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**The Distorted Governance Model of Venture Capital Limited Partnerships in China:
A Political Perspective**

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1 SUMMARY

The limited partnership has been recognised and legalised by the Law of Partnership Enterprises of China in 2006. Owing to the lacking regime of ‘piercing the veil of limited partners’ in this legislation, however, limited partners commonly actively participate in management without any unlimited liability, which has seriously decreased the efficiency of fund management and even led to governance failures in practice. The Chinese venture capital market is commonly regarded as a striking achievement of the market economy reform of China since the 1980s, the strong state control over the venture capital funds in contemporary China, however, is still unshakable. This article attempts to explore the root reason of this disadvantage in Chinese partnership law by considering the role of the state in the venture capital industry of China during the recent decades and concludes that the lacking regime of ‘piercing the veil of limited partners’ in Chinese partnership law is caused by the active role of state in the venture capital industry and the prioritized state-owned capital in the Chinese economy.

2 INTRODUCTION

The limited partnership as a kind of business organization was first introduced into the Chinese market as early as the late 1990s, which was applied as pilot projects in the venture capital (VC) industry. Ever since the new Law of Partnership Enterprises of the People’s Republic of China was enacted in 2006,

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the limited partnership has also been increasingly preferred by the investors of the Chinese VC market. Owing to the inherent shortcomings of the existing law of partnerships of China, however, the economic efficiency of limited partnerships under Chinese law is problematic: the limited partners (LPs) are commonly overly active in fund management which has led to serious failures in governance of VC funds. This article attempts to shed light upon the nature of the practical problems of Chinese venture capital limited partnerships (VCLPs) by using historical and political analysis of the VC industry in the Chinese economy.

This article is organized as follows: at the outset of the article, the status quo of VC funds in the Chinese economy is briefly overviewed; the following section of the article analyses the political economy of the Chinese VC market which links to the market economy with the ‘Chinese characteristics’; the third section of the article elaborates the process in which limited partnerships were recognized by the legislation in China during the recent decades and also illustrates how the political control over the private sector of the Chinese economy impeded the legalization of limited partnerships in the Chinese commercial law system. The following part of the article reviews the governance failures of VCLPs in practice which shows how the political-oriented partnership law has led to a distorted governance structure of limited partnerships in practice. As a response to this point, this article attempts to assess the possibility of developing an effective liability regime for constraining the limited partners’ overly active interference in fund management. As a concluding remark, this article argues that the distorted governance mechanism of the limited partnership under Chinese law is rooted in the powerful state control over the private economy of China which has actually granted uncontrolled powers to limited partners and the reform progress of the limited partnerships in China mainly depends on how far the marketization of the Chinese economy will go and to what extent the state control over the VC industry can be diluted.

3 THE STATUS QUO OF VENTURE CAPITAL IN CHINA

If it is said that petroleum is the ‘blood’ for industry, capital can also be assimilated as the ‘blood’ for enterprises. There are currently four main sources providing the finance for Chinese companies to expand

their businesses, namely (i) loans from commercial banks, (ii) the private lending market, (iii) the public stock market and (iv) the debt market. First of all, as regards loans from commercial banks, considering the risk of debt default, especially ever since the global economic crisis, China's commercial banks tend to lend money only to medium or large enterprises with a good reputation and credit records. For start-ups, without stable cash flow or adequate collateral, however, lending from commercial banks is quite difficult.¹ The second source is private lending, which may be more flexible for small and medium enterprises (SMEs). However, due to the risk of illegal fund-raising and relatively high interest rates, private lending is also not reliable for most private enterprises in China.² Thirdly, although the public stock markets regulated by the China Securities Regulatory Commission (CSRC) can provide a safer source of finance, for most private firms, however, the high requirements of listing have, in fact, blocked access to China's stock market: indeed, at present nearly 75% of the companies listed on China's domestic stock exchange are state-owned enterprises (SOEs).³ In parallel, the debt market in China also extraordinarily prioritizes SOEs, whereas the bonds issued by the SMEs only constituted 10% or less of the bond market in the past five years.⁴ Overall, the main financial sector in China can hardly meet the financing demands of SMEs.

As an alternative financing channel for SMEs, VC funds have been developing rapidly in China during the past two decades. Generally speaking, the Chinese VC industry can be divided into two phases. The first phase was before 2009, during which China's VC industry was dominated by US dollar-dominated funds and due to the serious recession caused by the global crisis. Since 2009 the local VC funds (renminbi- (RMB) dominated funds) gradually replaced foreign VC tycoons as leaders in China's VC market.⁵ As for the significance of the VC industry for the economic development in China, the

¹ Dongsheng Zhao, *A Guidebook on Legal Practices of Private Equity Funds: Fundraising, Financing, Restructuring and Listing* (Shanghai Academy of Social Science Press 2011), p 4-6.

