The Agency Problems in China's Private Equity Investments: A Cross-Jurisdictional Perspective

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Abstract

This thesis aims to identify and solve the agency problems in the life cycle of private equity (PE) investment under the commercial law system in China by comparing the legislative and adjudicative practices in the United Kingdom (UK) and other related jurisdictions. Based on transaction cost economics as the theoretical foundation of this research, the agency problems of PE investment derive from the two-level separation of ownership and control, one of which is the principal–agent relationship between the PE investors and the fund manager, and the other is the principal–agent relationship between the PE shareholders and the management of investee companies. As effective institutional solvers to agency problems, fiduciary duties as default rules have been widely developed and practised in common law countries to protect the interests of PE investors. Subject to the strong dependency on judicial practices, however, the economic function of fiduciary duties may not be fulfilled properly in the jurisdictions without a sound and independent judicial system such as that in China. Therefore, the logical purpose of this research was to find a series of feasible and cost-efficient approaches to reduce the agency costs in governance of three organizational structures that are involved in PE investments under Chinese legal and regulatory regimes, namely the limited partnership, business trust and corporation.

As the society and economy of the UK are developed along a free-market and liberalistic ideology, the contractual freedom as the core spirit of the UK's commercial law has been widely accepted and recognized in both legislative and adjudicative activities. Thus, both the decision-making rules in PE funds and corporate governance of portfolio companies in the UK are also labelled as showing high respect for contractual autonomy. The protective rules sprung from common law and equity in relation to the laws of business organizations and trusts also provide flexible approaches for reducing agency costs in PE investment. Hence, this thesis especially underlines the reference to, and transplantation of, the contractual techniques of the UK's business organization law for enhancing investor protection of the Chinese PE industry, by which the negative impacts of political intervention and uncertainty in judicial practices may be effectively constrained. In addition, in order to make this analysis more comprehensive and objective, this thesis also refers to the institutional transplantation of trusts and corporate governance in not only continental and mixed jurisdictions, but also several typical transitional economies in the world.

Based on, and beyond, the aforementioned research, this thesis argues that the basic legal framework of PE has undoubtedly been established in China. This notwithstanding, the strong state capitalistic ideology and authoritarian interest pattern still seriously impede the legal reform towards a more market-directed and investor-protection-oriented institutional construction. In a broader sense, another conclusion may also be put forward, namely that the transplantation of different business organizations across jurisdictions are determined by the distribution of the costs of protecting investors. As a brief model, the costs of investor protection are divided into internal and external approaches; the former refers to the cost of contractual arrangements within business organizations and the latter to the costs that are generated from the judicial and regulatory activities outside business organizations. Based on a detailed economic analysis of the main types of business organizations, this research concludes that 1) when the organizational and non-organizational protective approaches generate equal costs, such an organizational form should be most widely applicable and transplantable; and 2) the success of such legal transplantation depends on whether the gross costs of protecting investors can be reasonably distributed by the organizations and regulatory and judicial systems. The developing path of the commercial law system in China may preliminarily illustrate the above thesis, while more detailed studies may be developed in future.

Key words: private equity, agency problems, Chinese law, commercial organizations, comparative law

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Author's Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Signature:

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Date: 27 MAY 2017

Abbreviations

AMAC	Asset Management Association of China
AUT	Authorised unit trust
BOC	Bank of China
BVCA	British Private Equity and Venture Capital Association
BVI	British Virgin Islands
CA2006	Companies Act 2006
CAGR	Predicted compound annual growth rate
CAPE	China Association of Private Equity
CBA	China Banking Association
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCP	China Communist Party
CEO	Chief executive officer
CIS	Collective investment scheme
CITIC	China International Trusts Investment Corporation
CLO	Collateralized loan obligations
CSRC	China Securities Regulatory Commission
CTA	China Trustee Association
CVCA	China Venture Capital and Private Equity Association
DRULPA	Delaware Uniform Limited Partnership Act
EC	External cost
ECGI	European Corporate Governance Institute
edn	Edition
FCA	Financial Conduct Authority
FIVCIE	Foreign-invested Venture Capital Investment Enterprise
FSMA2000	Financial Services and Markets Act 2000
GC	Gross cost
GDP	Gross domestic product
GMG	Guidelines Monitoring Group

GP	General partner
HK	Hong Kong
HKSE	Hong Kong Stock Exchange
HNV	High net value
IC	Internal cost
ICP	Internet content provider
IDMC	Investment decision-making committee
IPO	Initial public offering
IRR	Internal rate of return
IT	Information technology
J&H	James & Hina Capital Management Corporation
JMP	Joint meeting of partners
KKR	Kohlberg Kravis Roberts & Co.
LBO	Leveraged buyout
LLC	Limited liability company
LLP	Limited liability partnership
LLSV	Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny
LP	Limited partner
LPA	Limited partnership agreement
LPA1907	Limited Partnerships Act 1907
LPM	Limited partners' meeting
LSE	London Stock Exchange
M&A	Mergers and acquisitions
MBO	Management buyout
MOFCOM	The Ministry of Commerce of the People's Republic of China
NASDAQ	National Association of Securities Dealers Automated Quotations
NBER	National Bureau of Economic Research
NDRC	National Development and Reform Commission
NPC	National Planning Commission
NVC	NVC Lighting Technology Corporation
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OUP	Oxford University Press

OVC	Oriental Venture Capital Fund
PA1890	Partnership Act 1890
PBOC	People’s Bank of China
PE	Private equity
PEIT	Private equity investment trust
PELP	Private equity limited partnership
PGM	Partners’ general meeting
PRC	The People’s Republic of China
QUT	Queensland University of Technology
RMB	Renminbi
ROE	Return on equity
SAIC	State Administration for Industry and Commerce
SCOPSR	State Commission Office for Public Sector Reform of China
SCNPC	Standing Committee of the National People’s Congress
SDIC	State Development & Investment Corporation
SHPEA	Shanghai Private Equity Association
SHSTC	Shanghai Science and Technology Committee
SIFL	Securities Investment Fund Law of People's Republic of China
SME	Small and medium enterprise
SOE	State-owned enterprise
SPC	Special purpose company
TPCA1988	Trust Property Control Act 57 of 1988
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America
USD	United States dollar
VAM	Value adjustment mechanism
VC	Venture capital
VIE	Variable interest entity
WFOE	Wholly foreign-owned enterprise
WWⅡ	The Second World War
ZPEVCA	ZhongGuanCun Private Equity and Venture Capital Association

Introduction

Since the mid-1980s, private equity (PE) investment has been playing an increasingly significant role in supporting corporate finance in the Chinese economy for more than three decades. Due to the immature capital market and legal protection in China, however, the agency problems in PE investment under the laws of business organizations of China are still serious which has increased transactions costs in the whole cycle of PE investment. As a response, this dissertation aims to find out feasible approaches to reduce the agency costs in Chinese PE investment by carrying out a series of comparative studies of limited partnership, investment trusts and corporate governance in China, UK and other related jurisdictions.

Briefly speaking, the agency problems in private equity (PE) transactions exist on two levels. On the one hand, compared with traditional financing approaches, private equity is a kind of expensive financing sources, which mainly invest in the companies having difficulties to access bank loans or public capital market due to their high risk. Therefore, when the managers of private equity funds search the start-ups or other private companies to invest, the asymmetry of information between the private equity funds and entrepreneurs will also be severe. On the other hand, the privacy of PE funds makes it hard to directly observe the performance of the fund managers or PE firms and in a general sense, the investors do not directly control the management of PE funds and the continuous supervision of the fund manager is impractical as well.

For the sake of discourse coherence, above research questions will be discussed on the basis of the contractual theory of the firm. As theoretical and methodological foundation of the research, the contractual theory of the firm conceives that the nature of the firm is a ‘nexus of contracts’, by which the transaction parties in the firm are able to haggle over each specific provision in the agreements to anticipate all the future conflicts or potential problems. Due to the complexity and contingencies in real market, however, the complete contract is infeasible. As an alternative approach to reducing agency costs, the fiduciary duty rules which flexibly address the agency problems between the principal and agent have become a core legal mechanism in common law jurisdictions. In a practical term, the fiduciary duty rules in business organization law of UK were mainly developed by the judicial practices of court system in a long history. In contrast, the court in civil law or socialist states is less active than the common law jurisdictions, where the role of fiduciary duties in solving agency problems may be limited. As a consequence, in the circumstance where the judicial system is inactive or restricted, the feasibility of transplanting fiduciary duties system for solving the agency problems in business organization laws will be problematic, or even though the fiduciary law is roughly adopted in such jurisdictions, the operation of it may generate high costs. In other words, in civil law and socialist jurisdictions, it may be more advisable to develop the internal governance approach to reduce the agency costs and to enhance protection for investors of business organizations.

Although in Chinese legal system the fundamental legal regimes of business organizations has been established in recent two decades, the operation and is considerably influenced and restricted by the state will of China. That is mainly to say that the prioritized economic and legal status of state-owned enterprises (SOEs) would still substantively influence the developing path of the PE industry of China. Specifically, in light of the political influence of the interested groups, the legal reform of the business organization law of China is and still will be directed in the interest of SOEs. Against such background, this research will especially consider the relationship between the state control power of Chinese financial and industrial markets and the development of PE legal system.

The limited partnership currently is widely adopted for organizing private equity and venture capital investment in western countries. In a typical limited partnership, there should be at least one general partner and one limited partner. The general partner who is entitled to exclusively manage the business of the partnership is required to be personally liable for the debts of the limited partnership by contrast, the limited partner is not allowed to involve in the management, as an exchange the limited liability protection is granted and once the limited partner actively involves in decision-making process, the limited liability protection will be waived. In such a governance structure, the limited partnership not only aligns the interests of both the manager (general partner) and the main owners (limited partners), but also enhances the independence of management.

Due to the immaturity of Chinese private equity industry, however, the existing protective mechanism of the limited partnerships in China is imperfect. Firstly, in concern of the loss of state control the capital, the limited partnership law in China refuses to establish the ‘veil piercing' rule of limited partners, by which when the SOEs as limited partners invest in the PE funds, they are able to actively intervene in the fund management without unlimited liability threat. Secondly, in Chinese law the effectiveness of unlimited liability on the responsible managerial staff of general partners is also limited, as the bankruptcy of individuals is not recognized by Chinese law. Thirdly, the contractual techniques in relation to the incentive of general partners in China's PE limited partnerships are also unsophisticated. Finally, because of the conflicts of the regulatory powers of different regulatory organs of Chinese government, the independence and effectiveness of the existing self-regulatory system is also problematic. As a consequence, above drawbacks in the governance of China's PE limited partnerships motivate the limited partners to actively intervene in fund management which seriously decreases the efficiency of the governance of the limited partnerships.

In comparison of the Chinese limited partnership law, in UK's legal system, both the Limited Partnership Act 1907 and financial regulatory system of collective investment scheme (CIS) have established a legal framework of private equity funds which mainly focus on the protection of limited partners, in which both the liability mechanism and self-regulatory system of PE limited partnerships are relatively well-established. Moreover, as one of the important centre of financial activities in the world, the practices of private equity and venture capital investment have developed a series of more effective contractual provisions in arranging and balancing the rights, duties and liabilities for both general partners and limited partners. By reference to the experience of UK, to a large extent, the governance of the Chinese PE limited partnership may be improved and the protection for limited partners can also be enhanced.

Due to the imperfect governance and protective mechanisms of the limited partnership, the trust as an alternative organizational structure are also popularly used to organize PE investment in China, through which the strict regulation of commercial trusts industry can provide better protection for PE investors. Nevertheless, because of the conservative attitude towards the collective lawsuits and special ownership structure of trust corporations, the judicial remedy for trustees is still problematic in China. Then the beneficiaries have to directly intervene in the trust management by actively exercising the voting rights of the beneficiaries' meeting under the financial regulations of China Banking Regulatory

Committee (CBRC) for protecting their interests in fund management. As a consequence, the trust corporation as trustee cannot independently exercise its shareholders' right in corporate governance of PE-held companies and eventually seriously impede the exit of PE investors by listing the investee companies on Chinese stock markets. To solve above problems, it would be useful to consider the economic functions of the trust as a kind of investment entities and protective mechanisms for beneficiaries in English trusts.

From an economic point of view, the parties in a free market should be responsible for his own behaviours, the economic efficiency depends on not only the external regulation but also the market participants' awareness and judgement of risk. By reviewing the fiduciary duties in English trusts, it can be seen that the duty of care and duty of loyalty in English case law establish a series of rules which clarify the boundary of the market risk which should be assumed by the settler/beneficiary and the personal liability of the trustee. In contrast, due to the lack of dual-ownership system and inactive judicial system in civil law jurisdictions, the protective mechanisms in trust-like arrangements are based on contractual relationship where the principal and beneficiary or even other stakeholders can reserve the managerial powers in trust-like arrangements which may increase the transaction costs in management. In other words, the institutional advantages of English trusts is the trustee's independent management and exclusion of unprofessional investors' intervention, by which the transaction costs can be reduced.

