Limited Partnership: A New Business Vehicle in People's Republic of China

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In June 2007, the National People’s Congress (‘NPC’) of the People’s Republic of China (‘PRC’) revised the Partnership Enterprise Law (‘PEL’) so as to introduce the limited partnership (‘LP’). Prior to the revision of this particular statute, the general partnership (‘GP’) was the only partnership vehicle allowed under PRC law.

One of the major reasons cited by the NPC for adopting the LP is to encourage the investment of capital in high-technology enterprises and to facilitate the development of the venture capital market amidst the overhaul of the country’s economic infrastructure. Having been admitted into the World Trade Organisation in 2001, the PRC has since become one of the most aggressive emerging markets in seeking venture capital investments.

The overall impression is that the PEL appears to pay more attention to the external relationship between the partnership and outsiders than on the internal relationships among the firm’s partners.

**DEFINITION AND FORMATION**

Under the PEL, a LP enterprise refers to a partnership formed by general and limited partners. The fiduciary doctrine is the primary regulator of partners’ relationships in the UK and US, the rights and obligations of partners in the PRC are spelt out in the PEL provisions.

The general partners exercise control over the day-to-day management of the LP while the limited partners must desist from participation in management activities in order to remain under the limited liability shield.

The LP is deemed to be valid from the date of issue of the partnership enterprise business licence. The LP provides that the LP has to comprise a minimum of two partners with the total number not exceeding 50 of these, there must be at least one general partner bearing unlimited liability for the debts and obligations of the LP. Unfortunately, the PEL stipulates that state-owned enterprises, listed companies, charitable bodies and social organisations cannot be general partners in a LP venture as the NPC is of the view that such institutions, being primarily financed by funds raised from the public, should not be exposed to potentially unlimited liability. These strictures may be misconceived (especially for state-owned enterprises and companies) as there is a sufficient mechanism protecting stakeholder interests in the revised company and securities laws.

In contrast to the other jurisdictions that unambiguously adopted either the entity or aggregate approach, the PEL is silent on whether the partnership enterprise is a legal person. The general impression is that the LP in the PRC appears to possess certain attributes that are consistent with the entity approach — 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.

If the PRC LP has a separate legal personality, there is concern that it may be taxed as an opaque entity in foreign jurisdictions. On the other hand, the venture capital LP has already been granted substantial tax advantages in the PRC and the LP’s strong entity features may thus not have too adverse an impact on tax considerations.

**Dissolution and bankruptcy**

Most of the grounds (such as unanimous consent among the partners to dissolve the partnership, expiration of partnership terms and revocation of the partnership business licence) for the dissolution of a partnership are also applicable to the LP.
under PRC law are in line with international practice. It should be pointed out that PRC partnerships must be dissolved if there are fewer than two partners over a 30-day period. In addition, the PEL requires the LP to be dissolved if the firm is left with only limited partners after the departure of all general partners. In the event that the firm is left with only general partners, the LP must be converted to a GP if there is only one general partner left in the LP, the firm has then to be dissolved.

Under the Delaware Revised Uniform Limited Partnership Act (‘DRULPA’), a LP will not be automatically dissolved if the sole remaining partner is either a limited partner or a general partner; instead, the Delaware LP is allowed to appoint another limited or general partner within a grace period of 90 days (or such other period as provided for in the partnership agreement). It is therefore suggested that a PRC LP with only one general partner should similarly be allowed to continue operating for a longer grace period so as to provide flexibility for the firm to explore more options and minimise unnecessary wastage and costs entailed by enforced dissolution.

After the dissolution of the LP, the general partners still have to bear unlimited joint and several liability for the debts incurred during the partnership's operations. Should the assets of the firm be insufficient to meet all of its debts, the creditors of the LP may either apply to the People’s Court for bankruptcy liquidation or claim directly against the general partners. In this manner, the NPC has thus provided some form of ‘double guarantees’ for the protection of the LP’s creditors.