² *Ibid.*

³ Roger Leeds and Nadiya Satyamurthy, *Private Equity Investing in Emerging Markets: Opportunities for Value Creation* (Palgrave Macmillan 2015), p 162.

⁴ *Ibid.*, p 163.

⁵ Justin Robertson, *Localizing Global Finance: The Rise of Western-style Private Equity in China* (Palgrave Macmillan 2015), p 47.

continuous expansion of the VC industry as an effective source of financing for China's SMEs has made a positive contribution to the economic growth of China as well.

4 THE STATE CONTROL OVER THE VC MARKET OF CHINA

Ever since the limited partnership was adopted into the Law of Partnership Enterprises in 2006, the limited partnership rapidly replaced corporate VC funds as the dominant legal structure for VC investment in China. The local investors as LPs in Chinese VC limited partnerships (VCLPs) are mainly the local government, state-owned securities companies and state-owned banking groups, most of which use publicly-owned capital to invest in VC projects, and assume limited liability.⁶ Owing to the lack of domestic fund management firms, unlike western-style VC funds, the state-owned ones in China are always willing to get involved in fund management in the name of maintaining and appreciating the value of state assets.⁷

Due to the short history of marketization of the Chinese economy, the division of politics and economics in China is still not well developed. The first wave of privatization of the SOEs during the 1990s has made it possible for individuals, especially the people who have personal relationships with senior officials of the Chinese government, to control the SOEs or their subsidiaries in different areas. Against such a background, China's top VC firms are commonly the subsidiaries of those large SOEs which are staffed at senior levels by the family members or relatives of the senior officials of the Chinese government (or so-called 'princelings').⁸ Moreover, VC industry is a high-risk business: the profitability of VC investment is determined by the prediction of the market trend of given industries. Therefore, having a close relationship with the Chinese government and regulators is an obvious strength in foreseeing market trends and seizing opportunities in competition.

⁶ *Ibid.*, p 113.

⁷ *Ibid.*, p 114-115. The crucial impact of this point on the governance failure in practice will be discussed in the following sections of this article.

⁸ Justin Robertson, *Localizing Global Finance: The Rise of Western-style Private Equity in China* (Palgrave Macmillan 2015)., p 56.

In practical terms, the function of princelings in VC firms is to guarantee the approval of listing application of investee companies on the Chinese stock exchanges.⁹ The investee company may choose a princeling-partner-mastered VC fund, in consideration of the relationship between such applicant company and the interested groups in the Chinese government. The CSRC is also willing to give higher priority to such companies given that the CSRC is reluctant to reject a company having a special relationship with princeling families.¹⁰

In sum, it is possible that the political impact of the Chinese VC industry may significantly influence the development of legal frameworks of limited partnerships under the commercial law of China. And any smart venture capitalists or investors must pay high attention to its relationship with the Chinese government and even particular interested groups of China for being prioritized at each stage throughout investment. This is perhaps one of the particularities of the economics of the Chinese VC market.

5 LIMITED PARTNERSHIPS AS BUSINESS ORGANIZATIONS IN CHINESE COMMERCIAL LAW

Although the limited partnership as a business organization has been familiarized by the participants of the Chinese VC market, owing to the authorities' conservative attitudes towards the non-state-owned economy, the legalization of limited partnerships in China was not easy. By reviewing the development of the legislative practice of limited partnerships in China it will aid the understanding of how state control distorted the governance structure of the limited partnership under Chinese commercial law.

§ 5.01 CHINESE LEGISLATORS' REJECTION OF LIMITED PARTNERSHIPS IN 1990s

The history of business partnerships in western countries has been present for hundreds of years. Nonetheless, the legislation regarding business partnerships in China did not appear until the mid-1990s. There were two main factors that impeded the legal transplantation of limited partnerships in China. On the one hand, as one strategy of encouraging the scientific and technological reform in China, the VC

⁹ *Ibid.*, p 55–57.

¹⁰ *Ibid.*, p 55-56.

investment was officially justified by the Chinese government as early as 1985.¹¹ Nevertheless, owing to the lack of unincorporated organizations in Chinese law at that moment, VC investment enterprises were uniformly formed as limited liability companies.¹² On the other hand, because VC investments in China were initiated and led by the government during the second half of the 1980s, the governance structure of limited liability companies kept the governmental control of the management of VC funds. Firstly, quite a large proportion of the VC firms were contributed and controlled by the Ministry of Finance of the Central Government of China or investment banking departments of the stated-owned commercial banks; secondly, the reform of the Chinese public finance system in the 1980s made it possible to increase the fiscal revenue of local government by running public-owned businesses including financial investment.¹³ It is apparent that in the early stages of the Chinese VC industry, the state kept a firm hand on the management of funds by exercising the voting right in the general meeting of shareholders of investment corporations.