As for the reform of PE investment trusts in China, the following points will be discussed in details in the third chapter of the research: firstly, in terms of the governance structure of the trust, this thesis recommends that in order to break the 'zero loss promise' in trust industry, the ownership structure of Chinese trust corporations should be diversified, by which the non-state shareholders will have the inherent motivation to compel the investors to bear reasonable market risk. At the same time, by reference to the regulatory system of collective investment schemes (CISs) of UK, the 'qualified investor' rules in the regulation of Chinese business trusts should be enhanced by introducing the qualitative test, the 'qualified investor' should not only means the ability of risk tolerance but also the ability of risk judgment. Secondly, for enhancing the efficiency of the management of trust, the regulations of Chinese business trusts should remove the intervention power of beneficiary's meeting, by which the judicial practices may be developed as the main remedial approach for solving the agency problems between the trustee and beneficiaries in private equity investment trusts. Finally, in order to enhance external supervisory power over the trust corporation, the laws and regulations of China should clarify the obligation and rights of the custodian banks of PEITs, which may push the custody to strictly supervise the performance of trust corporations.

After discussing the agency problems between the investors and managers within PE funds, another issues discussed in this research is the function and agency problems in the corporate governance of PE-held companies. In a typical corporate governance model of PE-held corporations, PE funds will involve in corporate governance in two levels. Firstly, as the majority shareholders, the entrepreneurs (the founders of investee companies) are usually able to dominate the general meeting, therefore, the private equity and venture capital investors as minority shareholders might be oppressed. Secondly, it is quite common that the entrepreneurs or founders of start-ups or private companies are also nominated as the CEO or the president of the board. Therefore, the information asymmetry between the board and PE shareholders also increases agency costs.

With the booming of high-tech and IT industry in China during recent two decades, the role of private equity and venture capital funds in corporate governance is being more and more important. The high premium of the public stock markets has attracted quite a large number of PE investors to get their return by listing the portfolio companies. Once the private company is listed, however, entrepreneur shareholders' control over the company will be significantly diluted. Because the culture in family enterprises is based on the acquaintance relationship rooted in traditional Chinese social ethics, the interpersonal relationship in Chinese family or private companies is commonly established on the entrepreneurs' personal authority, rather than the spirit of contract. Based on the above factors, a series of internal conflicts between private equity and venture capital shareholders and entrepreneurs of Chinese PE-held companies have drawn greater attention. In addition, due to the political restrictions, foreign investors are not permitted to invest in some special industries. As a response, foreign private equity and venture capital investors widely adopt the variable interest entities (VIE) which consists of a set of contractual arrangements to achieve overseas listing, however, the complexity of the VIE structure also exacerbates the agency problems in PE transactions. The chapter four of the dissertation will carry out a series of case studies to explore the nature of above problems of corporate governance of the PE-held companies in

China, especially, the social and political factors in relation to above problems will also be illustrated in details.

Since the rise and rapid development of the Neo-liberalism in US and UK during 1970s, deregulation and liberalization of capital market and corporate governance has been the main idea and philosophy in common law countries. The company law system of UK can be regarded as the most typical legislative achievement in relation to such a change in corporate governance. Specifically, due to the complex changes in British economy and politics in recent half a century, the ownership structure of UK companies has been quite dispersed, which significantly promoted the rise and booming of institutional investors including the PE funds in UK who eventually labeled the British corporate governance as 'shareholder-centered' model. As a legislative response to that, the Companies Act 2006 provide a series of systemic rules for shareholders to actively participate in corporate governance, such approaches are convinced as an efficient way to enhance the self-protection of minority shareholders and reduce agency costs in corporate governance. By reviewing both the legislation and common law cases in UK company law and comparing the related experience and lessons of legal transplantation in Eastern European countries, this research will especially pay attention to the feasibleness of transplanting the shareholder-centered model of company law to Chinese legal system for improving the self-protection of PE shareholders.

As a part of globalization, any legal transplant among different jurisdictions should never be regarded as a simple connection as 'importer-exporter' of a given legal institution, instead, in most cases, making significant changes to the 'imported' institutions in a country as the 'receiver' is inevitable[1]. And also, different social cultures, ideologies and histories may form the path of legal transplant more substantially than its political system[2]. Nevertheless, from a functional perspective, the comparative study of a shared legal issue in two legal systems may still be workable to find out the equivalent legal mechanisms to solve the same problems in different societies[3]. In the following chapters of this dissertation, the agency problems in the organizational laws of private equity in China will be discussed both theoretically and practically. By reference to the legal-economic analysis of the functions of different commercial entities, this research is expected to provide a proposal for comprehensively

[1] William Twining, 'Diffusion of Law: A Global Perspective' (2004) 49 Journal of Legal Pluralism 1, 35.
[2] Ibid, 34.
[3] Esin Örücü, 'Methodological Aspects of Comparative Law' (2006) 8 European Journal of Law Reform 29, 33.

enhancing the protection of investors of PE funds in the context of business organizational laws in China. Beyond the comparative research of the governance of private equity, this research also attempts to explore a new way to explain the driving force of the evolution and institutional changes of business organizations, while at this stage this idea may only be preliminary and needs to be studied in further research.

Chapter 1: The Agency Problems in Private Equity Organizations

1.1 Introduction

Private equity (PE) funds commonly refer to a series of vehicles used in collective investments, all of which are generally themed that the capital is raised privately from qualified investors and is mainly invested in private firms, with the exception of public-to-private funds used in privatizations.[1] Generally, the so-called PE funds can be categorised as venture capital (VC), development capital funds, management buyouts and leveraged buyouts (LBOs)[2]. In historical terms, PE as a means of corporate finance in modern economies initially emerged in the mid-1940s and has flourished in the United States (US) since the late 1970s to 1980s.[3] In the history of PE in the United Kingdom (UK), reform of privatization led by the Conservative government during the 1980s also made the PE market in the UK quite vibrant and internationally significant by late the 1980s.[4] From a legal and economic perspective, the emergence of PE, including venture capital as new players in global capital markets, also raised the question of how the rationale for PE should be explained academically in the context of corporate governance and the economics of laws.

In this chapter the contractual theory of the firm and agency theory as the analytical basis of this research will be explained, and the agency problems in the life cycle of typical PE investment will also be discussed in detail. In the following section, both the advantages and drawbacks of fiduciary duty in common law jurisdiction as the main legal solver to the

[1] Brian Cheffins and John Armour, 'The Eclipse of Private Equity' ECGI Working Paper Series in Law 82/2007 <http://ssrn.com/abstract=982114> accessed 15 January 2016.

[2] Strictly speaking, private equity and venture capital are two different kinds of private investment funds. The distinctions of the two can be summarized as follows: 1) PE funds mainly invest in those well-profitable and reputable public corporations, whereas VC funds are interested in those start-ups or small private-owned firms who usually have technical innovations and reliable core team but the profitability of their business is uncertain and risky; 2) in terms of the governance strategies, PE funds in most cases are the controlling shareholders in the investee companies by purchasing majority portion of shares, whereas VC funds play a role as minority shareholders; 3) compared with venture capitalists, PE funds usually prefer financial leverage to facilitate the share purchase for controlling the target companies; 4) in aspect of regulatory requirement, the main difference between the two types of investment funds is that, since PE funds are able to essentially impact large public corporations' decision-making, the regulations will focus more on the public interest such as the protection of employees of the investee companies and transparency of PE firms' decision-making process. In contrast, the law and regulations relating to VC investment will pay more attention on the protection for minority shareholders. Harry Cendrowski et al, *Private Equity: History, Governance, and Operations* (2nd edn, Wiley & Sons 2012) 20-22, 173-175.

[3] Ibid., 29–30.

[4] Luc Renneboog, Tomas Simons and Mike Wright, 'Why Do Public Firms Go Private in the UK?' (6 January 2006) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=873673> accessed 15 January 2016.

agency problems in commercial organizations will be illustrated in the light of legal transplantation. As this research is mainly aimed at enhancing the legal protection for investors in China's PE industry[5], the status quo of the Chinese PE industry, especially its special connection with China's state power, is overviewed, and specific problems in relation to investor protection of China's PE organizations are summarized. Finally, in the methodological aspect of this research, a functional comparison is made between the legal systems of PE organizations in China, the UK and other jurisdictions as the primary approach to carry out the detailed study in this dissertation. Some recommendations are made and advice is provided for improving the investor protection mechanisms in the Chinese PE industry.

1.2 The Nature of the Firm and Agency Problems in Private Equity Organizations

1.2.1 The Contractual Theory of the Firm in the Context of Social Transformation

1.2.1.1 The Firm as a 'Nexus of Contracts'

The landscape of the global economy and politics experienced dramatic change during late 1970s and 1980s. As a response to the stagflation in this period and competition with new-born economies such as Japan and West Germany, so-called neoliberalism, which is commonly characterized as a turning point in individualism and classic theory of market economy in academia, was established in the US and UK. In a practical sense, neoliberalism as a new ideology was also quickly adopted by the authorities of most common law countries.[6] Against this background, the development of the theory of the firm in law and economics also transformed. In stark contrast to the entity theory of the corporation supporting state intervention in internal governance of business organizations, the contractual theory of the firm particularly prioritizes the contractual freedom between the participants in

[5] It needs to be clarified that in this thesis, the term 'PE' which is related to China is generally include private equity and venture capital, although academically there are important distinctions between the two. The main reasons for this technical issue are given as follows: firstly, although at present VC funds still account for majority of the Chinese market, the typical PE funds especially those industrial buyouts funds have emerged and steadily developed in recent years. Secondly, both the PE and VC funds in China are organized in limited partnership and commercial trusts, in other words, the agency problems which are discussed in this research are generally applicable to both the PE and VC industry in China.
[6] See details in David Harvey, *A Brief History of Neoliberalism* (OUP 2005)10-45.

the free market,[7] which has been developed as a mainstream doctrine for legal–economic analysis of business organizations.

Generally speaking, contractarian scholars view the nature of business organization as the 'nexus of contracts'.[8] The original idea that regards the firm as 'a nexus of contracts' between the parties to a transaction was first raised by Ronald Coase in his distinguished work *The Nature of the Firm* (1937). Coase construed the emergence of firms as a substitution of 'transaction contracts' (or the 'price mechanism') in the market, by which the transactions costs[9] generated from market coordination would be reduced.[10] On the one hand, the utilization of the firm would reduce the costs in the market and, on the other, however, the utilization of a firm or organizations would not be free, and the information asymmetry and administration of employees in the hierarchical structure in the firm would also be costly. Hence, in theory, the profit of a firm would reach the optimal point where the costs of using the organizational structure are equal to the expenses of organizing such a deal in the market.[11] A little earlier than Coase, in 1932, Berle and Means came up with the thesis that due to the separation of ownership and control in public corporations, the shareholders should, but actually do not, play a significant role in scrutinizing the managers,[12] then the main theme in governance of business organizations would focus on how maximally to protect the owners' interests from managers' opportunistic behaviour.

In the 1970s, the contractual theory developed more practically and paid more attention to the economic rationale of different organizational forms and the agency problems in corporate governance. Alchian and Demsetz regarded the firm as a team production, which would be more efficient than those members working individually.[13] The agency problem would inevitably arise if the separation of ownership and control existed, therefore how to monitor the members in a production team or firm would be essential. Because of the different

[7] Henry N. Butler, 'The Contractual Theory of the Corporation' (1989) 11 (4) George Mason University Law Review 99, 100.
[8] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 The Journal of Financial Economics 305.
[9] The term 'transaction cost' commonly refers to the costs generated from the process of actions between the participants in the market, including the costs of negotiating, contracting and monitoring. *Supra* n 7, 103.
[10] Ronald Coase, 'The Nature of the Firm' (1937) 4 Economica 386.
[11] Ibid.
[12] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publisher 1968).
[13] Armen Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organizations' (1972) 62 The American Economic Review 777.

relationships between the team members, the choice of organizational forms would be varied. For example, the partnership structure would be preferred by professional concerns such as firms of solicitors and accountants, in which the self-monitoring between the members may improve the efficiency in such small professional businesses and enhance the trust among one another.[14] In the corporate form, however, because in most cases the shareholders are unable to monitor the management layer all the time and due to the existence of the public market, the trust between the shareholders and managers may not be stable enough. As a response to this issue, it was argued that entitling a part of residual claim to the managers would align the manager's interests with the residual claimants' interests;[15] in other words, the incentive mechanism for managerial staff may reduce the agency costs.

1.2.1.2 The Statutory Form of Firms as Standardized Contracts

In terms of the legal structure of business organizations, contractarians deem the statute as a kind of 'standardized contract' that provides a set of fixed contractual terms for the parties in organizations. Taking the corporation as an example, the limited liability protection sets a clear boundary between the company and shareholders; the statutory obligation and rights of the board of directors and general meeting of shareholders provide a default governance structure for the managers and owners. Although most company laws provide a wide range of contractual freedom in articles of association and ownership structure,[16] the existence of the laws of corporations as standardized contract and 'public goods' can significantly save on negotiation costs.[17] Similarly, the joint liability and unlimited liability of the members fixed by partnership laws also provide a special legal mechanism that can enhance the protection of the partners and reduce the agency costs by triggering the personal liabilities of general partners in given circumstances. Despite the fact that traditionally the trust may not have been regarded as a business organization, based on the widely used trust-like structure in financial investment, the organizational feature of trusts is also noteworthy.[18] Owing to the high-level flexibility in management and decision-making in a trust, the business trust has been applied

[14] Ibid.
[15] Butler (n7).
[16] Specific illustration and economic analysis of the articles of associations and class shares are available in Chapter 4 of this dissertation.
[17] Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 Columbia Law Review 1416, 1444-1446.
[18] Steven L. Schwarcz, 'Commercial Trusts as Business Organizations: An Invitation to Comparatists' (2003) 13 Duke Journal of Comparative & International Law 321.

as the organizational foundation in alternative investment. In specific terms, the pension funds, mutual funds and even venture capital can be organized in a trust structure, and the relevant legislation tends to provide clearer and fixed governance structures for both fund managers and investors (beneficiaries). In such a way, the balance of the flexibility in drafting trust deeds between the parties and the statutory structures of modern business trusts, especially the laws of investment funds, makes the trust-like investment vehicles more contractual and the statutory structure of trusts also plays a role as the cost-saver in creating a trust-like vehicle for commercial purposes.[19]

1.2.2 The Agency Problems in Private Equity Investments

Before the boom of PE in the US and UK since the 1980s, the ownership structures of companies in two such typical common law countries were highly dispersed. In other words, a single shareholder could hardly effectively control the firm or protect his or her economic interests by monitoring the managers or making influential decisions in shareholders' general meetings. As a response to such problems in corporate governance, the various shareholders needed to concentrate their shares collectively to enhance their control over the company. However, even though the shares in the hands of the minority shareholders can be concentrated by acquiring the equities from other shareholders, due to the limited time, energy and professional experience in corporate management, the operational experts in both financial investment and business management were strongly favoured by the owners of US and UK companies. Against this background, the most influential PE firms initially emerged in Wall Street and then in the UK by the late 1980s.[20] The agency problems also arise through every phase of PE/VC investments, PE investments are commonly made within complicated business organizational forms.

