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Revised Partnership Enterprise Law: An Impetus for Onshore Private Equity

By Christophe Han and James Weng

With the revision of the Partnership Enterprise Law, obstacles in the prior partnership law have been removed and new, more favourable elements have been introduced, including expansion of the scope of qualified partners, the creation of limited partnership and confirmation of pass-through tax treatment. It is widely anticipated that the revised Partnership Enterprise Law will give an impetus for the development of onshore private equity in China.

Shenzhen-based Nanhai Growth Venture Capital Partners (**Nanhai Growth**) received a business license on 26 June 2007, becoming the first onshore private equity firm registered in the form of a limited partnership. Nanhai Growth has closed its initial Rmb162 million (US$21.5 million) of funding, of which 60% of the funds raised will be invested in Shenzhen's pre-IPO companies, and the remaining 40% will be used for equity investment.

The launch of Nanhai Growth benefited from the recent revision of China's Partnership Enterprise Law. The law, originally promulgated in February 1997, was revised on 27 August 2006 by the standing committee of the National People's Congress (**NPC**), and came into effect on 1 June 2007. In addition to other significant amendments, the revised law has confirmed a pass-through tax regime and introduced the limited partnership structure, which is widely anticipated to greatly promote the development of onshore private equity in China.

Customary private equity structure and traditional practice in China

Private equity funds are the pools of capital invested by private equity firms. Although other structures exist, it is common practice for a private equity fund to be organized as a limited partnership controlled by a private equity firm. In the customary structure, a capital investor in private equity funds will become a passive limited partner (**LP**) in a fund partnership rather than becoming an investor in the firm itself. The investor undertakes a fund commitment but is not involved in fund management. Fund management is usually undertaken by a private equity firm, which is acting as a general partner (**GP**) and is responsible for all investment decision and management of the fund.

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However, the customary private equity structure is not permitted under the 1997 Partnership Enterprise Law, in that no limited partnership is recognized by the law and, therefore, all partners would have unlimited liability. In addition, only natural persons and not other legal entities are eligible to be partners. A corporate-level income tax will be levied on the revenue of the partnership enterprise, while the partners will be taxed on their personal income as well.

The inflexibility of the 1997 Partnership Enterprise Law has blocked the development of onshore private equity in China. The *Tentative Measures on Administration of Venture Capital Enterprise*, promulgated in 2005, permit a venture capital enterprise to be organized as a limited liability company, a company limited by shares or as other forms of enterprise allowed by the law. But due to the limitations of the 1997 law, it was not a feasible option to establish private equity in a partnership.

Another example relates to the *Rules on Administration of Foreign-invested Venture Capital Enterprise* (**FIVCE rules**), revised on 23 October 2002. The FIVCE rules allow a non-legal-person venture capital enterprise to adopt a dualistic liability structure, under which the requisite investors may be joint and severally liable while other investors may have only limited liability. This structure is similar to limited partnership to some extent. Nevertheless, the FIVCE rules do not speak in terms of general or limited partners or partnership agreements. Due to the lack of state-level limited partnership law, the venture capital therefore cannot be organized as a partnership but must be organized as a cooperative joint venture under the relevant joint venture laws.

The revised Partnership Enterprise Law

Compared with the 1997 Partnership Enterprise Law, the significant amendments in the revised Partnership Enterprise Law include:

Qualified partners

While only natural persons are allowed to act as partners under the 1997 law, the revised law allows natural persons, legal persons and other organizations to be partners. It is noteworthy that wholly state-owned companies, state-owned enterprises, listed companies, public welfare institution, and social organizations are prohibited from being GPs, but they can act as LPs.

Limited partnership enterprises

The introduction of limited partnership enterprises (**LPEs**) is considered to be one of the most significant breakthroughs in the revised law. An LPE may consist of two to 50 partners, among which there shall be at least one GP and one LP.

The LPE shall be managed by the GPs. The GPs are, in all major respects, in the same legal position as partners in a general partnership. For example, they have management control, share the profits of the enterprise in accordance with the partnership agreement and have joint and several liability for the debts of the partnership. As in a general partnership, the GPs have apparent authority as agents of the LPE.

In contrast with GPs, LPs are only liable for debts incurred by the LPE to the extent of their capital contributions. LPs are allowed to make capital contribution in cash or in kind, as well as in intellectual property rights, land use rights or other proprietary rights, but not by the partner's personal service. LPs have no management authority but can participate in the ways specified in the revised law, such as advising on management and operation, being involved in selecting certified public accountants or obtaining financial statements. LPs are not allowed to act as agents of the LPE.