The above situation did not change essentially until the 1990s. With the establishment of the Chinese stock market in 1990,¹⁴ some foreign institutional investors perceived a golden opportunity to earn big money from China's VC industry. As early as 1993, the first cross-border VC fund was set up by IDG Partners and the Committee of Science and Technology of China in Shanghai.¹⁵ During the following years, other international VC firms such as Walden International and H&Q Asia-Pacific also launched

¹¹ In March 1985, the Central Committee of the Communist Party of China issued the Decision on the Reform of Science and Technology Management System, in which the concept of venture investment was officially stated for the first time in China.

¹² The first company law of China was not enacted until 1993. Before that, enterprises in China were incorporated mainly referring to the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (1979), which was the first statute recognizing the legal status of limited liability companies in China.

¹³ Ruimin Zhong, *Research on China's Venture Capital: From the Perspective of Contracting Theory* (Doctoral thesis in Economics, Fudan University 2011), p 48.

¹⁴ In mainland China, there are two main branches of the stock market: (i) Shanghai Stock Exchange and (ii) Shenzhen Stock Exchange, both of which were established in December 1990.

¹⁵ The first cross-border VC fund in China was the PTV-China Funds, which was jointly contributed by IDG Partners and Shanghai Science and Technology Committee (SHSTC). Xirui Lian, *International PE/VC Funds in China* (Money China, 7 Mar. 2013), <http://pe.hexun.com/2013-03-07/151816907.html> (accessed 22 May 2017); Biwen Lee, *Why IDG Is Going Down: The Difficult Transition in China* (Money Weekly, 31 Mar. 2014) <http://www.licai.com/pe/201403/56807.html> (accessed 22 May 2017).

their Chinese VC funds.¹⁶ However, the foreign VC firms were extensively concerned that if VC funds in China were only organized in the form of investment corporations, the interests of foreign investors would be seriously threatened by the political power of Chinese authorities who may always oppress the minority shareholders in corporate governance.¹⁷

In consideration of continually attracting international capital to support the development of Chinese scientific and technological industries, both the Chinese legislators and scholars have widely realized that officially recognizing the legal status of partnership enterprises in the Chinese business law system had been a very urgent and realistic demand. The first partnership law in China was not enacted until early 1997. Unfortunately, this statute excluded limited partnerships and corporate partners.¹⁸ The doubt here is that although the basic reason and motivation for legislating partnership law during the mid-1990s was to encourage international VC investment in China, ironically, the final version of the statute excluded the limited partnership which actually is the most preferred organizational structure for VC investment.

In fact, the provisions regarding limited partnerships have been included by the earlier legislative drafts of the Law of Partnership Enterprises of the People's Republic of China (1997).¹⁹ However, in the consideration of the lack of a partnership enterprise registration system in China, the legislators had eventually deleted the provisions of limited partnerships in 1997.²⁰ Besides the exclusion of limited partnerships, most legislators also strongly feared that the limited liability of corporate partners might be a threat to domestic creditors, therefore, in the final version of the law only permitted natural persons

¹⁶ Beijing Docvit Law Firm, *Foreign PE in China* (CITIC Press 2011), p 34.

¹⁷ *Ibid.*, p 35.

¹⁸ According to the Law of Partnership Enterprises of China (1997), *ALL* the partners shall bear unlimited joint and several liabilities for the debts of the partnership enterprise (Art.8) and all the partners must have complete civil capacity (Article 9), in other words, only natural persons can be the partners of a partnership. Finally, the statute clearly prohibits any use of terms such as 'limited' or 'limited liability' (Art. 5), which means that at that moment, it was impossible to establish limited partnerships in China. The full text of this statute is available at http://www.gov.cn/banshi/2005-08/31/content_68746.htm.

¹⁹ Hereinafter referred to as 'The Partnership Law (1997)'.

²⁰ Xiaotao Zhang, *The Significant Necessity of Introducing Limited Partnerships in China* (People's Daily, 21 Nov. 2005) <http://theory.people.com.cn/GB/49154/49155/3873914.html>, (accessed 23 May 2017).

were permitted to invest in general partnerships in China.²¹ What's more, in political terms, because the Chinese reform of the market economy at that time was still at a very early stage, the authority was greatly reluctant to waive powerful control of private enterprises. In other words, the rapidly developing VC industry more or less was regarded as a threat to state-owned enterprises.²² As a result, the proposed limited partnership law eventually died on the vine: most Chinese VC funds in the 1990s (including domestic and international funds) were organized as corporations instead of limited partnerships.²³