On the level of the internal governance of PE funds, limited partnerships are the most widely used legal form in PE and VC investments which can provide a more suitable and efficient governance structure.[21] Briefly, capital contributors such as pension funds, insurance

[19] John H. Langein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 The Yale Law Journal 625.
[20] Mike Wright et al, 'Leveraged Buyouts in the U.K. and Continental Europe: Retrospect and Prospect' (July 2006). ECGI Finance Working Paper No. 126/2006; CentER Discussion Paper Series No. 2006-70 <http://ssrn.com/abstract=918121> accessed 20 January 2016.
[21] A detailed analysis of the agency problems in PE limited partnerships is available in Chapter 2 of this thesis.

companies and wealthy individuals contribute capital to a limited partnership. In this limited partnership, the contributors are limited partners who are protected by limited liability in the extent to which they contribute and, usually, these partners are not allowed to participate in the decision-making of the limited partnership. At the same time, the fund manager, mostly a PE or VC management firm, acts as the general partner who only contributes 1–2% of the capital of the PE fund but is exposed to the unlimited liability and is responsible for making decisions in fund management through the whole life cycle of the PE fund.[22] Furthermore, as one of the basic principles of the laws of limited partnerships, once the limited partners actively participate in the governance of the partnership, the limited liability protection will be waived. Under such pressure, the limited partners who actually contribute most of the capital of the PE funds will lose control over the management; in other words, the agency costs in the management of a PE limited partnership is still an important issue that should not be ignored. Similarly, in particular circumstances, such as China, the business trust will also be applied to PE and VC investment due to the high-level separation between the ownership and control over the capital in the PE investment trust funds. The agency costs in such organizational structure are much higher than the limited partnership structure.[23]

It is widely accepted that the emergence of PE, especially LBOs, may play an active role in reducing the agency costs in the companies with dispersed ownership structures. In practice, however, the protection of investors in PE and VC funds in the level of corporate governance still need to be further considered and improved: firstly, most PE firms (excluding VC funds) mainly do buyouts such as LBOs in which the high level of debt financing will be used to maximize their returns, in this method the high rate of leverage in the structure of corporate finance may distort the motivation of the decision-making of the investee companies' management layer. As a result, because the buyout funds mainly focus on the return rate of the investment from the portfolio companies in a fixed period (e.g., commonly ten years for a typical PE fund) instead of long-term development of the company, management's opportunistic behaviour in corporate governance may not be prevented. Again, owing to the high level of leverage, once the investment fails, the loss to both the PE shareholders and

[22] Steven N. Kaplan and Per Strömberg, 'Leveraged Buyouts and Private Equity' (July 2008) NBER Working Paper No. 14207 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1190356> accessed 20 January 2016.
[23] A detailed analysis of the agency problems in PE investment trusts is available in Chapter 3 of this thesis.

other owners of the investee companies may be disastrous.[24] Secondly, venture capital funds, usually provided by the minority shareholders in start-ups, may also be oppressed by the entrepreneurial controllers. As a result, the transaction costs including the agency and negotiating costs generated from drafting the contractual terms for enhancing the protection for the venture capitalists in corporate governance are also noticeable.

1.3 Fiduciary Duties as Solvers to Agency Problems in Business Organization Law

1.3.1 Fiduciary Duties as Default Rules in Commercial Law

Based on the contractual theory of the firm, the governance rules of the firm mainly depend on the agreement between the parties. Theoretically, the parties to a contract can optimize the governance structure by drafting specific contractual provisions, by which all circumstances will be predicted and stipulated in contracts. In fact, however, it is impossible to predict all the contingencies in future and even if it were possible, the costs of drafting such contracts would be insufferable; that is to say, the contract of the firm would be incomplete. In such circumstances, the primary issues that need to be considered is how to deal with the uncertainty generated from the incompleteness of firms' contracts.

As a response to the uncertainties, two main approaches may be useful. The first is that the legislators are expected to draft more specific and detailed statutes to provide solutions for the parties in the market in advance. However, aside from the problematic feasibility, owing to the complexity and volatility of business in modern society, over-detailed legislation may seriously limit the flexibility and adaptability of the laws in the real commercial world. Additionally, no matter how accurate the written laws can be, it is difficult to avoid the vagueness of definition in the statutes. For example, different parties may have different understandings of the same term in a law; or a given circumstance may lie out the definition

[24] In this regard, the mass-scale LBOs during 1980s by LBO tycoons such as KKR and Blackstone in the US perfectly illustrate the details of the transactions and especially the star case of LBO also shows how the PE fund can destroy the fate of a promising company. Moreover, owing to the boom of complex structured financial instruments in the past two decades, the opportunistic behaviours in LBOs may also transfer the risk in corporate decision-making to the public via collateralized loan obligations (CLOs). Charles R. Geisst, *Deals of the Century: Wall Street, Mergers, and the Making of Modern America* (John Wiley & Sons 2004) 179–232; Viral V. Acharya, Julian Franks, and Henri Servaes, 'Private Equity: Boom and Bust?' (Fall 2007) 19 (4) Journal of Applied Corporate Finance 1.

provided by the present legislation;[25] in other words, it is obvious that pursuing the completeness of legislation is still not efficient.

The second approach to addressing the uncertainties in commercial law is the intervention and remedy of external institutions. In the context of common law jurisdictions, fiduciary duties as default rules developed by the judiciary play an underlying role in dealing with the uncertainty in business law. In general, the fiduciary duty system is one of the core concepts in the law of business organizations in the Anglo-American jurisdiction. Although the fiduciary duties generally can be summarized as the duty of care and duty of loyalty which are imposed on persons such as the director in the company, the trustee of the trust fund or the managing partner in a partnership, the precise meaning of the fiduciary duties might not be understood correctly without a reference to the voluminous case law. From an economic point of view, the fiduciary duty system plays a role as a gap-filler for reducing or correcting the uncertainties in incomplete contracts, in which the contractual parties can spend more time on issues for their own specific needs and leave the broader issues to the court.[26] Moreover, judicial sanctions against a manager's breach of fiduciary duties also convince the parties of the firms that the external pressure of fiduciary duties is able to supervise the managers effectively to perform properly.[27] In summary, the application of fiduciary duty rules in the laws of commercial organizations has provided a flexible and costless way to extend the freedom of participants in transactions and to improve economic efficiency.

1.3.2 The Limitations of the Fiduciary Duty Regime

1.3.2.1 The Uncertainty in Application of Fiduciary Duties

Although the fiduciary duty regime as the default rules can save on transaction costs by allocating a part of the legislating power to the judicial system, which can make negotiation among the parties of the firm more efficient, every legal institution is a double-edged sword, the fiduciary duty rules of commercial organizations still have inherent shortcomings. Taking

[25] Iain G. MacNeil, 'Uncertainty in Commercial Law' (2009) 13 Edinburgh Law Review 68, 76.
[26] Iain G. MacNeil, 'Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 (1) Journal of Corporate Law Studies 107, 119.
[27] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 92.

the securities investment fund (such as unit trusts in the UK or mutual funds in the US) as an example, the duty of care requires the trustees to manage the trust assets prudently and professionally in the interests of beneficiaries exclusively. In the instance where a loss occurs and beneficiaries or investors file a lawsuit, it may be too difficult for a judge to decide whether or not a specific investment decision was reasonable. Moreover, owing to the time-consuming process of judicial review, even though the court provides adequate remedies for investors, the loss in specific investments involving stock market indexes, for instance, or financial derivatives, may still be exacerbated before the eventual adjudication.

Furthermore, imposing strict fiduciary duties on some given business organizations may decrease the advantages of such given investment entities; for instance, in a family partnership, the over-strict fiduciary duty may undermine kinship and trust between family members.[28] In terms of the limited partnership, in a general sense, limited partners do not manage the firm, which justifies the strict fiduciary burden on general partners. Because of the existence of unlimited liability on the general partners, however, the costs and benefits of the managing partners' fiduciary duties should still be balanced. Specifically, limited partnerships are usually used in risky investments, the flexibility of decision-making is essential for successful investment. In sum, the liability mechanism and governance structure within the limited partnership can be more efficient than the fiduciary duty system. As a response in practice, US courts have permitted the waiver of fiduciary duty in limited partnerships within limits.[29] Similarly, in the UK, although there are fewer judicial practices clearly permitting the full waiver of fiduciary duties via the drafting of contractual terms, the scope of fiduciary duties can be modified by contractual terms has been a basic principle.[30] Specifically, in consideration of the high costs involved in both the contracting and judicial practices of fiduciary duties, the rigid fiduciary duties of general partners in the UK's venture capital funds have been criticized, and it is argued that alternative mechanisms such as

[28] Larry E. Ribstein, 'Fiduciary Duties and Limited Partnership Agreements' (2004) 37 Suffolk University Law Review 927, 942; similarly, although some US judges also tried to impose fiduciary duties on close friends and one another, in a general sense, the relationship between friends should be distinct from the fiduciary relationship, as the business between friends is mainly based on the personal trust instead of professional relationship, the over-use of fiduciary law in personal social life may also break the basic human affection that constitutes the harmony in society. Ethan J. Leib, 'Friends as Fiduciaries' (2009) 86 (3) Washington University Law Review 665, 700–701.

[29] Ribstein (n 28).

[30] *Kelly v Cooper* [1993] AC 205.

reputation[31] and contractual adjustment[32] have been playing an important role in preventing opportunism.

In addition, the judicial attitudes towards directors' fiduciary duties stipulated in the articles of association in public corporations also still differ in different regions. The courts in the US, for example, tend to regard public corporations as 'public contracts'.[34] Therefore, the waiver of fiduciary duties as freedom to contract may be restricted or invalidated by judicial review.[35] As for the company law in the UK, though the Companies Act 2006 (CA2006) does not allow any provisions amending directors' liability in the articles of association,[36] directors' liabilities in certain circumstances may still be mitigated or waived by judicial discretion. Firstly, according to the CA2006, British judges are vested with the power to grant relief to directors of a company in certain cases regarding the directors' breach of fiduciary duties.[37] Secondly, in a practical sense, UK judges have accepted the mitigation or relief of directors or senior staff's duties to the company for nearly a century, directors may be exonerated from their liability through specific provisions in articles of association[38] and the court may mitigate or exempt a director's liability at its discretion on a case-by-case basis;[39] in other words, although basically it is still one of the most significant and unique legal regimes in common law jurisdiction, at least the strictness of fiduciary duties in commercial law is being more and more flexible, instead of overly rigid.

[31] Joseph A. MaCahery and Erik P.M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form' (2004) 5 European Business Organization Law Review 79, 82.
[32] A recent case decided by the High Court of Justice has shown that the duties of the general partner in a limited partnership can be narrowed down by contractual provisions in a limited partnership agreement (LPA), as the extent of fiduciary duties varies from case to case in the particular consideration of the current business of the partnership. *Inversiones Frieira SL v Colyzeo Investors II LP* [2012] EWHC 1450.
[34] Tamar Frankel, 'What Default Rules Teach Us About Corporations: What Understanding Corporations Teaches Us About Default Rules' (2006) 33 Florida State University Law Review 697, 713–718.
[35] Ibid.
[36] Section 232 (1).
[37] Section 1157.
[38] *Re Brazilian Rubber Plantations and Estates, Ltd* [1911] 1 Ch 425; *Re City Equitable Fire Insurance Co* [1925] Ch 407.
[39] *Barings plc (in Liquidation) and Another v Coopers & Lybrand (a Firm and Others)* [2003] EWHC 1319 (Ch).

1.3.2.2 The Barrier to the Legal Transplantation of Fiduciary Duties

Aside from the uncertainties in judicial interpretation, the legal transplantation of fiduciary duty regime across jurisdictions is also problematic. Some comparativists have stated that so far in transitional economies, the legal reforms brought about by the authorities were mainly focused on the statutory laws in European or US legal systems, while reforms of the judicial system was still unsatisfactory.[40] Even though the judicial practices were introduced in some emerging markets, the limited experience in coping with decision-making in business organizations (e.g., Poland)[41] and politically driven adjudications (e.g., Russia)[42] can hardly provide adequate protection for investors. What's more, as the analysis above shows, the basic function of fiduciary duties in commercial law is providing flexible and efficient protection for investors, whereas in some transitional jurisdictions the functions of commercial laws are not protective but are more political.[43] The over-dependence on transplanting the fiduciary duties in other jurisdictions may cause high social costs and the protective functions of fiduciary laws may be substantially weakened. It is obvious that the costs of any legal transplantation would not be nil, thus a mixture of indigenous or alternative solutions may be more efficient to the same legal problem in a given society and the convergence or divergence in legal transplantation is determined by the competition between different regimes.[44] In a nutshell, the limitations of the uncertainty and impracticality of fiduciary duties may lead to alternative legal reforms as more cost-efficient and favourable solutions to agency problems in a given jurisdiction.

