-day management of the fund. Typically, they are responsible for choosing portfolio companies in which to invest and manage the investments. The limited partners provide capital to the funds while must desist from participation in management activities.

* Legal Policy Officer, Accounting and Corporate Regulatory Authority, Singapore. PhD, LLM, Singapore; LLB (Hons), China. The author would like to thank the National University of Singapore PhD Program for supporting her research. Special thanks to Prof. Yeo Hwee Ying for providing valuable comments on earlier drafts.

1 In this paper, the term “private equity” (simu guquan) refers to an asset class consisting of equity securities in companies that are not publicly traded on a stock exchange. It includes the venture capital.


Art 68(7) of the PEL, for the very first time, provides a legal standing for the limited partner to pursue a legal action in its own name to safeguard the interests of the limited partnership “where the executive partner responsible for the conduct of the partnership affairs has neglected the exercise of his rights”. However, the PEL does not set forth the requirements and procedural for bringing such an action. There is some doubt as to whether a single legal provision would function effectively in practice.4

The derivative action is an important remedy available to limited partners in the limited partnership. Since the mid-1960’s, the United States (US) courts had recognized the limited partner’s derivative action.5 The statutory limited partner’s derivative action was later adopted in the Uniform Limited Partnership Act (ULPA) 1976.6 Today, limited partner’s derivative actions are available in many US states.7 Under the US statues, such as the Delaware Revised Uniform Limited Partnership Act (DRULPA), the ULPA 1985 and the ULPA 2001, limited partners have a right to bring a derivative action in the right 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.8 The limited partner’s derivative action is also frequently used to prosecute actions for breaches of fiduciary duty by general partners.9

As the derivative action is a new development in Chinese law, there is little academic research and judicial practice on this matter.10

---

4 Strictly speaking, the basis of the derivative action is drawn inferred from Art 68 of the PEL which is a safe harbor provision.
Moreover, unlike the shareholder derivative action which is widely discussed in academia, the limited partner's derivative action is still under-researched. This article thus seeks to fill the perceived legislative gaps in this matter and to provide an in-depth analysis on this remedial device in the context of China.

Given the popularity of the limited partnership in the private equity market of China, the subsequent discussion will mainly focus on the private equity limited partnership, namely, the private equity fund which is organised as the limited partnership. Meanwhile, the article will choose the US as the main comparative target. The reasons are threefold. The Chinese limited partnership, like its US counterpart, is the most common business vehicle in the venture capital and private equity market. Also, the safe harbour list and the concept of limited partner's derivative action under the Chinese limited partnership regime bear some resemblance to its US counterpart. Further, the US has a long history with the limited partner's derivative action. Whereas many jurisdictions like the United Kingdom (UK), Germany, France and Japan do not have equivalent mechanism in their limited partnership regimes. Therefore, it is believed that the vast experience of the US in legislation and judicial practice in this matter may help identify issues that might arise in the use of the Chinese regime.

12 There are a few English articles and books discussing the limited partner’s derivative action, including, inter alia, Helen Hubbard, “Alternative Remedies in Minority Partners’ Suits on Partnership Causes of Action” (1986) 39 Sw. L.J. 1021; Alan R Bromberg and Larry E. Ribstein, Bromberg and Ribstein on Partnership Boston: Little, Brown, 1988) Vol IV, §15.01.
14 For the legislative history of the PEL, see “Discussion on the Revision to the Partnership Enterprise Law”, National People’s Congress, News Release, 30 Apr 2006.
15 Limited Partnership Act, s 6(1) (1907) (UK); Lindley and Banks on Partnership, n 29 above, pp 869–870 (providing that a limited partner does not have authority to bring a derivative action; or to bring an ordinary action on behalf of the firm).
16 The author has checked the relevant legislation in these jurisdictions (ie, Japanese Commercial Code, German Commercial Code and French Commercial Code) and no limited partner derivative action is found in these codes.
Based on a comprehensive set of interviews with investors, fund managers and professionals\(^{17}\) and by examining the US legislative and judicial experience in the limited partner's derivative action, this article identifies the lacuna and problems within the Chinese derivative action regime and proposes recommendations.

The Deficiencies within the Chinese Regime

Unlike many US statutes\(^{18}\) which set out specific requirements and procedures for limited partner's derivative action, China does not provide an equivalent regulatory framework governing the limited partner's derivative action. The only relevant legal foundation for limited partners to bring an action “where the partner responsible for the conduct of the partnership affairs has neglected the exercise of his rights” is “hiding” in the safe harbour list under Art 68 of the PEL, which provides that:\(^{19}\) "A limited partner may neither carry out the partnership affairs nor represent the limited partnership when dealing with other parties. The following activities of limited partners shall not be deemed as ‘executing the partnership affairs’:

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;

\(^{17}\) The author had conducted an empirical study during the period of Aug 2008 and Mar 2011. 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 the private equity investment in China. The interviewees come from six cities which are the major places of venture capital and private equity investment in China, ie Beijing, Shanghai, Tianjin, Shenzhen, Chongqing and Guangzhou. Due to confidentiality reasons, this paper will not disclose the full identity of interviewees. Part II is a research on the feedback and observation from practitioners in the private equity sector of China. This information are obtained from: (a) the meeting minutes of various forums and conferences on private equity investment in China; and (b) the 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 on the limited partnership agreements. The limited partnership agreements are obtained from: (a) specific local law firms, ie the Chongqing Zhonghao Law Firm, the Yuantai Law Firm and the Shenzhen Huashang Law Firm; and (b) the books on China’s private equity limited partnerships, ie Li Shoushuang, China Private Equity Fund-Raising and Establishment (Beijing: Law Press China, 2009); Zou Jing, Placement and Operation of Private Equity-Legal Practice and Cases (Beijing: Law Press China 2009).

\(^{18}\) Eg the Delaware Revised Uniform Limited Partnership Act and the Uniform Limited Partnership Act 2001.

\(^{19}\) Emphasis added by the author.
(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 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 executive partner responsible for the conduct of partnership affairs has neglected the exercise of his rights; and
(8) providing guarantee for the limited partnership.”