§ 5.02 THE EMERGENCE OF LIMITED PARTNERSHIPS IN CHINESE VC MARKET (2001–2005)

Although in the Chinese legal system, there was no general law²⁴ recognizing limited partnerships as a kind of business organization before 2006, some local governments innovatively broke the prohibition by the Partnership Law (2007) and promulgated a series of administrative regulations that permits the use of limited partnerships in the VC industry. For instance, as early as January 2001 the Rules of Beijing Zhongguancun Science and Technology Park (2000), the first administrative order that clearly permitted both VCLPs, came into force and shortly afterwards, another similar regulation legislated by the local government of Zhuhai Special Economic Zone²⁵ also recognized the basic principle of limited partnerships. In addition, the above two regulations permitted the corporation to be a partner in a partnership enterprise. Against such a background, Sky-Green Investment L.P., the first practice of VCLPs in China was established in July 2001. However, owing to the conflict between the local

²¹ *Ibid.*

²² Lin Zhang, *Corporate Governance of Chinese State-Controlled Listed Companies: A Revisit Through the Lens of Venture Capital*, 15 (1) *European Business Organization Law Review* 107 (2014).

²³ *Supra* note 20.

²⁴ According to the Law on Legislation of the People's Republic of China (2015 Revision), in the legal system of the China, the legislation is divided into five main hierarchies, briefly speaking, all the general laws, regulations, local statutes and department rules of the People's Government should not conflict with the Constitution, and the regulations should not conflict with any general laws (Art. 78 & 79).

²⁵ The Interim Provisions on Science and Technology Venture Capital of the City of Zhuhai (2001).

regulation and the Partnership Law (1997), this VCLP fund was banned and dissolved by the CSRC in 2002.²⁶

The legislative activities mentioned above have shown that the limited partnership as a kind of efficient financing instrument has been highly demanded in China. However, any ignorance of the conflict between the lower level administrative regulations and the general law would be unwise. Against this background, in 2003 and 2005 the Central Government of China successively promulgated two specific nationwide regulations that preliminarily specified the application of VCLPs in China, namely the Provisions on Administration of Foreign-invested Venture Capital Investment Enterprises (2003)²⁷ and Interim Provisions for the Administration of Start-up Investment Enterprises (2005).²⁸ The basic legal structure of limited partnership was prescribed by the Interim Provision (2003). According to s 4 and 7 of the Interim Provisions 2003, foreign-invested VC investment enterprises (FIVCIEs) are allowed to be formed as unincorporated organizations, in which the contribution of the 'requisite investor(s)' 'shall not be less than 1% of the total capital contribution'; the requisite investor(s) 'shall undertake joint and several liability for the debts of the venture investment enterprise' and 'the liability of other investors shall be limited to the amount of capital contribution to which they subscribed'.²⁹ Similarly, the Interim Provision (2005) also clearly recognized start-up investment in the form of unincorporated enterprises and encourages the start-up investment enterprises to establish suitable incentive systems for the management of the enterprises.³⁰ In fact, the two experimental regulations were the preparation for the official recognition of limited partnerships in the later legal reform.

§ 5.03 THE LIMITED PARTNERSHIPS UNDER THE NEW PARTNERSHIP LAW (2006–2010s)

²⁶ Jun Zhang & Fengqiao Wei, *The Governance of PE Limited Partnerships: The Game Between General Partners and Limited Partners*, (Wuhan University Press 2012)., p 28–29.

²⁷ Hereinafter referred to as the 'FIVCIE Provisions (2003)'.

²⁸ Hereinafter referred to as the 'Interim Provisions (2005)'. The full English version is available at <http://www.lawinfochina.com/display.aspx?lib=law&id=4738&CGid>.

²⁹ Art. 4 and 7(6) of the Interim Provision (2003).

³⁰ Art. 6 and 18 of the Interim Provisions (2005).

[A] BASIC PRINCIPLES OF LIMITED PARTNERSHIPS IN CHINA

The most significant legal reform of China's VC industry is the new Partnership Law (2006 Revision) which officially recognised the legal status of limited partnerships and provided detailed guidelines on the governance of limited partnerships. According to Chapter 3 of the Partnership Law (2006 Revision), firstly, in order to prevent illegal fund-raising, Art. 61 provides that 'the number of partners of any limited partnership shall be between 2 and 50 persons'; secondly, pursuant to Art. 67 of the law, 'partnership affairs should be executed by general partners exclusively';³¹ in addition, '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'.³² Thirdly, the law also clarifies that the partners who do not participate in the execution of partnership affairs have the right to supervise the GP's implementation of these duties. The stipulations above have outlined the fundamental governance structure of China's VCLPs which mainly aims to enhance the professional management of the enterprise and prevent unprofessional intervention of LPs.

