

Limited Liability Partnerships: The Best Structure for Funds?

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The Partnership Enterprise Law of the People's Republic of China (Partnership Enterprise Law, or **PEL**) has been in force since 1 June 2007. This legislation provided a legal cornerstone for the formation of PRC domestic private funds. Following the implementation of the PEL, the limited partnership, a common structure in international practice in fund formation, will become a feasible choice for domestic private funds. Fund demand has increased in many industries, such as transportation, energy and environmental protection. Although China's domestic market is full of free capital as well as expertise in investment management, there are not enough investment vehicles. The limited partnership, which offers a good mechanism for combination of capital and expertise, which are the two core elements for private equity operation, is widely expected to promote the development of domestic private funds in China.

General Partners in Limited Partnership

Can a legal person become a general partner in the limited partnership? There seems to be no uniform answer in international practice. Generally speaking, jurisdictions fall into three categories: those in which such an arrangement is prohibited, allowed, or subject to the partners' own discretion.

In accordance with Article 15 of the PRC Company Law (Company Law), which came into force as of 1 January 2006, a company shall not become an investor that bears joint and several liability for the debts of the enterprises in which it invests, unless otherwise provided for in laws. Meanwhile, pursuant to the PEL, a partnership enterprise may be established by individuals, legal persons and other associations. The PEL only prohibits wholly state-owned companies, state-owned companies, listed companies, public-welfare-oriented institutions and social organizations to be general partners. As no such prohibition is imposed against other legal persons, it seems that the Company Law and the PEL have given room for legal persons to act as general partners in a limited partnership.

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In practice, some venture capital groups have been established in the form of limited partnerships following the implementation of the PEL. In these cases, individuals and institutional investors are acting as limited partners and some limited liability companies become the general partners. These examples evidence that the legal persons (such as limited liability companies) are allowed to be general partners in the view of relevant competent authorities in China.

“Safe Harbour” Rules under PRC Laws

In addition to taxation benefits, investors prefer limited partnerships because partners' liability is limited to the extent of capital contributions they have made. Limited partners are not allowed to undertake partnership affairs such as management and investment decisions, but they can participate in other ways under the so-called “safe harbour rules”. Yet limited partners are not absolutely safe - if they go beyond the allowed scope, such as becoming involved in partnership affairs, they shall also bear unlimited joint and several liability in the same manner as the general partners.

Generally speaking, if limited partners violate the safe harbour rules, they will lose limited liability protection and will be treated as general partners. There are some regulations similar to the safe harbor rules under the PEL. Pursuant to Article 68 of the PEL, the limited partners may neither undertake the partnership affairs nor represent the limited partnership when dealing with other parties. However, limited partners are allowed to participate in ways which are not deemed as performance of partnership affairs pursuant to the PEL, such as advising on management and operations, selecting certified public accountants or obtaining financial statements. Article 76 of the PEL provides for the consequences in case limited partners are in violation of the safe harbor rules, in which case the limited partner shall be liable in the same manner as a general partner in the transaction with a third party, and must compensate for the losses incurred by the partnership enterprise or other partners if its transaction with any third party is not duly authorized.

Withdrawal from a Limited Partnership: Not Absolutely Safe

In accordance with the PEL, limited partners might still undertake liability even after they have withdrawn from the partnership. In this sense, withdrawal from the partnership does not necessarily mean being safe from the perspective of the limited partners. Article 81 of the PEL provides that a limited partner who has withdrawn from the limited partnership shall be liable for debts incurred up to the time of withdrawal when property was received from the limited partnership enterprise.

To avoid such problems, transfer of partnership shares is a better approach for limited partners who decide to exit from the limited partnership. Pursuant to Article 73, a limited partner may, subject to the provisions of the partnership agreement, transfer his share to property in the limited partnership enterprise to a third party. In this situation, the obligation and liability will be born by the transferee, therefore it will be more favourable for the transferor to exit from the partnership.

Conclusion

As in international practice, the limited partnership rules under the PEL help to establish a combination of capital and wisdom. It is expected that such a structure may promote the formation and development of domestic private funds.

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