The Art 68 of the PEL bears substantial resemblances to s 303 of the ULPA 1985 and s 17-303 (b) (6) of the DRULPA. The purpose of these provisions is to restrain limited partners from interfering in management of the business. The safe harbour lists within these provisions intend to provide clarity to limited partners about what safe harbour activities do not amount to participating in the management of limited partnerships, but not intend to regulate the derivative action. The sub-clause (7) of Art 68 is merely one of the safe activities which a limited partner can carry out, but it fails to spell out any procedural rules regarding the derivative action:20

1 The PEL fails to specify who can be a proper plaintiff of a derivative action. For example, it is unclear whether the plaintiff be a partner at the time of instituting the action.
2 The PEL is silent on whether the limited partner has to meet any eligibility requirements. For instance, it is not clear whether the limited partner should exhaust its remedies before bringing the derivative action.
3 Art 68(7) merely states that “where the executive partner has neglected the exercise of his rights,” the limited partner may “urge the executive partner exercise his rights”. It is unclear whether this is one of the remedies which the plaintiff must exercise before pursuing the derivative action.

20 See n 2 above, p 107.
The PEL states that the defendant should be “the partner who is responsible for the conduct of the partnership affairs but who has neglected to vindicate partnership rights”. However, what constitutes “neglect in exercising of partner’s rights” remains to be clarified.

Who shall bear the expenses of the litigation is missing under the PEL.

Who may receive the proceeds or any benefits of a successful action is unclear.

The above lacuna within the PEL is a major problem with regards to limited partners’ right in pursuing a derivative action. Without a clear definition of and detailed procedure for the derivative action, the current bare provision cannot be viewed as affording effective protection for the limited partners who lack rights to participate in the management of the limited partnership.

The Need for the Limited Partner’s Derivative Action in China

Before we examine the legislative gaps within the limited partner’s derivative action under the PEL, it seems much more desirable to ask whether there is a need for such a mechanism in China.

Since the mid-1960’s, the US courts had begun to hold that it was justifiable to have limited partner’s derivative action as the passive roles of limited partners in limited partnerships resemble minority shareholders in corporations.21 In *Klebanow v New York Produce Exchange*,22 Judge Friendly stated that limited partners and shareholders resemble each other in the sense that both expect a share of the profits and are subordinate to general creditors. Both have some control over direction of the enterprise by veto on the admission of new partners and are able to examine books and have on demand true and full information of all things affecting the partnership.23 He argued that while the corporate shareholder could seek redress through a derivative action, the limited partners should also be allowed to pursue claims on behalf of the partnership, with any recovery being paid directly to the partnership.24 After this case, states like New York and Delaware gave limited partners the

21 See n 5 above.
24 See n 21 above.
statutory rights to sue on behalf of the partnership. The ULPA 1976 incorporated similar provisions as well. 25

In fact, it seems easier to justify the limited partner’s derivative actions than to justify shareholders’ derivative actions as there is less restraint on opportunistic behaviour in limited partnerships than that in corporations. 26 It is more difficult to remove a general partner in a limited partnership than removing a director in a corporation as directors of corporations are periodically elected but general partners have permanent tenure and removal of general partners usually requires unanimous consent of all partners. It is even more difficult to expel a general partner when there is only one general partner who is in charge of the partnership affairs. In addition, as observed by commentators Bromberg and Ribstein, there is no public market for the interests of most limited partners, hence aggrieved limited partners cannot follow “the Wall Street rule” and sell out the stock to express their dissatisfaction. 27

The strong entity character of the limited partnership is another factor justifying limited partners’ derivative actions in the US. 28 As the limited partnership is a separate legal entity from its partners, it is logical for the partnership itself to enforce rights of action vested in the firm and to sue for wrongs done to it. However, a limited partner, not being the management of the firm, is not empowered to control the day-to-day operation of the firm. Hence he is not allowed to bring a direct suit on behalf of the firm. Only a “derivative” action would enable the limited partner to pursue a remedy in the interests of limited partners and the limited partnership as a whole. Of course, such an argument does not apply to the limited partnerships in those jurisdictions which do not consider them separate legal entities, such as the UK and Singapore.

Deterrence and compensation are also frequently considered as the two major justifications of shareholder derivative actions. 29 Similarly, in the context of limited partnerships, the liability rules enforced by derivative actions may arguably play a fundamental role in aligning the


26 See n 12 above, Vol IV, §15.01(a), 15:43.

27 See n 12 above, Vol IV, §15.01(a), 15:44.

28 See n 12 above, Vol IV, §15.01(b).

interests of general partners and limited partners. It would thus deter mismanagement by the general partners and compensate the limited partnership and partners for the harm caused by the general partners.\textsuperscript{30}

While the above is a general justification for the limited partner’s derivative action, the next question is whether such a device is in need by Chinese practitioners.

\textbf{Centralised Management with Insufficient Legal Protection to Limited Partners}

The limited partner is arguably more vulnerable than the general partner under the default rule of the limited partnership regime. Limited partners have no right to manage the partnership and have to serve a passive role in the partnership operation.\textsuperscript{31} As this default rule centralises decision-making power in the hands of the general partners, it makes the limited partners face a familiar agency problem that the general partners may be emboldened to pursue their own self-interest at the expense of limited partners’ interest.

Moreover, under Chinese partnership law, there is no equivalent concept of fiduciary duty and no statutory duty is imposed on general partners. There are only a few broad principles regulating general partners’ conduct under the PEL: 1 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; 2 general partners shall not carry on any business competing with that of the partnership; and 3 general partners shall not engage in activities which may harm the interests of the partnership enterprise.\textsuperscript{32}

It is argued that these provisions are inadequate to address the fiduciary concern in the limited partnership as they are insufficient to cover all improper conduct by the general partner. Without strong duty constraint on general partners, limited partners may be concerned that general partners would not act in the best interests of the firm, thus tension between limited partners and general partners are likely to increase.

\textsuperscript{30} Nonetheless, it is admitted that either deterrence or compensation function has its own advantages and limitations. Arguably, which of these purposes should be primary justification is important only in designing the detailed rules of the derivative suit. See John C. Coffee, Jr and Donald E. Schwartz, “The Survival of the Derivative Suit: an Evaluation and a Proposal for Legislative Reform” (1981) 81 Colum. L. Rev. 261.


\textsuperscript{32} See above n 2, p 106.
Therefore, limited partners ought to be granted a right to lodge an action in the name of the limited partnership against errant general partners who allegedly cause harm to the limited partnership.