Moreover, the revised partnership law also promotes VC investment by improving a series of details of the old version of partnership law. In the first place, companies or other corporate bodies are now permitted to be partners of any kind of partnership enterprise.³³ This means that since the Partnership

³¹ It should also be noted that the Partnership Law (2006 Revision) also introduced 'safe harbour rules' into the law which stipulates that the following conducts of limited partners are not regarded as the execution of partnership affairs:

- (1) To participate in making a decision about the admission or withdraw of a general partner;
- (2) To put forward a proposal on the business management of the enterprise;
- (3) To participate in choosing an accounting firm to handle the audit business of the limited partnership enterprise;
- (4) To obtain a financial report of the limited partnership enterprise upon audit;
- (5) To consult the account books of the limited partnership enterprise and other financial materials which concern the limited partner's own interests;
- (6) To file claims or lodge a lawsuit against the liable partner(s) when this limited partner's interests in the limited partnership enterprise are impaired;
- (7) When the partner(s) responsible for executing the partnership affairs is (are) fails to exercise his (their rights), to urge them to exercise their rights or initiate a lawsuit for protecting the interests of this enterprise; and
- (8) To offer a guaranty for this enterprise in accordance with the law' (Art. 68).

³² The Partnership Law (2006 Revision), Art. 76.

³³ *Ibid.*, Art. 2. The only restriction in this regard is that of protecting the public interest, SOEs, listed companies and public-welfare-oriented public institutions or social organizations should not be general partners of any partnerships (Art. 3).

Law (2006 Revision) came into force in June 2007, much more capital controlled by institutional investors can be contributed to the Chinese VC industry. In the second place, this revised statute clarifies that the taxation of VCLPs is only imposed on partners and the partnership enterprises are exempted from corporate income tax,³⁴ which also makes the limited partnership more attractive to venture capitalists than the corporation.

Finally, the new Chinese partnerships law expands the scope of contractual freedom for both GPs and LPs which are not permitted for ordinary partnerships. For instance, (i) in any general partnership agreement, the stipulation that all the profit will be distributed to some of the partners is not permitted.³⁵ By contrast, because practically most partners of VCLPs are likely to agree on a ‘hurdle rate’³⁶ which serves as a part of the incentive mechanism for GPs, the law particularly permits all the partners of limited partnerships to autonomously determine the specific rules regarding profit distribution;³⁷ (ii) because in most circumstances LPs do not manage the partnership affairs, the law therefore particularly permits LPs to deal with the limited partnership³⁸ or run their own business which may compete with the limited partnership enterprise.³⁹

[B] THE GOVERNANCE STRUCTURE OF VCLPs UNDER THE NEW PARTNERSHIP LAW

In the Chinese VC market, the governance structure of VCLPs generally consists of three sections, namely (i) partners’ general meeting (PGM), (ii) LPs’ meeting (LPM) and (iii) investment decision-making committee (IDMC), each of which has different functions throughout the entire process of fund management. Firstly, the PGM is composed of all the LPs and GPs, and in the circumstance where a partner is an incorporated body, its representative should be a member of the PGM. According to Art. 31

³⁴ *Ibid.*, Art. 6.

³⁵ *Ibid.*, Art. 33.

³⁶ The so-called ‘hurdle rate’ is the minimum rate of return on a project that the fund manager and investors pre-agreed prior to opening the project. It is quite common in VC industry that if the actual return rate is below the hurdle rate, then the GP has no right to gain any profit from the investment.

³⁷ The Partnership Law (2006 Revision), Art. 69.

³⁸ *Ibid.*, Art. 70.

³⁹ *Ibid.*, Art. 76.

of the Partnership Law (2006 Revision), the matters regarding altering the name or business scope of the VCLP or assigning or disposing of the real estate and intellectual property of the VCLP should be subject to the unanimous consent of all the partners. Moreover, the issues in relation to (i) the admission of a new partner; (ii) the withdrawal of a partner(s); (iii) the transfer of shares between different partners and (iv) mutual conversions of GPs and LPs are also commonly determined by all the partners of the VCLP.⁴⁰ Generally speaking, the decision-making power of the PGM does not involve the specific investment or professional management affairs of VCLPs.