[40] Katharina Pistor and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory' (2002) ECGI Working Paper Series in Law No. 01/2002 <http://ssrn.com/abstract_id=343480> accessed 23 January 2016.

[41] Ibid.

[42] Katharina Pistor and Chenggang Xu, 'Beyond Law Enforcement: Governing Financial Markets in China and Russia' in Janos Kornai and Susan Rose-Ackerman (eds), *Building a Trustworthy State: Problems of Post-Socialist Transition* (Palgrave 2004) 167-190.

[43] For instance, according to Curtis Milhaupt and Katharina Pistor's study on the relationship of laws and economic development in six countries, the corporate laws and financial regulations in different countries can be characterised as 'protective' or 'coordinative'; the former legal style system emphasizes the legal protection for investors, whereas the latte refers to the legal regime with other aims in coordinating social or political relationships; specifically, US or common law jurisdictions (such as Singapore) are more protective than other countries; the corporate laws in Russia and China serve as more 'coordinative' in that the laws may be controlled by the state for political domination in the natural resources industry (Russia) or balancing complicated relationships among the central governments, local authorities, domestic SOEs and foreign investors (China). See details in Curtis J. Milhaupt and Katharina Pistor, *Law & Capitalism: What Corporate Crisis Reveal About Legal Systems and Economic Development Around the World* (The University of Chicago Press 2008) 173–195.

[44] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics' (1994) 3 International Review of Law and Economics 3, 15–16, 18–19.

1.4 The Political Economy of China's Private Equity Sector

Since the mid-1980s, the Chinese authority officially decided to build up a healthy market for developing science and technology which served as an important component of the market economy reform and opening up policy in China. PE and VC funds as effective financial support for innovative economy were introduced in China. Through around thirty years' rapid growth, PE has been playing an irreplaceable role in the Chinese economy. Although the legislator promulgated and improved financial regulatory and commercial organizational laws, the conflict between emerging private entrepreneurship and the unshakable status of state-owned enterprises (SOEs) still seriously increases transaction costs in PE investments in China. In this section, the following political-economic review of Chinese PE industry is an attempt to briefly draw a whole picture of political economy of the PE market in China and to explore the potential legal risks for the detailed analysis later.

1.4.1 The Economic and Financial Transitions in Contemporary China

After nearly thirty-five years' massive economic growth, the economic institution reform in China is at a turning point. During the last three decades, China's huge achievement in GDP growth attracted attention of the world, which mainly relied on government-led infrastructural investment, exports and real estate industry. From the year of 2012, however, Chinese economy has been changing dramatically. The over-unbalanced economic and industrial structure has become a serious obstruction of sustainability of Chinese economy[45]. Against such a macro background, China's State President Jinping Xi took over the power in March 2013, after which a series of important reforms in the fields of financial regulation and capital market were launched.

[45] See the changing of GDP growth rate of China during the recent decade from figure 1.1.

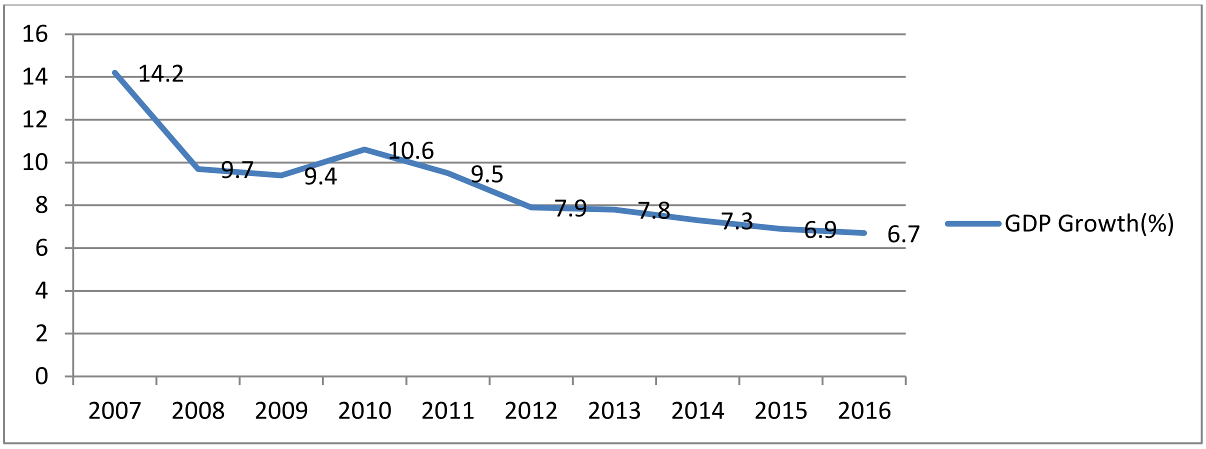

Figure 1.1 GDP Growth of China during 2007-2016

Source: Statistical Year Books issued by National Bureau of Statistics of China

Ever since the Decision on Major Issues concerning Comprehensively Deepening Reforms of China Communist Party (CCP), the supreme guide for present-day social reform of Chinese authority, was promulgated in November 2013[46], encouraging the private sector in Chinese economy and mixed ownership reform of SOEs are the two primary goals of current wave of social transition in China. Specifically, the following two dimensions constitute the whole picture of the economic and regulatory in contemporary China.

First of all, in order to optimize the governance efficiency of SOEs, the acquisition of the ownership of Chinese listed companies by private capital has been encouraged continuously, even though most of Chinese listed firms are still controlled by the state[47]. Almost at the meantime, the mixed ownership investment in the area of infrastructural construction are also widely permitted and encouraged by both the central and local Chinese governments[48].

Secondly, the legal and financial regulatory reforms also aim to fuel the development of private economy. As the starting point of the legal reform of Chinese non-state-owned sector,

[46] Hereinafter referred to as 'the Decision (2013)' [中共中央关于全面深化改革若干重大问题的决定（2013 年 11 月 10 日审议通过）].

[47] According to the statistics provided by the State Council, up to the end of 2015, nearly 67.7% of SOEs of China were mixed by non-state capital. 'The Main Problems and Approaches of the Mixed Ownership Reform of Chinese SOEs' (Economic Information Daily, 25th January 2017) ['国企混改的八大困境与方法'，经济参考报，2017 年 1 月 27 日] <http://mt.sohu.com/20170125/n479562447.shtml> accessed 11th March 2017.

[48] The private-public-partnership (PPP) which originated in the UK during 1980s has been national-widely introduced in China from 2015 as an important sector of the reform of marketization. The first uniformed national-wide PPP trading platform has been established in Tianjin in February 2017. See details from the official website of the PPP Research Centre of China <http://www.pppcenter.org.cn/> 11 March 2017 accessed.

the new revision of the Company Law of China in 2013 removed over-high threshold for capital registration and essentially reduced the cost of registering small start-ups[49]. The internet finance as a new star in Chinese financial market is also playing an increasingly important role in Chinese economy which has the potential to become the pillar industry of Chinese economy in international competition, as state-owned capital in this sub-market is the lowest. In terms of the financial regulatory system, the new Law of Securities Investment Funds (2012 Revision) firstly made huge effort to unify the regulatory power of Chinese investment fund industry. As one of the result, the emerging Chinese private investment fund industry is regulated by the central regulator[50] and the protection for public investors is also essentially enhanced by the law.

1.4.2 The Status quo of Private Equity 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 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 most commercial banks in China are owned by the state[51], Chinese commercial banks prefer to lend money only to the SOEs or medium to large enterprises with a good reputation and clean credit record[52]. For start-ups, without stable cash flow or adequate collateral, however, lending from commercial banks is quite difficult.[53] The second source is private lending, which may be more flexible for small and medium enterprises (SMEs). However, private lending is also not reliable for most private enterprises

[49] The relevant details are available in Chapter 4 of this thesis.
[50] The relevant details are available in Chapter 2 of this thesis.
[51] According to the Annual Report (2015) of China Banking Regulatory Commission (CBRC), up to 31 December 2015, there were 4262 banking corporations in total, only five of which are non-state-owned. < http://www.cbrc.gov.cn/chinese/home/docView/C41C682055714362AF1C86FEA7486BB5.html > accessed 11 March 2017.
[52] In practice, the management layer of the state-owned commercial banks concern about their personal reputation in political career, as once a non-state-owned enterprise fails to repay the loan, the authorities of the government and China Communist Party will strictly investigate the leaders of the bank doubting that he or she took bribes before approving such loans. Weiying Zhang, *The Theory of the Firm and the Reform of Chinese Enterprises* (Shanghai Century Publishing Group 2014) 269 [张维迎，*企业理论与中国企业改革*，上海世纪出版集团，2014，第 269 页].
[53] Dongsheng Zhao, *A Guidebook on Legal Practices of Private Equity Funds: Fundraising, Financing, Restructuring and Listing* (Shanghai Academy of Social Science Press 2011) 4–6 [赵东升，*私募股权基金法律实务大全——募集 融资 ·企业改造 ·上市*，上海社会科学院出版社，2011，第 4 至 6 页].

in China, because the risk of illegal fund-raising and interest rates are very high.[54] Thirdly, nevertheless 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 their access to China's stock market. As a consequence, at present nearly 75% of the companies listed on China's domestic stock exchange are SOEs.[55] 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.[56] Overall, the mainstream financial sector in China can hardly meet the demands of SMEs for financing.

As an alternative financing channel for SMEs, PE funds have been developing rapidly in China during the past two decades. Generally speaking, the Chinese PE industry can be divided into two phases. The first phase is before 2009, during which China's PE industry was dominated by US dollar-dominated funds. Owing to the serious recession caused by the global crisis, the local PE funds (renminbi- (RMB) dominated funds) gradually replaced foreign PE tycoons and became the leaders in Chinese PE market from 2009 (see Figure 1.1). As for the significance of the PE industry for the economic development in China, the continuous expansion of PE as an effective means of addressing the financing constraints for China's SMEs has also made a positive contribution to the economic growth of China (see Figure 1.2).

[54] Ibid.
[55] Roger Leeds and Nadiya Satyamurthy, *Private Equity Investing in Emerging Markets: Opportunities for Value Creation* (Palgrave Macmillan 2015) 162.
[56] Ibid., 163.

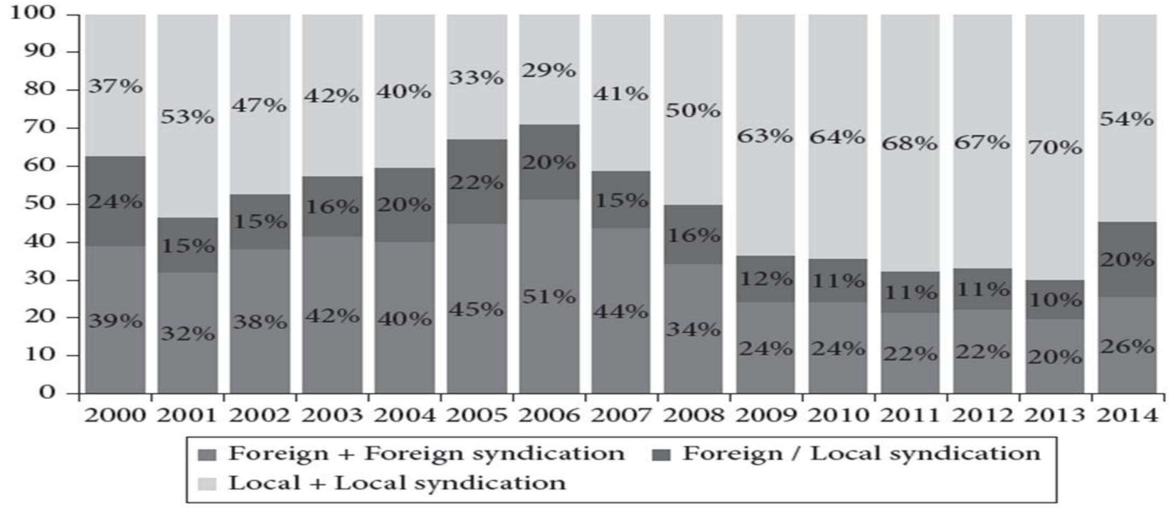

Figure 1.2: Number of investments in USD and RMB (in %) (2000–2014)

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

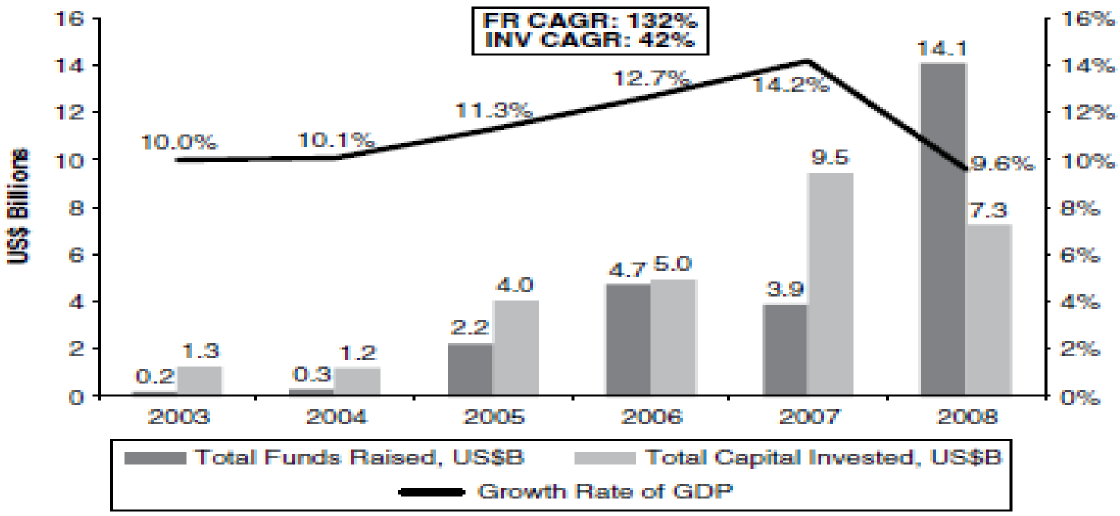

Figure 1.3: Growth in private equity fundraising and investment eclipses GDP growth rate (2003–2008)

Source: Leeds and Satyamurthy (n 55) 172.