**The Practical Desire in Chinese Private Equity Market**

Every creation of judicial remedy shall meet the needs of its potential users, namely the plaintiffs, so as to be a valuable and feasible legal device. Based on the results of the empirical study, there is a strong desire for the derivative action within the community of Chinese limited partners. Some interviewees also expressed the view that this mechanism may be a useful legal tool to protect limited partners’ legitimate rights in the future.33

Unlike the investors in the US and the UK venture capital and private equity funds who are generally passive in the management of the funds, recent news reports show that Chinese investors are comparatively active in that they have a strong desire to control the fund and always seek for a greater degree of involvement in the fund management.34 A large number of limited partners are unwilling to fully entrust their investment to general partners35 as they are concerned about the proper conduct of general partners in the running of the funds.36 In particular, when the corporate general partner is represented by a junior fund manager, it is likely for an experienced limited partner to question the competence of the junior. Also, when several funds are operated by the same general partner, limited partners would often question the allocation of investment opportunities. This inevitably causes conflicts

---

33 Telephone interview with Mr Hu (anonymity requested), associate, Chongqing Zhonghao Law Firm, China; telephone interview with Ms Dai (anonymity requested), associate, Chongqing Zhonghao Law Firm, Chongqing, China; e-mail consultation with Mr X (anonymity requested), partner, Yuantai Law Firm, Shanghai, China.


35 Ibid.

between limited partners and general partners. During the empirical study, the author also observed similar phenomenon.37

During the global financial crisis of 2007–2009, this conflict had become more severe. On the one hand, limited partners become more active in the fund’s management so as to ensure the fate of their investment. On the other hand, general partners have less bargaining power in the allocation of managerial powers as they are facing more difficulties in fund-raising process due to the lack of capital. Some general partners have to give up their controlling power in the management of the fund.38

The internal conflict between limited partners and general partners has also led to failures and dissolutions of the several private equity funds. We have seen many complaints from the general partners that limited partners’ interference had affected their decision-making in the operation of the fund.39 Limited partners are also accused of being too “short-sighted” as they do not fully appreciate the nature of private equity and have unrealistic expectations for large and quick returns.40

Given the increasing monitoring by limited partners in the management of the funds, one may reasonably expect certain legal rules to solve the internal disputes between limited partners and general partners. The limited partner’s derivative action may be one of the options.

**Will Limited Partners Sue?**

Will limited partners sue the general partners? The answer is unclear for the time being as the limited partnership is a brand new business vehicle in China. As of the date of this article, the author has not noticed any case which is initiated by limited partners in China.41 In order to

---

37 Telephone interview with Mr Chen (anonymity requested), associate, King and Wood Law Firm, Beijing; personal interview with Mr Liu (anonymity requested), partner, Guangdong Everwin Law Office, Guangzhou; telephone interview with Mr Liu (anonymity requested), legal adviser, Shenzhen Private Equity Mgmt Co (anonymity requested); telephone interview with Mr Feng (anonymity requested), associate, Chongqing Zhonghao Law Firm, Chongqing; e-mail consultation with Mr Miao (anonymity requested), partner, an offshore law firm (anonymity requested), Shanghai Representative Office; email consultation with Ms X, associate, Orrick, Herrington & Sutcliffe LLP, Shanghai Representative Office; email consultation with Mr X, partner, Yuantai Law Firm, Shanghai.


39 Ibid.

40 See n 34 above.

41 There is no official national case database in China, thus it is unknown whether there is any suit been brought by limited partners. As at the date of 28 Jan 2011, we have not seen any limited partner derivative action filed with the unofficial case database, ie the lawyee.net.
ascertain the feasibility of this remedy in the context of China, we may then consider the nation’s cultural norms, public image of the derivative action and the institutional environment, including the level of attorneys’ fees and the competence of judges.\(^\text{42}\)

It is generally accepted that ancient Chinese dislike conflict and strive to maintain group cohesiveness and harmony.\(^\text{43}\) Influenced by the Confucianism, “non-litigation (\textit{wusong})” becomes a special phenomenon widely recognised in ancient Chinese society.\(^\text{44}\) The essence of “non-litigation” is that people will settle disputes through traditional Chinese ethics and patriarchy rather than litigation.

Although this traditional negative attitude towards litigation still persists in modern China, there is a trend that people are becoming more litigious. They are more willing to utilise litigation to protect their legal rights in recent years.\(^\text{45}\) It has witnessed supportive attitudes of courts towards the shareholder derivative action.\(^\text{46}\) Since the shareholder derivative action was transplanted into the PRC Company Law in 2005, a number of derivative suits have been filed nationwide.\(^\text{47}\)

Moreover, decisions on whether to bring derivative actions are primarily determined by economics, not culture. The US experience shows that the leading cause of shareholder derivative actions is plaintiffs’ attorneys.\(^\text{48}\) If attorneys can win sufficient fee awards and as long as attorneys can find a nominal shareholder willing to lend his name to the complaint, suits will be filed.\(^\text{49}\) Also, the US investors have been able to use the threat of a lengthy legal process to force fund managers to resolve

---

\(^{42}\) For general discussion on the social meaning of shareholders derivative actions, see n 11 above, pp 66–75; Arad Reisberg, “Shareholders’ Remedies: the Choice of Objectives and the Social Meaning of Derivative Actions” (2005) 6(2) E.B.O.R. 227.

\(^{43}\) Confucius has a famous saying that “there is no difference between judgments made by me and those made by others. My objective is to persuade people not to pursue litigation.” See \textit{Lun Yu} at Yan Yuan.


\(^{49}\) Ibid.
disputes over alleged abusive mismanagement, even though they arguably rely on thin legal grounds.\textsuperscript{50}

In China, it would be difficult to ascertain exactly what benefits accrue to attorneys in derivative actions because attorney fees agreements are confidential. In addition, owing to the uneven development of the economy in different parts of China, attorney fees vary significantly from place to place.\textsuperscript{51} The existing fee rules for attorneys have no binding effect in practice, but are general guidance only.

\textbf{Other Remedies for Limited Partners in the Chinese Limited Partnership}

One may argue that a derivative action system for limited partners is redundant because there are alternative devices within the limited partnership regime which serve similar functions as that of a statutory derivative action. This section seeks to examine the possible ways for limited partners to counter general partners’ mismanagement or abuse of discretion under Chinese law and discuss whether they are effective, efficient and sufficient enough to protect the interests of limited partners and limited partnerships.