Secondly, for the purpose of the professional management of VC funds, the investment decision-making of VCLPs should be exclusively decided by GPs. However, some VCLPs in China also allow a limited number of LPs' representatives to be the members of the IDMC. For example, in the IDMC of the Oriental Fortune Capital Venture Capital Fund (2007), the largest domestic VCLP of China in 2007, any investment decision must be voted by three representatives from the GP and one representative from LPs, any of whom has a one-vote veto in any decision-making.⁴¹ Although the above practice may reduce the efficiency of fund management, such an alternative decision-making model, which can partly enhance the trust relationship between GPs and LPs, has been widely adopted in present-day China.⁴²

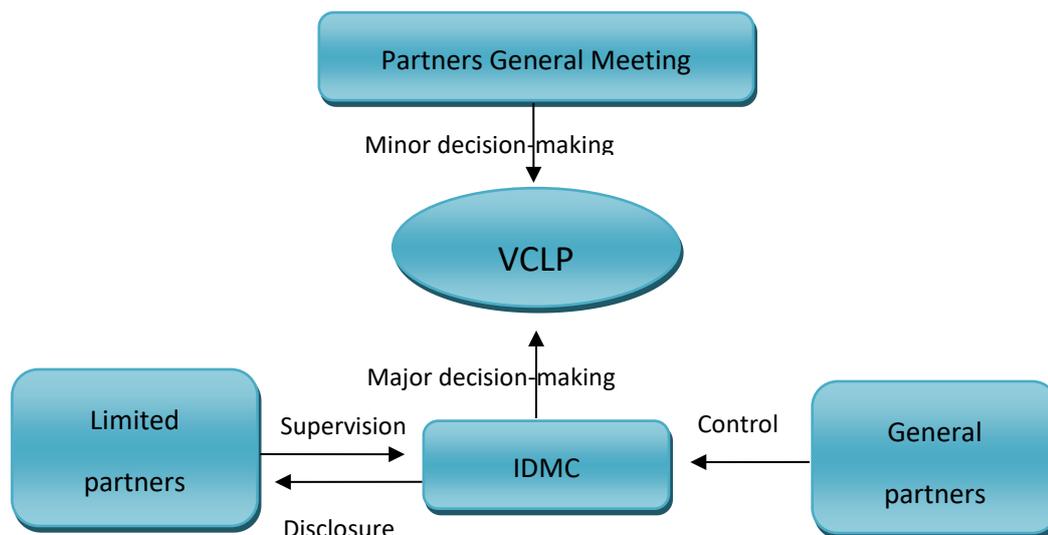
Additionally, if the representatives of LPs consider that there may be potential conflicts of interest, affiliated transactions or competitive businesses between GPs and LPs, then the representative LPs have the right to convene the LPM to determine the related issues. In most cases, the related matters should be passed by simple majority. It is not hard to see that the main function of the LPM of VCLPs is primarily a protective mechanism for LPs, but not a major decision-making body in fund management.⁴³

⁴⁰ *Supra* note 26, at p 111.

⁴¹ *Ibid.*, at p 114; Chen Yi, *Oriental Fortune Capital: Establish Trust with Limited Partners in Special Ways* (Southern Metropolis Daily, 26 Mar. 2012) <http://finance.sina.com.cn/chuangye/investors/20120326/102511677667.shtml> (accessed 17 Dec. 2016).

⁴² Wei Zhang, *How Should Lawyers Provide Professional Legal Services in Private Equity Business: The Practical Matters in the PRC Market*, In Renmin University of China School of Law (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014), p 73–77.

⁴³ A typical governance structure of VCLPs in China can be illustrated as in Figure 1 of this article.



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Figure 1: The governance structure of VCLPs in China

6 LPs REPLACE GPs: A DISTORTED GOVERNANCE MODEL WITH HIGH TRANSACTION COST

§ 6.01 LPs' INTERFERENCE AND GPs' RESPONSE

Owing to the lack of trust between LPs and GPs, a large number of VC investors participate in the managerial affairs of VCLPs to enhance the protection of LPs' interest. However, indeed, such an alternative approach can hardly play a positive role in protecting investors' interests. In most cases, the GP is able to weaken LPs' active intervention by making a series of arrangements in the decision-making procedure of the IDMC. Firstly, the GP may employ several external experts mainly including lawyers and scholars for example, as members of the IDMC in the name of professionalizing the decision-making process. Nonetheless, because most external experts are selected by the GP and do not represent the

⁴⁴ This model is summarised from a series of materials including Xin Liu, *The Investment Banking and Legal Services of Private Equity*, In Renmin University of China School of Law (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014), p 197–198; Jiyong Feng, *The Legal Issues in the Practices of Private Equity*, In Renmin University of China (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014), p 69.

majority in the IDMC,⁴⁵ the external members of the IDMC therefore may not independently make decisions even though they can provide professional and objective suggestions for investment decision-making, the final result of investment decision-making is still determined by the GP(s).

Secondly, according to Art. 68(2) & (7) of the Partnership Law (2006 Revision), LPs are entitled to (i) make suggestions for fund management and (ii) urge the GP to fulfil the duty of management on behalf of the LPs when the GP fails to do that. However, under the current partnership law system, LPs are not statutorily entitled to make decisions on the management in VCLPs. Therefore, any LPs' direct participation in fund management is at risk of being invalidated. To sum up, the decision-making procedure in the IDMC of VCLPs described above is not effective enough. However, remarkably, it increases LPs' supervisory cost.