1.4.3 The Role of State in Chinese Private Equity Industry

PE investment in China initially emerged during the same time in which the Chinese government advocated a 'socialist market economy'. The first PE-related legal document, namely the 'Decision on the Reform of the Science and Technology Management System',[57] was issued by the CCP in 1985. The first wave of Chinese PE and VC investments were dominated by the Chinese governments and SOEs. On a provincial level some local governments had also established more than 90 funds in 24 provinces with total capital of over US$45 billion for the purpose of supporting technical innovations.[58] In order to master the use of the capital powerfully, the Chinese PE market was controlled by state-owned capital via the organizational structure of the limited liability company, in which the Chinese government could directly control the PE funds by exercising the shareholders' power of the general meeting of the fund management companies.

Owing to the high rate of taxation and inefficient management, since the Law of Partnership Enterprises had been revised in 2006, the limited partnership rapidly replaced corporate PE funds as the dominant legal structure for PE investment in China.[59] The local investors as limited partners in China's private equity limited partnerships (PELPs) are mainly the local government, securities companies, listed companies, state-owned commercial banks, most of whom use publicly owned capital to invest in PE and VC projects, and assume limited liability.[60] Owing to the lack of domestic professional fund management firms, unlike Western PELPs, the state-owned ones in China are always willing to get involved in PE management in the name of maintaining and appreciating the value of state assets.[61]

In comparison with democratic countries, owing to the short history of democratization and marketization of Chinese society, the separation of politics from economy in China is still not well developed. The first wave of privatization reform of SOEs (particularly the management buyout (MBO) of SOEs) during the 1990s has made it possible for individuals, especially ones who have personal relationships with senior officials in the Chinese government and CCP, to control SOEs or their subsidiaries in different forms. Hence, research needs to be conducted on China's top domestic PE firms staffed at senior levels by the family members or relatives of the senior officials of Chinese government (or so-called 'princelings') or that

[57] [中共中央关于科学技术体制改革的决定(国发 1985 第 6 号)].
[58] Yong Zhen, *China's Capital Markets* (Chandos Publishing 2013) 108.
[59] According to the latest statistics issued by the National Development and Reform Commission (NDRC) of China, the number of PE limited partnerships has surpassed the number of corporate PE funds since 2012. See details in Figure 2.1 & 2.2 in Chapter 2 of this thesis.
[60] Yong Zhen, *China's Capital Markets* (Chandos Publishing 2013) 113.
[61] In this regard, a detailed analysis is available in Chapter 2 of this thesis.

are affiliated with large SOEs (see Table 1.1), which could assist to understand the hidden dimension of the legal problems in the Chinese PE industry. PE, especially the VC industry, is a high-risk business: the profitability of PE is determined by the prediction and control of market uncertainties. Having a princeling in the PE senior management layer is an obvious advantage in establishing close relationships with the Chinese government or even the regulators. In practical terms, the function of princelings in PE firms would be to enhance the possibility of listing investee companies on the Chinese stock exchanges for the purpose of exiting and cashing in shares.[62] For instance, the investee company may choose a princeling partner-mastered PE fund, in consideration of the relationship between such applicant company and the interested groups in the Chinese government and the CCP. The CSRC will give higher priority to such companies given that the officials of the CSRC are also reluctant to reject a company with a special relationship with princeling families.[63] In sum, it is possible that the political factors in the Chinese PE industry will also significantly influence the development of legal and regulatory frameworks for PE funds.

Firm	Founded	No. of USD funds	No. of RMB funds	Total funds raised (billions USD)*	Princeling	% of returnees
Aerospace Industrial Investment Fund	2010	0	1	0.8	Ma Yue	50
Boyu Capital	2010	2	0	2.5	Jiang Zhicheng	100
China Culture Industry Investment Fund	2011	0	1	1.1	Li Tong	100
China New Enterprise Invesment	2006	2	0	0.4	Yu Xiaoyang	100
China Renaissance Capital	2005	3	0	2.0	George Li	100
CITIC Capital Partners	2003	2	0	2.1	Jeffrey Zheng	83
CITIC Private Equity Funds	2008	1	3	3.3	Liu Lefei	60
GL Capital	2010	1	0	0.4	Jeffrey Li	60
New Horizon Capital	2005	4	1	2.8	Wen Yunsong	100
New Margin	1999	3	16	2.7	Jiang Miaheng	50

Table 1.1: Ten Chinese private equity firms with senior princelings in management

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

1.5 Agency Problems of Private Equity and Limitations of Judiciary in China

As mentioned earlier, modern firms feature separation between ownership and control, which gives rise to agency problems within firms. In the process of PE investment under Chinese law, agency costs are generated on two levels, the one is the agency problem between the fund managers and investors and the other is the agency problem between the entrepreneurs

[62] Justin Robertson, *Localizing Global Finance: The Rise of Western-style Private Equity in China* (Palgrave Macmillan 2015) 55–57.
[63] Ibid.

and PE shareholders in corporate governance of portfolio companies. As for the legal structure of PE funds, presently most PE funds are organized in the forms of limited partnership and commercial trust. Firstly, in terms of the governance of PE funds, owing to the inadequacy of experienced institutional investors and professional PE firms, both the limited partners of PELPs and beneficiaries of private equity investment trusts (PEITs) tend to intervene actively in the management of the fund which has considerably increased the transaction costs and risk of investment failure.[64] Secondly, the main problem in corporate governance of Chinese companies is the weak protection for minority shareholders. In specific terms, currently PE funds mainly pay attention to the non-state companies in China, in which the entrepreneurs (or the controlling families) as controlling shareholders and senior managers of the investee companies may oppress the PE minorities.[65] Although some empirical studies of the relationship between PE intervention in firm management and the efficiency of corporate governance show that the sophisticated and active role of PE shareholders in corporate governance can optimize the decision-making process in family-owned firms,[66] in the situation where PE shareholders are minority shareholders the balanced legal protection mechanisms are still essential for decreasing agency costs and avoiding serious conflicts between management and PE shareholders.

The analysis of the economic functions of the fiduciary duty system in promoting financial markets shows that the case-by-case method in settling the disputes in fiduciary-like relationships can expand the range of contractual freedom for the parties and save on transaction costs, the success of which mainly depends on the independence and professionalism of the judicial system. Although the adjudicative reform based on the case law model in common law jurisdictions has been officially pushed by the authorities of China in the past two decades, the rejection of separation of powers and the emphasis on both the socialist nature of Chinese society and the CCP’s leadership make it difficult to develop independent adjudication as a dominating remedial means for protecting investors in financial

[64] Ping Sui and Guangxin Li, *The Diagrammatic Analysis and Case Studies of Private Equity Funds in the New Era of Asset Management Industry* (Law Press 2014) 18 [隋平，李广新，*泛资管时代私募股权投资基金操作：图解与实例*，法律出版社，2014，第 18 页].

[65] Qilin Su, *Family Control, PE Investment and Corporate Governance of Private Listed Firm* (Economic Science Press 2013) 40–41 [苏启林，*家族控制、私募股权投资介入与民营上市公司治理*，经济科学出版社，2013，第 40 至 41 页].

[66] Ibid., 158–161.

markets like that in common law countries in the near future.[67] In the practical sense, because of the loose regulatory environment of private investment funds, the real-time supervision is not as strong as public-traded funds, and the proof of causation of the loss and mismanagement may be very costly and difficult for investors of PE funds. Finally, due to the costly procedures of lawsuits, the rational apathy of individual investors may also impede the application of class lawsuits in China's PE and VC market.[68]

1.6 The Methodological Aspects of the Research: A Response to Chinese Economy

The above summary and analysis of the status quo of private equity in the context of the economic reform in contemporary China illustrates that the legal issues of investor protection or tackling with the agency problems in organizational governance should be considered in a very close connection with the political economy of China. Accordingly, as a response to the agency problems in Chinese private equity investment, the methodology of such a research should be compatible with the particularity of Chinese social background. Prior to the detailed studies, two issues are worthy to be further illuminated.

1.6.1 The Appropriateness of the Theoretical Foundation

It is not surprising that one may doubt the appropriateness of using 'the contractual theory of the firm' as the doctrinal foundation for this research, because to how large extent the Chinese economy is market-oriented is still debatable. In fact, this research primarily involves three departmental laws of commercial legal system, namely the laws of partnerships, business trusts and corporations. Since the first company law was promulgated in early 1990s, the liberalistic and market-oriented reforms of commercial organization laws

[67] Chenguang Wang, 'Legal Transplantation and Legal Development in Transitional China' (December 2012) The World Bank Legal Review 161, 175.

[68] Tao Huang, 'Why the Courts are not So Important?: An Analysis of the State Managerial Behaviours of China's Securities Market' (The 9th Forum of China Legal Economics, Beijing, June 2011) [黄韬，'为什么法院不那么重要?——基于中国证券市场国家管理行为的一项分析'，第九届中国法经济学论坛会议论文，北京，2011] <http://www.financiallaw.sjtu.edu.cn/Uploads/CKFinder/files/%E4%B8%BA%E4%BB%80%E4%B9%88%E6%B3%95%E9%99%A2%E4%B8%8D%E9%82%A3%E4%B9%88%E9%87%8D%E8%A6%81_%E5%9F%BA%E4%BA%8E%E4%B8%AD%E5%9B%BD%E8%AF%81%E5%88%B8%E5%B8%82%E5%9C%BA%E5%9B%BD%E5%AE%B6%E7%AE%A1%E7%90%86%E8%A1%8C%E4%B8%BA%E7%9A%84%E4%B8%80%E9%A1%B9%E5%88%86%E6%9E%90_%E9%BB%84%E9%9F%AC(1).pdf>accessed 2 February 2016.

in China have been carried out respectively[69]. Even though the effectiveness of the present-day reform of Chinese SOEs is still not clear and of course, the political nepotism may still impede the marketization of Chinese economy, the unbalanced economic structure and serious corruption in the SOEs has pushed the authority to weaken the monopolistic status of state-owned enterprises and state control over private economy substantively[70].

Therefore, in regard of the institutional reform of private equity in China, contractualization and marketization are expectable. Specifically, in relation to the agency problems in Chinese PE and VC industry, the marketization may facilitate the following institutional changes: firstly, the clearer recognition of market economy will encourage the confidence of private economy of China, as an important sector of private economy, more sophisticated contractual techniques will be developed by both entrepreneurs and venture capitalists or PE experts. Secondly, the rapid expansion of asset management industry has been a dynamic of establishing a more reasonable regime of qualified investors and of promoting a more effective self-regulation of PE in China. Thirdly, the staged privatization of the SOEs will gradually dilute the political control of those state-owned PE firms, especially the investment trust corporations. As a result, the changes of the SOEs' ownership structure may not only facilitate the contractualization of Chinese company law but also rectify some distorted phenomenon in Chinese PE market. Of course, all of these expected reforms may be realized in several stages, instead of in an immediate process.

Moreover, in respect of social culture, the re-identification of Chinese individualism has been a remarkable, irresistible and widely influential transition in Chinese society. In the fourth chapter, readers will have an opportunity to see how the Chinese culture of 'rule of man' can be a barrier to fostering the contractual spirit in Chinese corporate governance[71]. However, it is not to say that the awareness of contract and the respect of market do not exist in China, nor to deny the substantive progress in Chinese civil society. Actually, some scholars has correctly pointed out that the present-day Chinese ideology is a complexity of liberalistic

[69] Such as the substantial changes of the Company Law in 2005 and 2013; the recognition of limited partnerships to the Law of Partnership Enterprises in 2006; the successive promulgation of the regulations in the field of collective investment trusts during 2001-2008; and the very substantial reform of the Law of Securities Investment Funds in the year of 2012. The details of these are available in the following chapters.
[70] See details of the theoretical analysis of Chinese economic reform from Zhang (n 52) 53-93, 384-399.
[71] See Section 4.5.2 of this thesis.

market, the authoritarian politics and Confucian traditions[72]. The individualistic awareness of human rights, equality and contractual freedom in civil society is rapidly developing and the progress of liberalistic reform depends on the extent to which the social stability and economic growth rely on the private sector of China. The overview of Chinese political economy in above section evidently suggests that the encouragement of non-state-owned sectors is not only a political promise of Chinese government for its consideration of international reputation but also a realistic and urgent demand for domestic development in a long-term future.