\textbf{Private Contractual Designs}

Arguably, private contractual arrangements are effective devices to constrain general partners’ misbehaviour. Terms of the partnership agreement would reflect accurately the actual concern of the partners.\textsuperscript{52} The \textit{ex ante} contractual arrangement may also avoid the high costs of litigation and protect partnership assets.\textsuperscript{53} Nevertheless, as has been shown by commentator Lee Harris, the importance of many contract design


\textsuperscript{51} Ascertaining attorneys’ fees in corporate derivative actions is difficult in China. Unlike Japanese Commercial Code which stipulates that attorneys are entitled to “reasonable amount” of attorneys’ fees upon plaintiff’s motion, the PRC Company Law 2005 is silent on this matter. Based on the limited number of published judgements in relation to the shareholder derivative action in China, no court-awarded derivative-suit fee is found.


features has been vastly overstated and many of these private contract features have severe shortcomings.54

First, the theory of incomplete contract55 has proved that parties cannot negotiate terms specifically to cover all contingencies because they cannot foresee every future event or know precisely how their own purposes may change.56 As private equity agreements are frequently investment agreements, partners may not properly conceive the future event when the contract is concluded. In particular, there is some doubt as to those duties drafted by partners or partners’ counsels would adequately address all future problems in a fluid long-limited partnership relationship.57

Moreover, the risk of negotiating or drafting error, uncertainty regarding the terms’ validity, lack of judicial precedent concerning the terms’ meaning or effect and lack of investor or other third-party familiarity with the terms would also affect the efficiency of the contractual arrangement.58

Given the fact that the limited partnership is a new business entity and there is a shortage of experienced private equity professionals in China,59 it is unlikely that the newly established or small limited partnership firms will have a well tailor-made partnership agreement to regulate the behaviour of the general partners. Indeed, many general partners also expressed their concerns on this issue.60

Also, based on the examined private equity agreements,61 it is found that there are a few contractual restrictions on the general partners’ behaviour. Numerous interviewees also mentioned that limited partners are less likely to focus on the language of duties or liability of general

54 See n 50 above, p 6.
61 See n 17 above.
partners or to appreciate the significance of the language. Lay investors may not apprehend what duties a general partner should have either. 62

Second, as mentioned above in The Practical Desire in Chinese Private Equity Market, 63 there is an active monitoring by limited partners of the activities of general partners in China. It is very common for limited partners to establish various advisory boards or investment committees and to take an active role in the operation of the fund ex ante prior to general partners’ abuse. It is reported that many famous private equity firms in China, like the Shenzhen Oriental Fortune Capital (shenzhen dongfang fuhai), the Zheshang Haipeng Venture Capital (zheshang haipeng chuangtou) and the Shenzhen Fortune Venture Capital (shenzhen dachen chuangtou) all set up the investment committees. 64 Typically, the committee usually consists of both general partners and limited partners. It is responsible for the investment issues such as asset allocation and investment strategy.65 In fact, the US has also seen increased monitoring by limited partners of the operation of general partners through various alternative private enforcement mechanisms, such as the advisory boards and law suits.66

Some Chinese limited partners even designed a new approach to supervise investment allocation by general partners. That is for both limited partners and general partners to decide the portfolio companies together and conduct fund-raising exercises later. This model is different from the international practice where the fund is raised earlier than identifying targeted investee companies.67 This approach may imply a potential failure of contract design since limited partners would turn to other enforcement mechanisms for protection of their interests, but not contract designs.68

Third, advocates of transaction cost argue that contract is not always effective in every transaction.69 Since investment agreements are generally complicated and costly to negotiate,70 regulating general

---

62 Telephone interview with Mr Lin (anonymity requested), legal adviser, Shanghai Private Equity Mgmt Co (anonymity requested).
63 See nn 34–40 above.
64 See n 34 above.
66 See n 34 above.
68 See Lee, n 50 above, p 34.
69 See Williamson, n 56 above, p 70.
partners’ conduct by agreements may not be cost efficient than the derivative action. Some interviewees also argued that leaving parties to tailor all the duties and liabilities of the general partners is undesirable.\textsuperscript{71} Of course, whether or not the negotiation costs would offset the benefit of these clauses may require another piece of empirical studies.

Fourth, some may argue that a well-designed distribution and compensation arrangement would serve as an incentive to encourage general partners to work in the best interests of the limited partnership so as to reduce the prospect of general partners’ misbehaviour.\textsuperscript{72} However, cases show that this arrangement may not achieve a desirable function for agent abuse in the context of Chinese private equity limited partnerships.\textsuperscript{73}

In China, it is common for parties to set out various prerequisites of profit distribution in the partnership agreement, thus making it difficult for general partners to be entitled to an attractive compensation.\textsuperscript{74} The international practice is that management fees typically ranging from 1.5 per cent to 3 per cent of total capital commitments of the fund would be paid to the general partners on an annual basis; and a carried interest typically up to 20 per cent of the profits of the fund would be paid to general partners as a performance incentive.\textsuperscript{75} While many Chinese partnership agreements include a minimum rate of return on the capital invested before the general partner can earn any carried interests, some agreements even provide that the general partners are not allowed to receive the carried interest until the investee companies are successfully listed on the stock exchange.\textsuperscript{76}

This practice is particularly common during the economic downturn when general partners face difficulties in fund-raising and when limited partners have stronger bargaining power in negotiation.\textsuperscript{77} Under this

\textsuperscript{71} Telephone interview with Mr Feng (anonymity requested), associate, Chongqing Zhonghao Law Firm; telephone interview with Mr Lin (anonymity requested), legal adviser, Shanghai Private Equity Mgmt Co (anonymity requested).

\textsuperscript{72} See David Rosenberg, “Venture Capital Limited Partnerships: A Study in Freedom of Contract” (2002) 2 Colum.Bus.L.Rev 363, 390–391 (Noting that the interests of general partners and limited partners are aligned “to a great extent by making the general partner’s compensation dependent on the success of the firms in the partnership’s portfolio”).

\textsuperscript{73} See n 34 above.

\textsuperscript{74} For further introduction on parallel funds in China, see Zou Jing, \textit{Placement and Operation of Private Equity-Legal Practice and Cases} (Beijing: Law Press China 2009), p 102.

\textsuperscript{75} James M. Schell, \textit{Private Equity Funds: Business Structure and Operations}, (Law Journal Press, 1999), §1.03 (3).

\textsuperscript{76} See n 38 above.