§ 6.02 GOVERNANCE COLLAPSE OF VCLPs IN CHINA: A CASE STUDY

Although sometimes GPs can actually control the decision-making process by adjusting specific voting rules of the IDMC, for the purpose of raising sufficient capital in a reasonable schedule, those VC firms who have not established a good professional reputation have no other choice but to allow LPs to substantially control the fund. However, this abnormal governance model has been proven to be a failure in practice. This issue can be clearly illustrated by a case study of Oriental Venture Capital (2007) (OVC).

As one of the earliest practices of VCLPs in China,⁴⁶ the OVC was established in July 2007 which consisted of nine LPs and one GP, namely the James & Hina Capital Management Corporation (J&H). Because J&H was a very young player in China's VC market,⁴⁷ and the Partnership Law (2006 Revision) just came into force on 1 June 2007, it was difficult for such an inexperienced fund manager to raise as huge as RMB 1 billion in such a short period of time. As a compromise with the LPs, the GP agreed to

⁴⁵ *Supra* note 26, at p 125.

⁴⁶ The first domestic VCLP in China was the Shenzhen South Sea Venture Capital Fund which was established in June 2007. *Ibid.*, at p 129.

⁴⁷ J&M was established in March 2007, for a brief period of four months before it became the general partner of the OVC. Refer to the official website of J&M: <http://www.jhcapital.cn/>.

set a so-called 'joint meeting of partners' (JMP) as the supreme decision-making body of the fund,⁴⁸ whereby any investment decision would be subject to the capital majority rule.⁴⁹ In such a situation, since the GP only contributed around 1% of the total amount of funds, the OVC was directly controlled by the LPs. As a consequence, owing to the stalemated decision-making process, finally the OVC was dismissed by all the partners in October 2007 only three months after its establishment.⁵⁰

7 FURTHER REFORM OF CHINESE PARTNERSHIP LAW: CAN THE LIMITED PARTNERS BE TAMED IN FUTURE?

§ 7.01 HIGHLY PRIORITIZED LPs AND THE PARTNERSHIP LAW OF CHINA

From an economic point of view, the exclusion of limited partners' participation in the managerial affairs of limited partnerships is a foundation for the efficient management of VCLPs, which can cut down the costs of negotiation in decision-making processes. To this end, in the laws of limited partnerships of common law countries, typically such as the United Kingdom⁵¹ and the United States,⁵² unlimited liability is imposed on limited partners, if limited partners take part in the management of the limited partnership.

⁴⁸ Yu Zhao, *Private Equity Funds in China's Legal System*, (Doctor of Law thesis, Jilin University 2010), p 38.

⁴⁹ Specifically, the decision rule of the OVC can be summarized as follows: first, all the limited partners and general partners were entitled to vote on all the issues. The chair of the joint meeting should be the partner who contributed the most, and every vote represented contribution of RMB 5 million. Second, any matters or investment decisions must be approved by votes representing no less than two thirds of the total contribution. In pursuance of the Partnership Law (2006 Revision), however, the decision-making rule of limited partnerships under the law is that the LP should not participate in the governance of the partnership. In the circumstances where there are two or more GPs in a limited partnership, the decision-making rule between the GPs depends on specific clauses in the limited partnership agreement (LPA). If it is not stipulated in the agreement, the 'voting method of 'one partner, one vote' and 'pass upon more than half of the votes of all partners' shall be adopted as default rules' (Art. 30). *Supra* note 26, at p 129.

⁵⁰ *Ibid.*, at p 129–130.

⁵¹ Section 6 (1) of Limited Partnership Act 1907 stipulates that '[...] If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.'

⁵² Section 17–303(a) of the Delaware Uniform Limited Partnership Act (DRULPA) provides that '[a] limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of the rights and powers of a limited partner, he or she participates in the control of the business. [...]

The aforesaid OVC case shows that owing to the lack of trust between fund managers (GPs) and fund investors (LPs), the LPs of the Chinese VCLPs are eager to actively replace the GPs in investment decision-making. This sometimes has severely threatened the stability and efficiency of fund management. From a legal perspective, indeed, such a problem is rooted in the weaknesses of the existing Chinese partnership law: although the Partnership Law (2006 Revision) clarifies that LPs are not in charge of the management of limited partnerships (Art. 67), however, the law never makes it clear whether the unlimited liability will be triggered, once a LP has actively participated in decision-making of the limited partnership or materially controlled management affairs. Hence, the lack of personal liability deterrence on LPs actually has motivated investors to replace professional fund managers and to actively interfere in fund management, even though many of them are not experts in corporate governance or financial investment. In other words, LPs' active interference in fund management is actually connived by the law of partnerships in China.