**Tax treatment**

The partnership itself is not subject to taxation while each partner will have to be individually taxed on its share of the profits generated by the firm. In the PRC, the income tax to be paid by an individual partner is based on a progressive rate ranging, at present, from 5 per cent to 35 per cent.

The PRC Ministry of Finance and State Administration of Taxation announced a tax reform exercise in 2007 to encourage investments in small- and medium-size high-technology enterprises as well as to encourage foreign investments. Under this preferential taxation policy, 70 per cent of the venture capital enterprise’s investments in unlisted high-technology companies (via equity investments) for at least two years may be deducted from its taxable income if certain criteria are met by the venture capital enterprise and the investee company.

**PARTICULAR CONCERNS**

**Liability of partners**

The key feature of the LP is the limited liability of limited partners. Similar to the LP-related statutes of other jurisdictions, the PEL stipulates that the limited partners are not permitted to take part in the management of the firm and they lack authority to act for or bind the partnership – the so-called ‘control rule’. Nevertheless, it is possible for limited partners to engage in certain ‘safe harbor’ activities without affecting their limited liability shield. The PEL provides an exhaustive ‘safe harbor’ list which is comparatively shorter than the corresponding list spelt out in the DRULPA. In fact, the Uniform Limited Partnership Act (‘ULPA’) has even liberalised further in 2001 by eliminating the ‘control rule’ and instituting a full status-based liability shield for each limited partner even if it participates in the management and control of the LP.

New Zealand has opted for a more flexible approach by providing in their LP Act a non-exhaustive list of permitted activities if a limited partner is involved in any particular activity not included in the ‘safe harbor’ list, the court will then have to separately consider whether it is deemed to have taken part in the LP’s management. In comparison, the ‘exhaustive’ approach of PRC appears to be unduly restrictive. Since PRC’s venture capital market is in urgent need of funds at present, it may be expedient for the PEL to provide a non-exhaustive list instead so as to accommodate the possibility of other activities not originally envisaged by the NPC.

Another shortcoming of the PEL is that it fails to spell out unambiguously the extent of the limited partner’s liability should it participate in the management of the firm. This lack of clarity is likely to give rise to practical difficulties and thereby undermine the LP’s attractiveness to limited partners (especially for venture capital investors). Perhaps the NPC should consider the estoppel approach adopted by Delaware (and many other American states); if the limited partner does participate in the control of the business, the DRULPA stipulates that it will only lose its liability shield vis-à-vis those who transact with the LP in the belief that the limited partner is (because of its conduct or representation) a general partner.

The PEL does envisage two special situations where the limited partner may be required to bear unlimited liability:

- where a limited partner acts without authority in transactions involving third parties and in so doing causes loss to the firm or other partners, it will bear unlimited liability for the debts thus incurred and is liable to compensate the LP and other partners accordingly;
- where a third party reasonably believes that a limited partner is a general partner and accordingly proceeds to transact with such a partner, the latter is liable for that particular transaction to the same extent that a general partner would be under such circumstances.

Although the onus of proof lies on the third party, this burden is not difficult to discharge since the PEL generally does not allow limited partners to participate in the LP’s management, any limited partner who actively controls or acts on behalf of the firm will naturally be viewed as an ’apparent’ general partner. If there is any hint of suspicion that a limited partner may be unwittingly drawn into situations that require it to bear personal liability for the debts of the firm, the LP may then lose its inherent attractiveness of limited liability for investors and entrepreneurs. Hence, it is suggested that the PEL should impose a greater burden of proof on the third party.

**Corporate general partners of LP**

The PEL allows partnerships to be formed by individuals and legal persons (except for state-owned enterprises, listed companies, charitable bodies and social organisations), thus opening the door for corporate general partner(s) to direct the LP’s business. This hybrid vehicle combines the advantages of

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corporate identity and limited liability of companies with the contractual flexibility and tax advantages of partnerships. However, one should not overlook the possibility of potential problems arising under certain situations:

- An unscrupulous general partner hoping to evade personal liability may establish a shelf company to function as a corporate general partner of the LP; in effect, the shelf company is merely a ‘dummy’ acting as an agent for the individual general partner. For such a variation of the LP structure, the corporate general partner has no substantial assets to be liquidated in the event of the LP’s bankruptcy and there may in the worst-case scenario be no one actually bearing unlimited liability. It is thus incumbent upon the investors to assess the financial status of the sole corporate general partner before entering into any agreement with such an LP. A possible safeguard is to impose on the corporate general partner some minimum capital contribution or the maintenance of a certain percentage net worth throughout the existence of the LP.