\textsuperscript{77} A 2009 survey indicated that 43% of the interviewees were of the opinion that limited partners had more bargaining power; while only 2% of them were of the opinion that general partners had more bargaining power. See Lü Sheng, “Post Financial Crisis – Changes to Fundraising Conditions”, China Venture, 7 July 2009.
circumstance, the distribution or compensation contractual design might not serve as an effective incentive to constrain misbehaviour of general partners. From the standpoint of general partners, some unfair compensation arrangements might, on the contrary, function as disincentives in their daily operation of the fund. It is reported that a number of limited partners are not satisfied with the remuneration made to the general partners.\(^{78}\)

**Reputation and Market Constraints**

It is widely argued that reputational constraints play a vital role in deterring mismanagement of general partners so as to protect the interest of limited partners.\(^{79}\) As typical private equity fund usually has a 10-year life and the fund must be returned to the limited partners eventually, a poor fund performance will eventually hurt general partners’ efforts to raise capital for a new fund.\(^{80}\) When there are a large number of competitors and weak industry concentration, a general partner ought to have a strong incentive in enhancing his reputation in order to ensure a ready exit with good returns for the fund within a reasonable period.\(^{81}\)

Nonetheless, while ordinary investors in private equity funds appear to rely heavily on reputational constraints to protect the fate of their investment, analysis may be changed in the context of China. First, recent news indicates that investors in large public and private joint venture funds are likely motivated by issues beyond the reputation of general partners, like local tax incentives, local legislations, political pressure and local economic development plans.\(^{82}\)

The National Social Security Funds (NSSF) and the government guide funds (zhengfu yindao jijin) have become the largest institutional

---

78 See n 38 above.
investors for private equity industry in China.\textsuperscript{83} As the NSSF is closely watched by the central government and the administrators of the NSSF are usually appointed by the governments, the NSSF would generally direct the general partners to invest in those areas which would be responsive to public demands and make less risky investment choices, especially in certain state-owned enterprises or its local subsidiaries.\textsuperscript{84} Similarly, the purpose of the government guide funds is to direct a certain portion of funding to be invested in targeted local encouraged industries, such as science and technology, green and cultural innovation fields.\textsuperscript{85} Local governments also require general partners to invest in certain encouraged industries and provide tax waivers to certain general partners.\textsuperscript{86} 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. The US pension funds also have similar experience in this matter.\textsuperscript{87}

Second, the international practice is that general partners are generally required to contribute 1 per cent of the committed capital to alleviate management abuse.\textsuperscript{88} However, such a contribution rate is much higher in some Chinese funds and can be up to 10 per cent.\textsuperscript{89} For example, a famous private equity firm, the Fortune and Paradise Silicon Valley requires general partners to make capital contribution of 5 per cent and 10 per cent respectively.\textsuperscript{90} In some government guide funds, general partners are even required to contribute 70 per cent of the committed capital.\textsuperscript{91} In fact, many limited partners admit that they adopt this approach simply to ensure that general partners are "loyal" to the funds and to share the risk of investment if there is poor performance.\textsuperscript{92}

The above evidences seem to support the view that Chinese limited partners do not heavily rely on reputation of the general partners. Put another way, if the relationship between limited partners and general

\textsuperscript{83} See n 82 above.

\textsuperscript{84} Chen Ming, "Private Equity Became the Key Investment of National Social Security Funds", available at http://www.ftrscx.cn/art/view690069668710.html.

\textsuperscript{85} See n 82 above.


\textsuperscript{87} See n 54 above, pp 32–33.

\textsuperscript{88} Josh Lerner Et Al., Venture Capital And Private Equity: A Casebook (John Wiley & Sons, 4th edn 2009), p 73


\textsuperscript{90} Ibid.

\textsuperscript{91} Ibid.

\textsuperscript{92} Ibid.
partners were really done on the basis of reputation, they might not need such monitoring devices.

Third, reputation is a long-term measure that works best only if those who depend on reputation are relatively stable and routinely rely on it to generate new deal flow.\(^93\) As private equity investments are generally long-term investments, it may take time for limited partners to redirect investments away from general partners with sullied reputation and toward the reputable general partners.\(^94\)

Fourth, the recent credit crunch, hedge fund scandals and numerous hedge fund collapses suggest that it is no longer possible to rely primarily on manager reputation and historical track record.\(^95\) In China, due to the lack of national personal credit reporting system and the lack of Personal Bankruptcy Law, the effectiveness of reputation constrain becomes a critical issue, especially when those who have good reputation abuse management powers. Significantly, cases relating to fraudulent fund-raising in private equity investments increase rapidly in recent years.\(^96\)

Last but not the least, it is argued that the derivative action may not be simply replaced by reputation sanctions as the latter is not enforceable under law and does not have the compensation function as that of the derivative action.

**An Action for Accounting and Removal of Partners**

Under the PEL, a partner shall account to the firm for any proceeds received by taking the advantage of his position, any partnership’s benefits seized by him; or any illegal properties wrongfully withheld by the errant partners. If the same cause loss to the partnership or to other partners, he shall make compensation to the firm as well.\(^97\) The PEL also provides that general partners shall account to the firm for any of the partnership’s benefits derived from any transaction competing with that of the partnership or any self-dealing business with the partnership. The general partner shall make compensation to the firm if any loss is caused to the partnership or to the other partners.\(^98\)

\(^93\) See n 50 above, p 33.
\(^94\) Ibid.
It is argued that although this mechanism serves a strong compensation function, they only deter limited abuses by general partners. The scope of application for plaintiffs is much narrower than that of the limited partner’s derivative action.

People may also argue that a threat to compel general partners to dissociate from the firm may be an effective way to counter abuses of rights by general partners. Under the PEL, where a partner causes any damage to the partnership due to intentional or gross negligence; or conducts any improper action in the course of partnership business, the said partner may be compelled to dissociate from the firm upon the unanimous consent of the other partners.99 This may lead to negative ramifications to the smooth operation of the partnership. Especially under the PEL, a limited partnership with only limited partners or with only one general partner would lead to the dissolution of the firm.100

**Dissolution**

One may submit that aggrieved limited partners may pursue dissolution of partnerships to deter errant general partners’ wrongdoings or omitted action. Pursuant to the PEL, if limited partners can prove that the limited partnership could not be reasonably carried on because of the alleged wrongdoing of the general partner, the partnership would be at risk of dissolution.101

It is argued that this mechanism might not be a desirable alternative to the limited partner’s derivative action because significant ramifications would result from dissolution of a partnership, such as the financial costs and tax consideration of partners. Particularly, in private equity limited partnerships which have already made substantial investment in portfolio companies, dissolution of the firm would come at substantial expense of limited partners. Arguably, if the partnership business is profitable and the objective of the derivative action is to counter abuse of