Moreover, in order to prioritize the limited liability of LPs, the so-called 'safe harbour rules' have also been transplanted into the partnership law of China, according to which the LPs can legally control the business of the funds in a wide scope.⁵³ However, the statute does not clarify the circumstance where a LP takes part in limited partnership management that is not within the scope of the above 'safe harbour' clauses what the legal consequence of the active LP is; in other words, if no adverse legal consequence will be triggered when a LP participates in the management of a limited partnership, how can the law effectively restrict limited partners' intervention in executing partnership affairs? Based on the existing Chinese partnership law, the only provision that associates the unlimited liabilities and acts of limited

⁵³ Specifically, Article 68 (2) of the Partnership Law (2006 Revision) provides that the following acts of a limited partner shall not be deemed as execution of partnership affairs: '(1) To participate in making a decision about the admission or withdraw of a general partner; (2) To put forward a proposal on the business management of the enterprise; (3) To participate in choosing an accounting firm to handle the audit business of the limited partnership enterprise; (4) To obtain a financial report of the limited partnership enterprise upon audit; (5) To consult the account books of the limited partnership enterprise and other financial materials which concern the limited partner's own interests; (6) To file claims or lodge a lawsuit against the liable partner(s) when this limited partner's interests in the limited partnership enterprise are impaired; (7) When the partner(s) responsible for executing the partnership affairs is (are) fails to exercise his (their rights), to urge them to exercise their rights or initiate a lawsuit for protecting the interests of this enterprise; and (8) To offer a guaranty for this enterprise in accordance with the law.'

partners is Art. 67 of the Partnership Law (2006 Revision), which stipulates that '[w]here it is reasonable for a third person to believe a limited partner as a general partner and concludes a transaction with him, this limited partner shall bear the same liabilities for this transaction as a general partner shall do'.

Therefore, it is commonly believed that in the situation where the LP participates in controlling the business of the limited partnership with a third party who believes that the executive partner is the GP of limited partnerships, such an active LP should assume the same liability as a GP. The outstanding issue here is that if a LP did not carry out any transaction with a third party but has substantively influenced the decision-making within the limited partnership, such as the selection of investment targets, once the certain investment fails, should the limited partner assume the same liability as a general partner? According to the current Chinese partnership law, the answer is not clear yet.

§ 7.02 STRONG STATE CONTROL AS A BARRIER TO FURTHER REFORM OF LIMITED PARTNERSHIPS IN CHINA

Although the discussed issue in this article occurred ten years ago, the same problem still exists in today's venture capital market of China and the new version of partnership law of China has not been amended further after 2006; in other words, the previously existing drawbacks in the legislation has not been improved yet. Owing to the lack of 'piercing the veil of limited partners' regime in the Chinese law of partnership enterprises, the overly active limited partners still commonly interfere in managerial affairs of VC funds, which substantively decreases the efficiency of investment.

Based on the above political-economic analysis of the role of state in Chinese VC industry, it is not unreasonable to argue that the distorted governance structure of limited partnerships under Chinese law is closely related to the prioritized state-owned capital in VC market, therefore the prospect of the quality of governance of VCLPs in China may also depend on the progress of the market environment of the Chinese VC industry and particularly the extent to which the state is willing to waive its control over the VC fund management. Importantly, the powerful status of the Chinese government or SOEs as limited partners in market competition may continuously hinder the legal transplantation of the regime of 'piercing the veil of limited partners', because the direct interference in fund management will still be

insisted upon by the state for the purpose of controlling the private sector of the Chinese economy and giving priority to the state-owned capital for making profit. As a result, the Chinese legislators' conservative attitude towards the rapidly expanding private economy may continue to impede the development of limited partnerships in Chinese commercial law.

8 CONCLUSION

The reform of market economy has been the core task of transitional China for approximately the last four decades, though the authoritarian political power of the Chinese government is still firmly controlling and influencing the developing direction of the Chinese economy and its legal system. This article aims to highlight the most typical legal problems in Chinese venture capital limited partnerships under existing Chinese commercial law system. Particularly, this article also illustrates how the authoritarian politics may directly and essentially impact the legal transplant of business organizations in a transitional economy. In other words, the economic function and governance structure of business organizations may be distorted by political powers and then the transaction costs will be increased. The limited partnership as a kind of business organization is still young in the Chinese venture capital industry and its inherent drawbacks which have caused serious practical problems may be solved in future, however, the conflicts and intense competition between the state-owned capital and the new-born private sector of the Chinese economy may dramatically delay such a legal reform.