1.6.2 The Appropriateness of the Referential System for Analysis

As the title of this research shows, comparative law as the basic methodology will be employed through the whole structure of this dissertation. Therefore, the selection of an appropriate referential system for analysis is crucial for the persuasiveness of the research. It is obvious that this research mainly aims to develop a coherent and feasible proposal for institutional reforms for China's private equity market. It is undeniable that there are more similarities in legal tradition between China and some countries with characteristics of continental law, such as Germany and Japan, especially in China and Germany or Japan, the ownership structures of corporations are highly concentrated, whereas the shareholding structure UK corporations is dispersed[74]. In other words, it is suggested that the continental legal tradition may be more suitable for China.

In consideration of the details of the institutional background of China, however, the above hypothesis will be refuted. First, owing to the existence of developed banking market and relatively conservative attitude towards high risks in Germany and Japan, there are much more financing sources in the market of banking loan for companies, therefore the banks have motivation to actively monitor the decision-making of the borrowers *ex ante*, interim and *ex post*[75]. Moreover, for keeping both the safety of loan and commercial co-operation, the

[72] See Teemu Ruskola, *Legal Orientalism: China, the United States and Modern Law* (Harvard University Press 2013) 207-218; Zhongqiu Zhang, *Comparative Studies of Chinese and Western Legal Cultures* (4th ed., Law Press China 2009) 395-399 [张中秋，*中西法律文化比较研究*，第 4 版，法律出版社，2009，第 395 至 399 页].

[74] Rafael la Porta, Florencio Lopez - De - Silanes, Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54 (2) The Journal of Finance 471.

[75] Mark J. Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 (8) The Yale Law Journal 1927.

commercial banks in Germany tend to keep long-term relationships with the companies. As a consequence, the commercial banks are willing to be shareholders and to participate in corporate governance by direct voting and by casting proxy votes in borrowing corporations[76]. By contrast, the financing from Chinese commercial banks are extremely inadequate, as the threshold of mortgage loan is very high, which is insufferable for most start-ups. Moreover, even though the Chinese banks are vested with voting rights in shareholders' meeting of borrowing companies, the absolute state control over the commercial banks will inactivate their incentives to monitor the performance of borrowing companies[77].

Second, as another unique monitoring mechanism in German corporate governance, the co-determination plays a significant role in reducing the agency problems. For enhancing the protection of stakeholders in German companies, not only shareholders but also employees are vested voting rights in corporate governance, by which employees are able to exert influence on corporate decision-making at the level of supervisory board[78]. The feasibility of such kind of protection mechanism to a large extent is determined by the long history and tradition of social democratic ideology[79], hence the function of the German co-determination system are rooted in the unique social and cultural background of Germany which does not exist in China. This is especially true for the PE-held firms in China.

Again, the uniqueness of each jurisdiction should never be ignored and its path dependence in institutional transition can hardly be changed or replaced in a short term. Compared with other major developed economies, the UK model in the area of private equity and business organizations may be more suitable as a reference for cotemporary China. Firstly, owing to the very special political and economic factors, both the limited partnership and business trust are widely used as the organizational forms for Chinese private equity funds[80]. Although the US is the largest market of PE, however, the corporation is the most typical organizational

[76] Julian Franks and Colin Mayer, 'Ownership and Control of German Corporations' (2001) 14 (4) Review of Financial Studies 943.
[77] Jinqian Qiu, *Ownership Structure, Corporate Governance and Institutional Shareholder: The Case of Chinese Listed Companies* (Law Press China 2005) 65-69.
[78] Jean Jacques du Plessis et al, *Principles of Contemporary Corporate Governance* (2 nd ed., Cambridge University Press 2011) 348-351.
[79] Ibid; Yongqing Zhao, *Research on the Democratic Socialism Model of Germany* (Peking University Press 2005) 115-132 [赵永清，*德国民主社会主义模式研究*，北京大学出版社，2005，第 115 至 132 页].
[80] The reasons for why business trusts are popular in Chinese PE market will be explained in Chapter 2&3.

form for the private investment funds of the US[81] which may not be really referential for Chinese existing legal system. By contrast, the legal regime of unit trusts in British financial law which has been quite mature for collective investment is particularly useful for China. Moreover, as the most important institutional foundation for Chinese private investment funds, the existing Law of Securities Investment Funds of China (2012 Revision) clarifies that the securities investment funds in China are organized on the basis of trust law[82], thus it is obvious that the British law is more compatible for China. Second, in comparison with the 'director primacy model' of corporate governance in the US, the UK-style 'shareholder primacy model' is more feasible and suitable for institutional transition in China. For the SOEs' stake, it is naive to believe that the Chinese authority's political control over the institutional transition of company law can be essentially weakened in an expectable future[83]. The state as the majority shareholders of SOEs has the motivation to impede the diversification of shareholding structure of Chinese companies. In other words, in the present stage of economic reform, the British model may be more feasible and practical for China.

[81] Timothy Spangler, *The Law of Private Investment Funds* (2nd end, Oxford University Press 2012) 10-12.
[82] Article 2 of The Law of Securities Investment Funds of P.R.China (2012 Revision) [中华人民共和国证券投资基金法（2012 年修订）] provides that '[…] the matters not covered by the present Law shall be governed by the Trust Law of the People's Republic of China, the Securities Law of the People's Republic of China, and other relevant laws and administrative regulations' . More relevant details will be discussed in Chapter 2.
[83] Milhaupt and Pistor (n 43) 146-149.

Chapter 2: The Protection for Limited Partners of Private Equity Limited Partnerships

2.1 Introduction

Generally speaking, the limited partnership has been widely adopted for organizing PE and VC investment in developed countries. In a typical limited partnership there should be at least one general partner and one limited partner. The general partner who is entitled to manage the business of the partnership exclusively is required to be personally liable for the debts of the limited partnership. By contrast, the limited partner who is not allowed to be involved in the management is protected by limited liability. In terms of the profit distribution mechanism, the general partner is entitled to share a substantial amount of the profit of the limited partnership, which aligns the interests of the manager and investors. In the commercial law system of the UK, both the Limited Partnership Act 1907 and the financial regulatory system of collective investment schemes (CISs) established a legal framework of PE funds that mainly focuses on the protection for limited partners in PE limited partnerships (PELPs). Similarly, in the Chinese PE and VC market, since the Law of Partnership Enterprises of China was amended in 2007, the limited partnership has also been increasingly preferred by investors in the PE and VC industry. Owing to the immaturity of the Chinese PE and VC industry, however, the existing protective mechanism of the limited partnerships in China is imperfect. By means of legal–economic analysis of the limited partnerships and comparing the legal structure of PELPs in China and the UK, this chapter aims to explore a series of feasible approaches to improve the internal governance and ownership structures to reduce the agency costs in limited partnerships.

Specifically, the following issues are discussed in this chapter: Firstly, by reviewing the evolution of the limited partnership in the commercial law of the UK and comparing it with the economic and legal features of the company and business trust, this chapter argues that the combination of limited and unlimited liabilities, the efficient governance structure of the limited partnership and the effective incentive mechanism for the general partner make the limited partnership more advantageous in organizing risky transactions. The basic principles of the regulatory system of PELPs under UK law are then summarised, especially as a supplement to the official regulation. The self-regulatory rules of the British Private Equity and Venture Capital Association (BVCA) are also analysed. By reviewing the history and evolution of PELPs in China (section 3), the legal framework of PELPs in China is outlined and it illustrates that the Chinese government's control power in economic reform plays a significant role in shaping the regulatory system of PELPs in China. In section 4, main legal problems in Chinese PELPs are summarised in three domains, from which it can be seen that the nature of the legal problem of the PE and VC funds in China is the unprofessional limited partners' intervention in management, which is caused by the lack of trust between the general partners and limited partners and the imperfect liability and incentive mechanisms in the limited partnership.

With reference to the experience of the legal regime of PELPs in the UK, this chapter proposes that the legal reform of PELPs in China should be carried out in the following respects: First, in order to align the interests of general partners and limited partners, the profit distribution approach between general partners and limited partners should be structured. Second, by enhancing the personal liabilities of responsible directors of PE and VC firms, the risk of opportunism by general partners may be reduced. Thirdly, to improve the efficiency in the management of PELPs, the ambit of limited partners' personal liability should be clarified in the statutes. Finally, in order to enhance the reputational mechanism within the PE and VC market in China, it is recommended that the self-regulatory system be rearranged.

2.2 The Features of Limited Partnerships: Historical and Legal–economic Analysis

2.2.1 The Origins of Limited Partnership in the History of English Law

In a world-wide sense, the origin of the limited partnership can be traced back to the *commenda* which was, firstly, used for maritime ventures in medieval Italy.[1] In the legal history of the UK, however, the emergence of the limited partnership was quite late: the official statutes of both the general partnership and limited partnership were not enacted until

[1] In detail, in a *commenda,* the passive partners contribute capital and vessels, and assume limited liability to the extent of their contributions, the managing partner(s) are responsible for managing the maritime trade and assume unlimited liability for the loss of the trade. As a sort of incentive mechanism, the profit of the maritime trade was shared between the managing and passive partners. Henry Hansmann, Reinier Kraakman, Richard Squire, 'Law and the Rise of Firm' (2006) 119 Harvard Law Review 1335, 1372–1374.

recent centuries. The dominating business organization in England was the joint stock company since the seventeenth century, which was exclusively chartered by the English Crown. In order to protect creditors and minority shareholders, however, the English Parliament tended to grant the corporate charters only to those enterprises with large fixed assets,[2] which meant that only a small number of corporations could be chartered to run their businesses. By the late seventeenth century, the aforementioned situation had driven English entrepreneurs to seek new forms of commercial organizations[3]. Although there was no specific statute regulating partnerships in the UK before the Partnership Act 1890,[4] the basic rules of general partnerships had been developed in common law and equity. The legal rules regarding contracts in common law are applicable to partnerships.[5] A partnership will not be created unless there is a consistent binding declaration of will among its partners.[6] Moreover, the common law rules relating to variation are also applicable to partnerships.[7] In addition, the mutual agent rules in common law were also transplanted to partnerships; the difference is that in the partnership each partner is also the principal of the other partners.[8] Furthermore, the case law rules applied to partnerships are not limited to contract law; the rules of fiduciary duties developed by the courts of equity are also applied to the partnership. That is to say, each partner owes a fiduciary duty to his or her co-partners and all the partners are expected to perform with due care and good faith towards each other or one another.[9] Correspondingly, according to the definition of *partnership* under the Partnership Act 1890, the essence of a partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit'[10]; in other words, the English law regards the partnership as a kind of 'relationship' rather than an 'entity'. Therefore, a series of existing rules in case law regarding contracts, agency or trust are also applicable to the legal issues in partnerships.[11]

As a basic rule, all the partners in an English general partnership should bear unlimited liability for all debts of the partnership.[12] With the complication involved in the division of

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[2] Ibid., 1379.
[3] Ibid.
[4] R.C. I'Anson Banks, *Lindley & Banks on Partnership* (19th edn Thomson Reuters (Legal) Limited 2010) 1.
[5] Ibid., 12.
[6] Geoffrey Morse, *Partnership Law* (7th edn OUP 2010) 12.
[7] Ibid., 12.
[8] Ibid., 104.
[9] Ibid., 12-13.
[10] Partnership Act 1890, s 1(1).
[11] Morse (n 6) 12-13.
[12] Partnership Act 1890, s 9.

labour during the nineteenth century, however, it became imperative that a new enterprise providing limited liability protection that could better attract capital and professional employment be developed.[13] The Limited Partnership Act 1907, firstly, enabled the limited partnership to be formed in the UK, which provides that in a limited partnership, there should be (i) at least one general partner who controls the limited partnership and bears unlimited liability and (ii) one or more limited partners whose liability is only limited to amounts of their contribution[14] and who are totally excluded from the management of the partnership.

The evolution of partnership law in the UK at the introduction of partnership in the UK is based on two main factors. Firstly, the demands of the flexibility of formation of a partnership can generate more opportunities for entrepreneurs to establish a firm to run their business. Secondly, the unincorporated body nature of partnerships makes it possible to adopt existing rules in common law and equity of other laws to efficiently develop the legislation on partnerships. Finally, the emergence of the law of limited partnerships in the UK shows that the separation of control and ownership, and the mixture of limited and unlimited liabilities among general and limited partners can more efficiently integrate monetary and human capital to suit the needs of economic development.

2.2.2 The Legal-economic Analysis of Limited Partnerships: Security and Efficiency

From the review of the origin of the limited partnership in history, one can see that the fundamental social factor of the emergence of the limited partnership was the demand for a new organizational form that could effectively enhance the protection of investors in high-risk businesses. In modern times, PE and VC investment is also one of the most risky financial activities in the world economy, which is also mainly organized in the form of limited partnership. The next section of this research is a legal–economic analysis and a comparison between the main commercial organizations, namely the general partnership, corporation and business trust, and explores the unique economic characteristics of limited partnerships and explains why parties choose limited partnerships to conduct business.

[13] R.C. I'Anson Banks (n 4) 985–986.
[14] Limited Partnership Act 1907, s 4.