100 Ibid.
101 These events include:
   (1) The term of partnership expires and the partners decide not to operate it any longer;
   (2) Any of the dissolution causes as stipulated in the partnership agreement occurs;
   (3) All partners make a decision to dissolve it;
   (4) 30 days have lapsed since the number of partners fails to reach the quorum;
   (5) The partnership aim as stipulated in the partnership agreement has been realized or is unable to be realized;
   (6) Its business license is revoked, or it is ordered to close up or to be revoked; or
   (7) Other reasons as provided for by any law or administrative regulation.
the general partners only, it is not advisable to have the profitable going concern wound up. Commentator Troy also argued that dissolution is often an expensive way to enforce fiduciary duties and not a preferable way to deter mismanagement of partners.\textsuperscript{102}

**Limited Partners’ Withdrawal from the Limited Partnership**

An aggrieved limited partner may attempt to disassociate and withdraw from the partnership if the entire body of limited partners is injured by the actions or omitted actions of a general partner. While this may be an effective deterrent tool when there is only one general partner in the partnership, withdrawal may not be an optimal solution for aggrieved limited partners in the Chinese regime. According to Art 75 of the PEL, in the event that the limited partnership is left with only general partners, the limited partnership must be converted to the general partnership.\textsuperscript{103} Moreover, if all 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 to a general partnership. This would incur unnecessary formation and dissolution costs and would have significant implication to the business of the limited partnership.

**Personal Liability of General Partners**

One may further argue that the personal liability borne by the general partners may discourage them from pursuing mismanagement and risky activities (such as excessive borrowings and overleveraged activities) so as to safeguard the interests of limited partners and the limited partnership.\textsuperscript{104} However, such optimism is arguably misconceived to a certain extent. As has been observed by commentator Ribstein, personal liability has little effect on the general partner’s incentives to self-deal, for example, by taking partnership opportunities or excessive

\textsuperscript{102} See n 21 above.

\textsuperscript{103} Enterprise Law, Art 75 & 24 (2006) (PRC); See also Li Fei, *Interpretation of Partnership Enterprise Law of the People’s Republic of China* (Beijing: Law Press China, 2006), p 122. However, the precise manner in which a limited partnership converts to a general partnership remains unclear as the Partnership Enterprise Law does not spell out any rules on the conversion process.

When the general partner is actually organised as a corporation, the issue of unlimited liability has effectively been sidestepped. Moreover, this liability device only reduces creditors’ risks without alleviating the concern of limited partners. As observed by an experienced Chinese lawyer, the real concern of Chinese limited partners is not whether the general partners have the capacity to bear unlimited liability for the debts of the firm, but whether the general partner has the capacity to compensate the general partners when they cause harm to the partnership.

**Conclusion on Remedies**

In light of the above, it is admitted that each intra-partnership dispute resolution and external mechanism has its own value and function in constraining misbehaviour of general partners. However, they may not work as well as is suggested by commentators in the Chinese context. In essence, the severe internal conflicts and agency problem within the private equity limited partnerships are not resolved effectively by contract designs and reputational constraints. A consequence of a potential failure of these remedial mechanisms is that Chinese limited partners heavily rely on alternative private enforcement mechanisms for protection, but not complex contract design features.

Moreover, even if the derivative action may not be more efficient among the various mechanisms, it might be more effective in the sense that it has strong deterrent and compensation functions.

Furthermore, although filing a lawsuit is costly, the limited partners may be able to use the threat of the legal battle as an *ex post* way to force general partners to resolve disputes over alleged misbehaviour. Ultimately, when the fraudulent or abusive act of the general partner affects all partners proportionately and management is unable to protect the interests of the partnership, derivative actions give limited partners, who do not normally involve in management, a supplementary way to protect the interest of the business.

Indeed, it is not easy to force general partners to resolve disputes over alleged misbehaviour. Besides strong legal rules on agent misbehaviour...
and private enforcement through contractual designs, many other mechanisms are required to achieve a desirable result, such as providing more detailed rules on the duties and liabilities of general partners and increasing the qualification requirements for general partners.

**Making the Limited Partner’s Derivative Action Work in China**

Assuming the rule of derivative action is desirable and in any event it has been recognised by law, the next question that arises is how to make it work in the context of China. There is no doubt that the special market conditions of private equity sector in China and the special needs of the plaintiff limited partners require well-designed legal rules to regulate the limited partner’s derivative actions.

**Who are the Defendants?**

Pursuant to Art 68(7) of the PEL, the defendant of the derivative action is the “executive partner who has neglected to vindicate partnership rights” only. However, the PEL is silent on what constitutes “neglected to vindicate partnership rights”. Such an uncertainty would definitely create judicial and practical difficulties in the implementation of the derivative actions.

In addition, compared to the DRULPA, the scope of application under Art 68(7) is too narrow. In the US, a derivative claim generally exists when the entire body of limited partners is injured by the actions or omitted actions for which a complaint has been submitted. Limited partners are entitled to bring a derivative action to enforce a limited partnership's right or remedy a wrong to the limited partnership where the general partner fails or refuses to do so. The DRULPA provides that a limited partner may bring a derivative action 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.

Given the increasing number of private equity limited partnerships and the complexity of private equity investments, it is suggested that the PEL ought to provide a broader scope of application to the plaintiffs so as

---

110 Delaware Revised Uniform Limited Partnership Act, § 17-1001.
to cover potential claims. For example, the gravamen of the plaintiff limited partner may include any injury or wrong done by the general partner to the partnership and any legitimate rights of the partnership which are sought to be vindicated.

In particular, as discussed earlier, the investment committee is responsible for the major issues in many Chinese private equity limited partnerships. If the investment committee or other equivalent mechanism is the de facto management of the funds and the one which does not wish to file an action against the general partners allegedly causing harm to the funds, the limited partners may have to petition the investment committee to proceed first. If such petition fails or the investment committee fails to vindicate the rights of the funds, the limited partners may bring an action on behalf of the funds.

Another question which is unclear under the PEL is whether the derivative action can be brought against a former general partner who failed to exercise the legitimate rights of the limited partnership.

The ULPA 1985 and the ULPA 2001 do not consider a former general partner as a proper defendant. It seems undesirable to pursue a derivative action against a former general partner as the PEL has provided a compensation mechanism for a former partner to bear liability for the debts incurred before his joining to the firm. Pursuant to Art 44 of the PEL, a general partner will assume joint liability with the existing partners for the debts incurred by the partnership before his joining to the firm. In addition, Art 53 of the PEL provides that dissociated general partners have to bear joint liability for the debts of the firm incurred before his dissociation from the firm.

Given the fact that these statutory provisions actually impose a liability burden should a former general partner who fails to exercise his rights and cause harm to the firm, there is no need to additionally burden former directors with the liability arising from a derivative suit.