LPs may transact with their own LPE or engage in business that may compete with the LPE unless otherwise stated in the partnership agreement. The interest of an LP may be pledged as security, subject to restrictions agreed to in the partnership agreement. In addition, LPs can transfer their equity interest in the LPE to a third party after serving a 30-day notice to the other partners.

Taxation

The law confirms that partnership enterprises will not pay a corporate-level income tax, while the partners shall pay income tax in relation to the income or gains they receive from the partnership enterprises. In other words, partnership enterprises are treated as pass-through entities for income tax purposes. This treatment will significantly mitigate the tax burden of the investors in partnership-structured private equity.

Foreign participation

The revised law specifically contemplates foreign entities and individuals participating in partnership enterprises in China. The relevant regulations will be formulated by the State Council. In January 2007, the Ministry of Commerce (**MOC**) publicized the draft of the *Measures for Administration of Foreign Invested Partnership Enterprise* (**draft measures**), which will be submitted to the State Council for further deliberation. Pursuant to the draft measures, establishment of a foreign-invested partnership enterprise (**FIPE**) shall be subject to approval from the MOC or its counterparts at the provincial level.

The draft measures clarify that Chinese natural persons are permitted to be partners of FIPEs And that FIPEs must comply with China's foreign investment industry policies. Foreign partners may make capital contribution in cash, in kind, in intellectual properties and other forms of properties but not by personal service. The capital contribution shall be settled within 90 days upon approval of the establishment of the FIPE. The foreign GPs are requested to disclose their investments, real estate, and other major properties and, if there is a significant change to their properties, they are required to file with the approving and registration authority.

The draft measures confirm that income tax will not be levied on a corporate level but against partners directly. It is specifically provided that the FIPEs engaging in venture capital investment will be entitled to relevant tax benefits to be granted by the tax authority. The draft measures also clarify that partnership rules are not applicable to the non-legal-person cooperative joint ventures.

Special general partnership enterprises

The revised law permits professional service providers who provide compensable services based on professional knowledge and special skills to organize as a special general partnership enterprise (**SGPE**), to which distinct rules regarding the partners' liabilities will apply. In general, if an SGPE incurs liabilities due to the intentional or grossly wrongful act of one or more of the partners, such partners shall bear unlimited joint and several liability, while the other partners' liability shall be limited to the extent proportionate to their shares in the SGPE's properties. In connection with liability not resulting from the intentional or gross negligent activity, all the partners shall bear unlimited joint and several liability.

Bankruptcy

The revised law provides for more detailed procedures reflecting the principles and procedures of the bankruptcy law promulgated in August 2006.

Impetus for onshore private equity

Revised Partnership Enterprise Law: An Impetus for Onshore Private Equity

The outlook for private equity deals in China is starting to brighten, thanks to China's robust and continuing economic growth and the white-hot performance of the domestic stock exchanges. Though there still remain other unfavourable elements in the business and legal environments in China, it is widely expected that the removal of obstacles in the prior partnership law, in combination with the creation of limited partnerships as well as other favourable conditions in the revised Partnership Enterprise Law, will bring great vigour to the formation of onshore private equity. Such expectations are based on the following reasons:

- The revised Partnership Enterprise Law has become much closer to international practice, particularly in relation to the private equity area. Pass-through tax treatment and limited liability are key features of limited partnerships for pooled investment funds established in offshore jurisdictions like the Cayman Islands. The introduction of similar mechanisms in the revised law will enable onshore private equity to be organized in a way similar to the customary practices.

- Under the current enterprise law system, a private equity fund organized as a limited partnership will be more practical and flexible than one organized in the form of a company. Because of the strict corporate governance requirements under China's company law, management of a partnership private equity will be more flexible than that of a company. Pursuant to the company law, the shareholders of a limited company or a company limited by shares shall enjoy profit and loss in proportion to their capital contribution. Articles of association of a company shall comply with the compulsory regulation imposed by the company law, and amendment to the articles shall be subject to requisite procedures and requirements. In comparison, the revised Partnership Enterprise Law has granted much more room for partners to reach an agreement in ways other than the manner set forth in the law, which makes it more flexible and convenient in accommodating the legal requirements for structuring a private equity fund.

Conclusion

China's revised partnership enterprise law makes it possible for onshore private equity to be organized in a way similar to international customary practices. The MOC and the State Council are working on regulations regarding foreign participation in partnerships. It is no doubt that these new rules will favour the development of domestic- or foreign-funded onshore private equity.

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