2.2.2.1 The Moderate Separation of Ownership and Control

a. The Exclusion of Unprofessional Intervention: Management Efficiency

Ever since the industrial revolution in the eighteenth century, the business scale of enterprises has expanded extensively and ownership has diffused extensively, because no individual or family was able to provide sufficient capital to sustain the growth of enterprises.[15] In such a situation, with the increase of owners, the ownership of the corporation was diluted, which meant that none of the owners could dominate the business affairs of the company. For management efficiency, the separation of ownership and control came about.[16] In the classic model of modern corporate governance, in principle the substantive decisions on the business affairs of the company should be determined by directors who actually play a role as the agent of shareholders. However, the information asymmetry between the principals and agents motivate the owners to be vigilant against directors. As a result, a series of participating powers of shareholders in corporate governance were developed as a part of basic principles of modern company law.

Generally speaking, shareholders of a company may have powers and rights with regard to the participation of corporate management. Although the independent managerial power of the board of a company can theoretically save negotiation costs, for protecting the interest of shareholders, modern UK company laws tend to accord veto and approval rights to shareholders where a transaction proposed by the directors involves conflict of interests for directors;[17] in other words, the approval procedures of significant transactions of the firm can be regarded as the cost for solving agency problems in corporate governance.

Similarly, in terms of general partnerships, it is the common governance rule that all the partners have an equal right to participate in firm management.[18] Thus, the decision-making

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[15] Thomas Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007) 4.
[16] Ibid.; Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers 1991) 5.
[17] For example, under the Companies Act 2006, any *'substantial property transactions'* must be approved by the members of the company (s 190); David Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 206.
[18] For instance, s 24(5) of the Partnership Act 1890 of UK states that 'every partner may take part in the management of the partnership business'; s 26 of the Partnership Enterprise Law of the People's Republic of China (2006 Revision) also provides that 'The partners enjoy equal rights to the execution of partnership affairs.'

process of the general partnership will be run on the basis of majority rule among all the partners. In contrast, the basic rule of the governance of limited partnerships is that as the passive owner of the enterprise, limited partners are forbidden from participating in any substantive decision-making matters, which means that the managing partner can independently act without the consent of limited partners. In this governance structure, the management will be able to deal with any emerging or unexpected issues more efficiently without intervention or procedural restrictions by the members. In consideration of the importance of high-level professional judgment in a risky financial market, the above advantage of limited partnerships exactly meets the demands for flexible management of the firm.

b. The Profit Sharing between GPs and LPs: Reduction of Agency Costs

In principle, the limited partners must not be allowed to participate in the managerial affairs of the limited partnership, otherwise they will assume unlimited liability for the debt of the partnership.[19] In this regard, theoretically, the degree of the exclusion of non-professional intervention is almost the same as business trusts where beneficiaries and settlers are prohibited from firm management or decision-making. However, one of the essential problems in a trust is the lack of incentive mechanism for the trustee. Thus, in a trust, the agency problem can only be mitigated by means of external protection, such as judicial practices in respect of fiduciary duties. Although in trusts, theoretically, the fixed rate of management fees can make trustees benefit from the business, nevertheless, the irrelevance of the manager's performance and personal income has significantly limited the efficiency of the trust in high-risk transactions.[20]

In comparison with trusts, the limited partnership can provide a more effective and efficient incentive mechanism to reduce agency costs. Firstly, because both the general partner (active

[19] For instance, s 6(1) of the Limited Partnership Act 1907 provides 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'.

[20] Just as some trust law scholars have mentioned that traditionally the basic rule of the profit distribution excluded the trustees from gaining the carried interest of a trust. Even in a commercial trust, the sharing of profit must be approved in advance by beneficiaries, otherwise for the trustee it will be impossible to share a proportion of profit of trust business. Steven L. Schwarcz, 'Commercial Trusts as Business Organizations: An Invitation to Comparatists' (2003) Duke Journal of Comparative & International Law 321; John H. Langbein, 'The Secret Life of the Trust: The Trust as an Instrument of Commerce' (1997) 107 Yale Law Journal 165.

partner) and limited partner (passive partner) hold shares in the enterprise, the general partner who is in charge of the management of the firm will be directly motivated to work hard in the interest of the firm; in other words, to a large extent, the moderate separation of ownership and control in a limited partnership mitigates the agency problem. Although in a general partnership the profit is also distributed in accordance with the proportion of each partner's contribution, the governance structure of general partnerships, however, is based on all the partners' participation in management, which may increase the negotiation costs in decision-making. Secondly, as a common rule in the law of limited partnerships, the managing partner (general partner) is entitled to share a proportion of the profit of the business. Therefore, in limited partnerships the conflict of interest between the principal and manager can be mitigated significantly. Compared with the ownership structure of business trusts, it is evident that the incentive mechanism makes limited partnerships more advantageous in solving the agency problems between a manager and owner.

2.2.2.2 Organic Bond of Limited and Unlimited Liabilities: Transaction Security

a. Limited Liability of Contributors: Efficient Fund Raising

From a historic point of view, a limited liability regime has been widely adopted for quite a long time. Not only limited partners of limited partnerships, but also equity investors of other business organizations such as corporations and trusts can enjoy limited liability protection.[21] The main advantages of limited liability in commercial activities have been widely recognized and can be summarised as follows:

First of all, in the case of a rational person who engages in commercial business, the higher the risk he or she takes, the stronger his or her motivation to monitor his or her agent. Accordingly, compared with the unlimited liability structure, limited liability can fix the peak value of the investor's loss, thus the investor does not need to spend too much on monitoring the agent's behaviour.[22] In the circumstance where all the equity investors of an enterprise are exposed to unlimited liability, each investor will be motivated to monitor other investors for ensuring that they do not withdraw or transfer their assets, because all the wealth of each

[21] Limited Partnership Act 1907, s 4; Companies Act 2006, s 3.
[22] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 41–42.

investor may be available for paying the debt of the firm.[23] By contrast, limited liability fixes and identifies the scope of each contributor's liability, thus the costs of monitoring for each one is reduced.

Secondly, limited liability can fix the share price of the enterprise, by which the market price of shares can reflect the additional information of the firm's value. Conversely, if the liability of equity holders is unlimited, the equity or shares are not the homogeneous commodity in the public market. As a consequence, investors have to explore more information to examine the potential risk to, and value of, the firm;[24] in other words, the limited liability can improve the efficiency of information utilization. Furthermore, the transferability of shares makes it possible to replace the manager, if the performance of the manager is unsatisfactory to the new owners. It can be seen that limited liability plays a positive role in improving the performance of managers.[25]

Thirdly, the protection mechanism of limited liability enables the owners of the firm to engage in diversified investment, including those risky transactions that may generate high return for the firm, but not to be restricted to those conservative investment strategies. In this regard, compared with unlimited liability, the limited liability regime also contributes to the efficiency of investment.[26]

Finally, from a social point of view, the emergence of limited liability in commercial organizations enables individuals of relatively modest means to act as entrepreneurs, which optimizes the allocation of social resources.[27]

In terms of limited partnerships, the advantages of the limited liability of passive investors can also be illustrated by reviewing the evolutionary path of the commercial partnership in medieval Italy. The Italian household in the Middle Ages is deemed the progenitor of modern general partnerships, in which both the sons and father of a family jointly managed the family

[23] Ibid., 42.
[24] Ibid., 43.
[25] Ibid., 42–43.
[26] Ibid., 43–44; Hansmann et al (n 1) 1350.
[27] Rebecca J. Huss, 'Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age' (2001) 70 University of Cincinnati Law Review 95, 103-104.

assets.[28] With the accumulation of wealth among Italian families and development of commerce, the said household gradually evolved into a new sort of organization, namely the so-called *compagnia*, in which the business of the family was managed not only by family members, but also those entrusted persons who did not have a relationship with the family. The liability of all the members of the *compagnia* was joint and several.[29] However, the unlimited joint and several liability imposed a heavy burden on individual merchants, especially on those individuals who were not rich enough to hedge against such liabilities. As a consequence, the unlimited liability regime was a substantive obstacle of fund-raising in risky businesses. Against this background, as discussed earlier in this chapter, the maritime ventures with higher risk were organized in the form of limited partnership or *commenda*, rather than general partnerships or *compagnia.*

b. Unlimited Joint and Several Liabilities of Controllers: Efficient Management

The separation of control and ownership is one of the most significant legal features of modern enterprises. However, this causes serious agency problems. In particular, the profit distribution mechanism of limited partnerships will considerably motivate the controller to engage in high-risk transactions for the purpose of gaining high return. As a result, compared with general partnerships, opportunism on the part of the managing partner in the limited partnership may give rise to greater loss to the owners of the business. The application of unlimited joint and several liability to general partners can, to some extent, balance the risk and efficiency of the management of limited partnerships.

The unlimited joint and several liability deterrence can make the controller of a firm work prudently and maintain awareness of risk all the time, otherwise he or she may have to repay the debt of the firm in person, by which the protection of passive partners or limited partners can be enhanced and the agency risk may be reduced. Additionally, as a general rule in partnership law, once the limited partner or passive partner substantially participates in the management of the partnership, the limited liability protection will be lost;[30] in other words,

[28] Hansmann et al (n 1) 1365.
[29] Ibid., 1365.
[30] For example, historically, by the fifteenth century, a version of *commenda* was used for land trade, namely the '*accomandita*', passive investors could only enjoy limited liability protection as long as they waived participation in the management; similarly, the Limited Partnership Act 1907 also provides that 'If a limited

the existence of unlimited joint and several liabilities in a firm can not only refrain the opportunism of the controller, but also prevent the non-professional contributors from intervening in firm management. The dual functions of the unlimited joint and several liability regimes are particularly suited to high-risk business activities, such as maritime trading in the past and venture capital at present.

Furthermore, from the creditor's point of view, the existence of unlimited liability of the dealer can also enhance the worthiness between creditors and general partners of limited partnerships. This thesis can be illustrated by the banking business run by the Medici family, the most influential merchant group in medieval Italy. With the prosperity of inland trading in Italy, the demand for banking financing was increased remarkably. By the fifteenth century, the Medici bank had expanded its business by creating its branches in cities other than Florence where the bank was based. To control the risk inherent in these diverse locations, the central Medici bank was a limited partner and the managers of local branches were the general partners,[31] that is, the banking business at that time was run in the form of *commenda* or limited partnership. Once the reliability of the local manager was established, the organizational structure of the banking partnership would be changed into *compagnia* or general partnership, because at that time personal liability was important for creditworthiness.[32] By contrast, the commercial law in Siena, which was the dominant banking centre of Europe during the Middle Ages, refused to recognise joint and several liability; in other words, the liability of the members of Sienese firms was restricted to their *pro rata* share of the debt. Consequently, to some extent, the lack of trust accelerated the fading of Siena in its competition with Florence, which finally replaced Siena as the heart city of European banking by the late Renaissance.[33] In sum, the existence of unlimited joint and several liabilities of the owners can enhance the creditworthiness of a firm participating in high-risk businesses, which is one of the advantages of limited partnerships over corporations in complex and risky financial investment.

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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.'
Ibid., 1373; s 6(1) of the Limited Partnership Act 1907.

[31] Ibid., 1373.

[32] Ibid., 1374.

[33] Ibid., 1374; Robert W. Hillman, 'Limited Liability in Historical Perspective' (1997) 54 Wash & Lee Law Review 615, 625–626.

2.3 The Legal System of PE Limited Partnerships in the UK

As summarised above, the limited partnership has emerged in the history of commercial law for centuries. In the UK, which is regarded as one of the most influential financial centres in the world, however, the first official legislation of limited partnerships was not enacted until early twentieth century. Currently, with the rise and quick boom of PE and VC investment in the middle of the twentieth century, the limited partnership has been adopted as the primary organizational structure of PE and VC funds in the UK.[34] In the section that follows, both the evolution and legal principles of PELPs under UK laws will be examined and the practical effect of the self-regulation regime of PELPs in the UK will be analysed as well.

2.3.1 The Framework of Limited Partnerships in the United Kingdom

The first official statute on partnership in the UK was the Partnership Act 1890 (PA1890), which has remained unchanged through the century and remains valid. However, this Act only laid down a legal framework for general partnerships rather than limited partnerships.[35] In the early twentieth century, the Limited Partnerships Act 1907, which is the only separate statute creating limited partnerships was enacted in the UK. For the first time, this statute permitted individuals to organize a limited partnership enterprise by distinguishing the 'limited partners' who are afforded limited liability protection and 'general partner(s)' who are required to be liable for all the debts or obligations of the firm.[36]

According to s 4 of the Partnership Act 1890, it provides that, unlike in English partnerships, a firm registered in Scotland is a legal person which is distinct from its partner, at the same time, s 7 of the Limited Partnerships Act 1907 provides that the provisions of the Partnership Act 1890 are also applicable to limited partnerships, unless otherwise provided by the law. Therefore, the limited partnership in Scotland has its own independent personality. Today, the legal personality of Scottish limited partnerships has been a special advantage of Scottish partnership enterprises in cross-jurisdictional financial investment, which enable the Scottish limited partnership fund to invest in the enterprises directly and to hold equities, avoiding the

[34] Iain G. MacNeil, *An Introduction to the Law of Financial Investment* (2nd edn, Hart Publishing 2012) 184.
[35] In pursuance of s 9 of the Partnership Act 1890, any partner of a partnership should be liable for the debt of the firm jointly with other partners.
[36] Limited Partnerships Act 1907, s 4.

risk of more complex organizational structure. The converse is not true, because both the Limited Partnerships Act 1907 and Partnership Act 1890 require that all the partners in any English partnership enterprise should be a person (natural or legal person).[37] In contrast, if a general or limited partnership registered in any other jurisdictions where a partnership is not recognised as a separate legal entity, the opportunities for investment will be restricted.