**Who is the Proper Plaintiff?**

Art 68(7) of the PEL indicates that the right to bring a derivative action belongs to limited partners, but it fails to set out clear rules as to whether

---

111 Text accompanying n 64.


113 See Partnership Enterprise Law, Art 44 (2006) (PRC). Note that Art 77 of the Partnership Enterprise Law provides that a new limited partner must bear liabilities to the extent of his capital contribution even for the firm’s debts incurred before he joins the firm.
the limited partner must be a limited partner at the time of the impugned transaction(s) that is the subject of complaint or whether the limited partner must be a limited partner at the time of suit.

Under several US Acts, a proper plaintiff of a derivative action must be a partner at the time of bringing the action and was a partner when the conduct giving rise to the action occurred; or whose status as a partner devolved upon the person by operation of law or pursuant to the terms of the partnership agreement from a person that was a partner at the time of the conduct. Such an approach only permits a partner to bring a derivative claim in respect of wrongs committed after he becomes a partner, but not prior to his becoming a partner.

Pursuant to the PEL, an external assignee of partnership shares can be a partner after revision of partnership agreements. If the law permits an external assignee of partnership shares to bring a derivative claim in respect of wrongs committed prior to his becoming a partner, it may induce opportunistic litigation by the partner. It is thus suggested that in order to prevent those incoming partners from gaining illegal benefits from derivative actions, the law may consider following the US approach by requiring a limited partner to possess the requisites before bringing a derivative action.

Another question that follows is whether the plaintiff limited partner can fairly and adequately represent the limited partnership and whether the plaintiff will be acting in good faith in bringing the derivative action. This question is crucial because unlike the direct action which belongs to the plaintiff individually, the limited partner’s derivative action belongs to the limited partnership as a whole.

There are cases which rule that a plaintiff whose interest is adverse to the limited partners is not an adequate representative of the limited partnership. In Davis v Comed In, an eight-part test was established to determine the standing requirement of fair and adequate representation in derivative actions. They are: “(1) the economic antagonism between the plaintiff limited partner and other limited partners; (2) the plaintiff’s enumerated remedy; (3) whether the plaintiff is the driving force behind the litigation; (4) the familiarity of plaintiff with the litigation; (5) other existing litigation between the parties; (6) the magnitude of the plaintiff’s personal interest compared with his interest in the partnership.”

116 Frazier v Manson, 651 F. 2d 1078, 1081 (5th Cir. 1981); Albright Missouri, Inc. v Billeter, 829 F.2d631, 639 (8th Cir. 1987), cited in n 12 above, Vol IV, §15.05(d), 15:54, n 49.
117 619 F . 2d 588 (6th Cir. 1980).
derivative claims; (7) any vindictiveness between the parties; and (8) any support or approval obtained from other limited partners. Such a detailed requirement would positively serve to deter any potential abuse of the derivative action by bad faith limited partners.

Recently in Jennings v Kay Jennings Family Ltd Partnership, the Supreme Court of Virginia emphasised that the criteria for determining a suitable plaintiff limited partner is the economic antagonisms between the plaintiff limited partner and other limited partners. In other words, if the plaintiff’s economic interests are different from those of other limited partners, the plaintiff is unlikely to be considered as the adequate plaintiff for the derivative action.

Besides case law, US-Virginia also provides statutory provision requiring that “the derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the limited partners and the partnership in enforcing the right of the partnership”.

It seems that the test established in the above cases might not be viable at the current stage of China. Lawsuits involving the derivative actions rely heavily on the intervention of the power of the judiciary and the support of judicial judgment. However, China is still in the initial stage of building rule of law. Not only that the expertise of judges varies from place to place, but also that there is a shortage of qualified judges in rural and poor places. Arguably, there may be less qualified judges in dealing with this brand new and technical derivative action. Therefore, it is inappropriate to rely too much on judges’ roles in interpreting derivative actions at this stage.

Exhaustion of Remedies

The PEL is silent on the prerequisites for limited partners to bring a derivative action. Art 68(7) merely states that if the general partner has

---

120 For discussion on this case, see n 9 above.
125 Ibid.
neglected the exercise of his rights, the limited partner may urge the general partner to exercise his rights. However, it is uncertain whether the plaintiff must urge the general partner to exercise his rights first before bringing the derivative action. Without clarification of these matters, it would be difficult to pursue a derivative action and a defendant would easily defend the pleading. It may also incur unnecessarily litigation costs and expenses.

Under the ULPA 2001, the limited partner must firstly show that the limited partner has made a demand and the general partners’ response to the demand, such as the general partners have failed to act upon the request of the limited partner. However, the limited partner does not need to make a demand if the general partner can show that such a demand would be futile. For example, the plaintiff limited partner was denied access to the partnership books or investment materials or the only third party is the defendant. At common law, limited partners shall take certain procedural steps prior to filing a derivative action.

In view of the above, it is suggested that the PEL or the future judicial interpretations on the PEL may consider providing similar guidelines and requiring the plaintiff to state with particularity: (1) the date and content of plaintiff’s demand and the general partners’ response to the demand, or (2) why demand should be excused as futile.

In addition, while the law has not made any effort to revise the existing rule, partners may always prescribe prerequisites for bringing a derivative action in the partnership agreement, such as: (1) in spite of urgent circumstances that may cause incurable damage to the limited partnership in the absence of immediate action, waiting for the expiration of the time deadline for the general partner to act after receiving such a request from the limited partner; or (2) consulting other limited partners and ascertaining whether they would support the derivative action. For instance, a demand of a limited partner can be satisfied by the errant general partner’s exercising of legitimate rights for the interest of the limited partnership; or by the limited partner’s ratifying the transaction in question.

It is believed that a consultation or conversation among limited partners would reduce and eliminate the prospect of a limited partner to bring an action. It may also prevent a bad faith limited partner, who is

---

126 Uniform Limited Partnership Act 2001, §1004 provides that “In a derivative action, the complaint must state with particularity: (1) the date and content of plaintiff's demand and the general partners’ response to the demand; or (2) why demand should be excused as futile.”

127 See n 12 above, Vol IV, §15.05(g), 15:65.

128 See n 12 above, Vol IV, §15.05(d), 15:51–15:53.

129 See n 12 above, Vol IV, §15.05(d).
not seeking the whole interest of limited partners, but who is holding an economic conspiracy for himself from bringing a derivative action.

Security, Expenses and Proceeds

Security for expenses
The security requirement of bringing a derivative action is not addressed by the PEL. Security for expenses is an effective means to deter abuse of derivative actions in practice, so as to avoid unnecessary expenses for both sides. However, the security for expenses is useful only when the plaintiff limited partner acts in bad faith in bringing the derivative action. Meanwhile, a burdensome security for expenses may become an inappropriate disincentive to the aggrieved limited partner.