- Unlike an individual general partner who is able to make decisions on his own, a corporate general partner can only act through its directors and corporate officers. For the US LP model, conflicts of fiduciary duties may arise where the corporate general partner (acting through its directors and corporate officers) owes fiduciary duties to the partnership firm and its limited partners but then these corporate representatives at the same time owe fiduciary duties to their own corporation. Although there is no equivalent concept of fiduciary duty under PRC law and the PEL does not address this issue, similar conflicts of interests may still arise for PRC LPs with corporate general partners. Should the managers representing the corporate general partner consider their employer’s interests over those of the limited partners in the LP enterprise? How is one to determine whose interests ought to prevail in situations of conflict? It is recommended that the parties should pre-empt such potential conflicts by prescribing the specific roles and duties of the parties in the partnership agreement or the corporate articles. However, the latter option may prove unrealistic if the corporate partner is not a special-purpose entity but an investment or trading company with a diversified business; in such a case, the more effective approach may be the imposition of a statutory fiduciary duty on the general partner.

- In practice, the corporate general partner may at regular intervals replace its representatives who participate in the management of the LP. Hence, it may be more difficult for any limited partner to control the transfer of managerial authority to a third party for an LP with corporate general partners (as compared to an LP with only individual general partners). The limited partner must thus be able to clearly identify the specific representative(s) appointed by the corporate general partner to run the LP business.

- In the PRC, the LP with only one (general) partner is not allowed to continue business since it fails to meet the PEL’s minimum requirement of two partners. Strict compliance with this technicality will generate uncertainties for the continuity of the LP (besides the costs incurred in winding up the partnership). In contrast, Singapore has proposed that an LP with only one partner (who must be a general partner) ought to be allowed to remain in operation; this is clearly preferred for reasons of business stability and economic efficiency.

In order to safeguard the limited partners’ interests in an LP with a sole corporate general partner, the parties should explicitly prescribe the duties and obligations of the sole corporate general partner by specifying the latter’s scope of authority in the LP agreement.

Duties of partners
At present, PRC law does not share any equivalent concept of fiduciary duty present in common law jurisdictions. In stark contrast to the detailed statutory duties in the UK and US-Delaware governing the internal relationships between general partners and limited partners, the PEL outlines the following broad rules:

- the managing general partner should regularly report to the other partners on the process of partnership activities, the business and financial status of the partnership;

- the general partners should not carry on any business competing with that of the partnership;

These three PEL provisions are patently inadequate to address fiduciary concerns especially in the case of an LP with a sole corporate general partner. In fact, there has been a trend in the US that the directors and controlling managers of corporate general partners owe a direct duty to the limited partners. It is thus suggested that NPC should address these difficulties by specifically imposing direct statutory obligations (rather than a broad fiduciary duty) to prevent unscrupulous general partners from taking advantage of their positions in the LP; for example, there ought to be a provision in the PEL enjoining that the corporate general partner’s duty to the LP should prevail over the duty to the corporate shareholders and creditors in order to address such potential conflicts of interests.

Others may proffer counter-arguments that such statutory imposition is not really necessary as, in their view, the market should be able to rein in any rogue behaviour of general partners; after all, a general partner operating in a highly competitive venture capital market ought to have a strong interest in enhancing his reputation in order to ensure a ready exit with good returns for the fund within a reasonable period. In addition, it has been asserted that the personal liability borne by the general partner should be sufficient to safeguard the limited partners. Such optimism is arguably misconceived in view of the following:

- in the PRC, the LP is a novel concept and many of the investors are still inexperienced in dealing with LP transactions;
the lack of a sound credit system in the PRC increases the risk of investments;

- in the opinion of Ribstein, ‘personal liability has little effect on the general partner’s incentives to self-deal, for example, by taking partnership opportunities or excessive compensation’;

- when the general partner is actually organised as a limited liability company, the issue of unlimited liability has effectively been sidestepped.