In many US states, such as New York\textsuperscript{130} and California,\textsuperscript{131} the plaintiffs are required to provide the security for expenses. Significantly, California’s approach appears an advisable one in achieving the balancing between the plaintiffs and the defendants. On the one hand, it provides a security for expense to prevent unmeritorious suits, such as, the plaintiff sues for the benefit of another or there is a reason to believe that he will be unable to pay the costs of the defendant. On the other hand, it provides conditions to avoid making security for expenses an inappropriate disincentive to the aggrieved limited partner, including, \textit{inter alia}, after hearing, the court determines that the party asking security has established a probability that there is no reasonable possibility that the cause of action will benefit the partnership or the partners or the party asking security did not participate in the transaction that is the subject of the complaint.\textsuperscript{132}

However, China shall not simply copy the US approach without envisaging its particular infrastructure. Considering the current level of judicial practice, it is suggested that China ought not be given such a wide discretion to order security whenever it thinks fit. The requirements of security for expenses should be specifically spelt out by law so as to avoid different courts setting forth different conditions to order security for expenses.

\textsuperscript{130} NewYork Partnership Law §121–1003. See n 12 above, Vol IV, §15.05(g), 15:66.
\textsuperscript{131} California Corporation Code §15702(a) (1) and (e). See n 12 above, Vol IV, §15.05(g), 15:66.
\textsuperscript{132} See Mark D. West, “The Pricing of Shareholder Derivative Actions in Japan and the United States” (1994) 88 \textit{Nw. U.L.Rev.} 1436, 1466 (noting that Japanese corporate rules, modelled after that of California, allow the court, at the request of the defendant, to order the shareholder-plaintiff to furnish adequate security).
Who bears the expenses?

There is no rule as to who is to bear the expenses of the derivative action under the PEL. The issue of costs has a great impact on the utility of the derivative action. The high cost of litigation may be a major disincentive for limited partners to bring a derivative action. Meanwhile, the possibility of recovering costs and fees are an important incentive for limited partners to commence derivative actions.

In the US, a plaintiff limited partner shall generally by default pay the expenses of the derivative suit. If a derivative action is successful in whole or in part, the court may award the plaintiff a certain amount of expenses including reasonable attorney fees from the recovery of the limited partnership. However, if the court finds that the action was commenced without reasonable cause or the plaintiff did not fairly and adequately represent the interests of the limited partners and the partnership in enforcing the right of the partnership, it may require the plaintiff to pay any defendant’s reasonable expenses, including reasonable attorney fees incurred in defending the action. In Smith v Croft, Judge Walton held that a shareholder’s ability to finance the action himself will be a relevant question of whether the court will make a costs order.

Japanese experience in dealing with corporate derivative action may shed light on this issue. Pursuant to the Japanese commercial code, attorneys are entitled to “reasonable amount” of attorneys’ fees upon plaintiff’s motion. Japanese courts also routinely used the specific fee rules when deciding bond motions to demonstrate the burden placed on defendant directors.

In China, plaintiffs of civil suits have to advance the filing fees based on the sliding scale relative to the amount of damages claimed. Also, plaintiffs will have to pay application fees for enforcement of the judgments and the application fees is payable according to the amount claimed for enforcement. Thus plaintiffs would have to pay substantial fees if the claims of amount are large. In addition, the losing party would have to bear the filing fees and other litigation fees allocated by the court.
excluding attorney’s fees. If the plaintiff loses the case, he has to pay a considerable amount of litigation costs.141

Statistics show that the majority of limited partners in China’s private equity market are private enterprises and wealthy individuals.142 There is a trend that the NSSF, the national pension funds, insurance companies and other institutional investors will become the mainstream of Chinese limited partner’s community.143 It thus appears feasible to require limited partners to pay the expenses of the derivative actions as there is little doubt as to these limited partners’ capacity to pay the expenses of the derivative suit.

In the light of the above, it is suggested that the law ought to require plaintiff limited partners to pay the expense of the suit in general, but the court may award the plaintiff reasonable expenses, including reasonable attorney fees, filling fees and application fees from the recovery of the limited partnership. Nevertheless, the costs and fees rules would need to be re-evaluated if any real change is to occur.

Who receives the proceeds?
The PEL is silent as to who shall receive the proceeds or benefits of a successful derivative proceeding. The US practice is that the benefit of a derivative action goes to the firm and not to the derivative plaintiff. If the derivative plaintiff receives any proceeds, the derivative plaintiff shall immediately remit them to the limited partnership.144

The limited partner’s derivative claim is a protection of the limited partnership firm when the entire body of limited partners is injured by the actions or omitted actions for which a complaint has been submitted.145 Hence, the proceeds or benefits of a derivative action should be owned by the limited partnership firm but not to the individual plaintiff limited partners.

141 The Supreme People Court’s Measures on the People’s Courts’ Acceptance of Litigation Fees 1989, Art 19.
145 See n 9 above, p 168.
One may argue that if China adopts this approach, the derivative action would be extremely rare in practice as those who bring an action will not directly benefit from the suit, but have to share the proceeds with other limited partners and general partners. Nevertheless, it is argued that the interests of the limited partnership and that of the limited partners are generally aligned over the long run and they may both benefit from the proceeds. Moreover, the expectation for limited partners to bring a derivative action is not just to receive the proceeds from successful litigation, but also to deter misconduct of the errant general partner.

It is therefore recommended that the proceeds of a successful action ought to be awarded to the limited partnership and not to the limited partner(s) who initiated the litigation. This is also in line with the practice in the corporate derivative action.

Conclusion

There is no denying that the introduction of derivative actions is a major development in Chinese partnership legislation. Although the effectiveness of the limited partner’s derivative action in China would require comprehensive judicial support and it may involve substantial litigation costs, at the very least, it grants limited partners an additional right to protect their interests in the limited partnership firm.

Nevertheless, to make the derivative action work effectively, more detailed statutory rules are needed to flesh out this device. To balance the interests of the plaintiff and the defendant and given the “exceptional” nature of derivative actions, it is recommended that the derivative action should be brought by a simple and modern procedure and should be subject to tight judicial control at all stages. In addition, it is suggested that Chinese courts shall refer to the body of Anglo-American cases to see how they interpret vague and open-ended standards in the derivative action and how they strike the right balance between managerial freedom and limited partners’ protection in the limited partnership.