Hence, there is clearly a compelling need for the PEL to impose a statutory duty of loyalty and care on the general partners – in line with company law practice in the PRC. 49

Derivative action
Similar to the DRULPA, the PEL prescribes that the limited partner may pursue legal action in its own name to safeguard the interests of the LP ‘where the partner responsible for the conduct of the partnership affairs has neglected the exercise of his rights’. 50 Although asserting the limited partner’s right to initiate a ‘derivative’ action, the PEL fails to spell out any procedural rules:

- apart from mentioning that the plaintiff must be a partner at the time of instituting the action, the PEL is silent on whether the limited partner has to meet any eligibility requirements; for example, it is unclear whether the limited partner should first exhaust its remedies (such as waiting for the expiration of the time deadline for the general partner to act after receiving such a request from the limited partner in spite of urgent circumstances that may cause incurable damage to the LP in the absence of immediate action); 51

- 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;

- it is also uncertain in the PRC who may receive the proceeds of a successful action and who should bear the expenses incurred; since the purpose of a ‘derivative’ action is to protect the LP as a whole rather than any of the partners, the proceeds of a successful action ought to be awarded to the LP and not to the limited partner(s) who initiated the litigation.

The necessity of allowing such ‘derivative’ action is understandable as there are insufficient duties owed by the general partner to the limited partner under the PEL. In addition, it is difficult for the limited partner (who is not permitted to freely dissociate from the LP) to reclaim his contribution to the partnership when it dissociates from it. 52 Since the limited partner is more vulnerable than the general partner under the PEL, it ought to be granted the right to lodge an action in the name of the LP against errant general partners who either wrongly fail to prosecute a partnership claim or breach their partnership duties. 53 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 LP’s management).

CONCLUSION
There is little doubt that the adoption of the LP marks a milestone in the evolution of PRC partnership law as well as the development of the venture capital industry in this new economic powerhouse. However, the PEL furnishes only basic provisions on the LP structure and there are still various issues that require attention; for example, although several new concepts (such as ‘derivative’ action and ‘control’ rule) have been adopted under the PEL, there are insufficient detailed rules provided for effective implementation purposes. In addition, there remain certain restrictions for foreigners to invest in private equity LPs.

Without a well-established venture capital market and a business-friendly regulatory environment, the recently introduced LP vehicle may not be that widely adopted by investors in the PRC. Hence, the legislature should review on a regular basis the rules governing the LP – in tandem with the developments of the venture capital market – so as to meet rapidly changing business needs as well as to balance the interests of the different parties involved.

3 The Australian states have partnership statutes which allow for LPs. New Zealand’s LP Act came into force on 2 May 2008. Singapore LP Act came into operation in May 2009.
4 See ‘LP will become the important business form in private equity real estate’, copy available from Shanghai Diligence Law Firm’s website at www.diligence.com.cn (viewed 2 October 2008).
5 Article 60, PRC PEL (2006).
6 The establishment of partnership ventures in PRC by foreign individuals and enterprises is governed by the Administrative Measures for the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals 2009.
7 See detailed discussion in s 3 on duties of partners under Heading III which looks at particular concerns.
11 Article 61, PRC PEL 2006.
12 See T Prime and G Scanlan, ‘Limited Partnership reform – the entity, the fiduciary duties and the execution of deeds’ (2007) Comp Law 262 at 265. The aggregate approach regards a partnership as an aggregation of the individual partners whereas the entity approach views the partnership as an entity separate from its partners.
Under PRC law, legal persons refer to organisations which possess the capacity for civil rights and independently enjoy civil rights and undertake civil obligations.

Article 49, PRC Civil Procedural Law; and Article 40, Opinion on Several Issues of Applying PRC Civil Procedure Law.


Article 80, PRC PEL (2006).


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