In comparison with general partnerships, the fundamental characteristic of a limited partnership is the separation of the control and ownership between the general partner (GP) and limited partner (LP), in which the pool of the capital is managed by the GPs on behalf of all partners. In pursuance of the definition of *collective investment schemes* (CISs) under the Financial Services and Markets Act 2000,[38] limited partnerships may be regulated as CISs by the Financial Conduct Authority.[39] Moreover, in terms of PELPs, because the regulation only allows those sophisticated investors who are regarded as being capable of understanding and tolerating the huge risk inherent in investing in PE, in most cases, PELPs are exempted from FCA regulation.[40]

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[37] Ibid., s 4(2) and (4); s 1 of the Partnership Act 1890.

[38] Hereinafter referred to as the 'FSMA2000'. Section 235 of the FSMA2000 defines CISs as having the following characteristics:

> (1) In this Part 'collective investment scheme' means any investment arrangements with respect to property of any description, including schemes. money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income. (2) The arrangements must be such that the persons who are to participate ('participants') do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions. (3) The arrangements must also have either or both of the following characteristics—(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; (b) the property is managed as a whole by or on behalf of the operator of the scheme. (4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another. (5) The Treasury may by order provide that arrangements do not amount to a collective investment scheme—(a) in specified circumstances; or (b) if the arrangements fall within a specified category of arrangement.

[39] Hereinafter referred to as the 'FCA'.

[40]According to Part III of the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, which is the legal basis of unregulated PELPs in the UK, any unregulated CIS is only permitted to be invested by the 'qualified investors' mainly including investment professionals, existing participants in an unregulated scheme, group companies, certified high net worth individuals, high net worth companies, unincorporated associations sophisticated investors and associations of high net worth or sophisticated investors and so forth. The basic standards of testing qualified investors are the ability to identify and tolerate high risk in unregulated investment activities.

2.3.2 The Protective Mechanisms of Limited Partners in the UK Partnership Laws

2.3.2.1 Directors' Personal Liability of Corporate GPs in PE Limited Partnerships

As a basic and statutory rule of limited partnership law, the general partner is liable severally and unlimitedly for all the debts of the limited partnership in the circumstance where the limited partnership goes bankrupt. To some extent, the unlimited liability may restrict the general partner from engaging in overly risky or wrongful activities. However, since the limited partnership is mainly used in high-risk financial activities, such as PE and hedge funds, in most cases only those corporate bodies with enough capital and entity shielding are willing to act as a general partner of PELPs. Practically, a PELP is universally managed by the individuals who are the directors[41] of the fund management corporation (the corporate general partner).

Generally speaking, a director owes a duty of care to the company and may assume personal liabilities for the loss that is caused by his or her wrongdoing. Specifically, the case law has established that a director must exercise his or her managerial power with 'reasonable care', which means that an ordinary person will also be expected to exercise managerial power with such a level of care and skills in the same circumstances.[42] At the same time, the corporate general partner also assumes the duty of care to other partners. Thus, if the director(s) wrongfully or negligently make a business decision for the PELP and eventually cause losses to the limited partnership, the limited partners of the PELP are entitled to be repaid by the general partner and then the PE management corporation or corporate general partner has the right to claim against the responsible director(s) to assume personal liabilities for the corporate general partner.

As discussed in Chapter 1 of this thesis, the economic function of fiduciary duty rules in commercial law is a kind of default rules that can save on the contracting costs and the court should be involved routinely in determining the boundary of the personal liability of the fiduciary, agent or director. However, from an economic perspective, the court should also consider whether the costs of making a decision that may cause losses is less than the

[41] Vicki Dallas, 'Pointers for the Private Equity Firm Director' (Buchalter Nemer Publications). <http://www.buchalter.com/publication/pointers-for-the-private-equity-firm-director/> accessed 24 May 2015.
[42] *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425.

potential profit it may gain.[43] In terms of PE and VC firms, because the risks in start-ups are higher than ordinary mergers and acquisitions, accurate judgement of the prospect of a portfolio company or certain industries is sometimes unrealistic.

In practical terms, the three basic principles for judging a director's personal liability were established by common law before the 'objective reasonable standard' was adopted in the Companies Act 2006[44]: first, a director should not be expected to act as an expert, but only needs to display the skills and knowledge he or she actually possesses; second, a director is not bound to continuously devote attention to the affairs of the company, because commonly his duty is to attend periodical board meetings by which he is not expected to continually gain all the information of the company[45]; third, in the absence of suspicious circumstances, a director is entitled to determine the exigencies of the business by resorting to the expertise and experience of his or her colleagues or co-directors. However, the director's fiduciary duties as a kind of default rule should be as certain and express as it can, otherwise its gap-filling function in business organizations would not be properly fulfilled.[46] Therefore, for the sake of clarifying the duties of the directors of companies, the Companies Act 2006 of the UK[47] adopts the 'objective reasonable standard' to judge the duties and personal liabilities of a director of a company. According to the CA2006, the director of a company is required to exercise his or her managerial power with reasonable care, skill and diligence, which 'would be exercised by a reasonably diligent person'[48] and, at the same, the specific knowledge and skills that the director has should be considered in judging the director's performance.[49]

From the above brief analysis of the personal liability of directors under the company law in the UK, in the circumstances where a director of a PE and VC firm wrongfully makes decisions in a portfolio company and causes the bankruptcy of the PELP, it is clear that the PE firm may claim against the responsible director. In this way, the deterrence of personal liability may drive the director who is a representative of the PE firm in the board of the

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[43] Easterbrook and Fischel (n 22) 93.
[44] *Re City Equitable Fire Insurance Co., Ltd* [1925] Ch 407, CA.
[45] This dictum should be more appropriate to the circumstances of a non-executive director. By contrast, an executive director is usually required to pay full attention to the affairs of the company. Martha Bruce FCIS, *Rights and Duties of Directors* (5th edn, Reed Elsevier (UK) Ltd, 2002) 48.
[46] Iain G. MacNeil, 'Uncertainty in Commercial Law' (2009) 13 Edinburgh Law Review 68, 75.
[47] Hereinafter referred to as the 'CA2006'.
[48] CA2006, section 174(a).
[49] Ibid., section 174(b).

portfolio company to work diligently and carefully. At the same time, both the common law and official legislation leave leeway to limit the extent of the director's personal liability.

2.3.2.2 The Incentive Mechanism of PE Limited Partnerships in the UK

As discussed above, the profit of the partners in general partnerships is distributed in proportion to the capital subscribed by each partner, unless they agree otherwise. The foundation of this principle is that because all the partners are entitled to take part in the management of partnership, the residual control aligns with the residual claim of the firm asset which can, to some extent, mitigate the agency problem. By contrast, the managerial power over the limited partnership is exclusively controlled by the general partner. However, the profit will be distributed between the limited partner(s) and general partner(s), which means that the agency problem here is more distinct than in general partnerships. The extra incentive mechanism for managing partners is necessary. In general, the income of general partners from managing PELPs in the UK is composed of three parts: (i) the management fee, (ii) capital gains and (iii) carried interest, the contractual arrangements of which play a significant role in motivating the general partner to work on behalf of the firm.

Firstly, the management fee is usually charged annually at a rate of 1–2.5% on investors' commitments,[50] which will mainly be used to cover the expenses of the fund operation. In order to enhance the incentive mechanism of PELPs, the total amount of the management fee will be paid separately in several investment periods, rather than being paid in a lump sum.[51] Furthermore, the management fee can also be counted based on the amount of the invested commitments rather than the total commitments.[52] In this way, there will be an effective incentive effect motivating the GP to actively and efficiently select projects for investment, rather than expanding the scale of the fund or raising new funds. Secondly, the GP also contributes around 1% of all the commitments, which can bring a deal of capital gains for the GP, if the PELP generates profit.

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[50] The concept 'commitment' refers to the total amount of capital that each limited partner undertakes to contribute. Gus Black and Chris Gardner, 'Private Equity Funds' in Dick Frase (eds), *Law and Regulation of Investment Management*, (2nd edn, Sweet & Maxwell 2011) 531.

[51] Ibid., 532.

[52] Ibid.

The main body of the GP's return made by the fund is the carried interest. In the UK there are commonly two models for calculating the carried interest, the one is the 'deal-by-deal' model where the carried interest will be separately calculated on the basis of every individual investment project and the other is the 'whole-of-fund' model where all the profit and loss of the PE fund will be assessed together by the end of the fund lifecycle.[53] It is obvious that the incentive mechanisms in each model is different, in the 'deal-to-deal' model, the fund manager can be continually motivated to manage each project diligently, because it is expectable of the GP to make profit from each project immediately. By contrast, the 'whole-of-fund' approach will incentivise the GP to pay more attention to the projects that may bring higher profit, because there is no short-term incentive for the GP to maximize the potential return of each investment.

Although the 'deal-to-deal' model is advantageous for continually incentivizing the general partner through the whole process of fund management, the problem is that if the return of some projects is negative, a part of the profit that should be distributed to the limited partner(s) is actually allocated to the general partner in advance. From a limited partner(s)' perspective, it is necessary to set out some legal arrangements taking back the profit to which the limited partners are entitle that has been paid as a proportion of the GP's carried interest by the end of each project. In practice the so-called claw-back provision can effectively solve the problem. Firstly, this provision entitles the limited partner (s) to claw back the return paid by means of carried interest from the general partner, when a loss occurs in some projects invested by the fund. Practically, the limited partnership agreement commonly requires the GP to deposit a proportion of carried interest of each project into an escrow account, which can be distributed only if limited partners have received a certain level of profit.[54]

2.3.2.3 The Proposed 'Safe Harbour' Provisions: LPs' Power in Decision-making

The Limited Partnership Act 1907 provides that in a situation where the limited partner intervenes in the firm's management, he or she is required to assume unlimited liability.[55] From the perspective of enterprise governance, this rule operates as deterrent precluding

[53] Ibid.
[54] Ibid., 533.
[55] Section 6 (1) of the Limited Partnerships Act 1907.

unsophisticated investors from firm management which can promote efficiency of management. In recent decades, however, owing to the development of collective investment in financial markets, this rule has been adjusted. For example, according to section16(4) of The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 in the situation where a collective investment scheme is formed as limited partnership, the exercise of rights conferred on limited partners does not constitute taking part in the management of the partnership business.

Similarly, given the high-risk activities of PE and hedge fund limited partnerships, the agency problem between limited partners and general partners has become increasingly noteworthy. Influenced by the lobbying efforts from those qualified investors of PE and VC and real estate funds, it was proposed that 'safe harbour' provisions be introduced, which may make it permissible for limited partners to take part in the decision-making process of the partnership without incurring liability.[56] In fact, the existing partnership law system in the UK has actually left a space for limited partners' participation that does not cause any loss of limited liability protection.[57] Against this background, the Law Commission and the Scottish Law Commission recommended a series of provisions, the so-called 'safe harbour rules' that allowed limited partners' limited participation in partnership management without causing unlimited liability.[58]

To recap, the scope of recommended 'safe harbour' provisions can be classified into two categories: (i) direct participation and (ii) indirect participation in firm management. According to the suggestions of the Law Commission and Scottish Law Commission, firstly, it was recommended that the following direct decision-making activities in which limited

[56] Joseph A. MaCahery and Erik P.M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A competitive, VC oriented business form' (2004) 5 European Business Organization Law Review 61, 79; Timothy Spangler, *The Law of Private Investment Funds* (2nd edn OUP 2012) 137–138.

[57] Section 6 (5) of the LPA 1907 provides that 'any difference arising as to the ordinary matters connected with the partnership business may be decided by a majority of the general partners'; additionally, according to s24(8) of the Partnership Act 1890, 'any difference arising as to ordinary matters connected with the partnership may be decided by a majority of the partners, no change may be made in the nature of the business without the consent of all existing partners', which means that the limited partner can play a role in deciding the change of the nature of the business of the partnership.

[58] The Law Commission and the Scottish Law Commission, *Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965* (Law Com No. 283, 2003). This report was proposed and drafted by the Law Commission and Scottish Law Commission which tends to general reform of the partnership laws in the UK. A proposal for amending the LPA 1907 was also proposed in this document. However, the recommendations were not adopted by lawmakers; in other words, at present the LPA 1907 strictly prohibits limited partners from participating in the management of the limited partnership.

partners participated should not be regarded as taking part in management: (i) a change in the partnership agreement; (ii) approval or rejection of a class of investment by the limited partnership; (iii) the change of the general nature of the business, such as the altering of duration or capital of the firm; (iv) the winding up of the limited partnership; (v) the disposal of the assets of the limited partnership; (vi) engagement in contracts for the limited partnership; (vii) enforcing the limited partner's right under the partnership agreement; (viii) investigating, reviewing and approving the accounts of the limited partnership; (ix) any actual or potential conflicts of interest between a limited partner(s) or general partner(s); (x) acting as a director, employee or shareholder in a corporate general partnership.[59] Secondly, in respect of indirect participation in decision-making processes, limited partner(s) are also allowed to provide consultation and advice regarding the activities or account of the limited partnership for a general partner (or general partners).[60] In sum, the recommended 'safe harbour' provisions generally permit limited partner(s) to participate in the decision-making of non-day-to-day managerial affairs.

The noteworthy issue about the 'safe harbour' provisions is whether entitling limited partners to approve or disapprove a class of investment or permitting limited partner(s) to be directors, employees or shareholders in a corporate general partner, may decrease efficiency of firm management? In fact, some professionals in PE and VC industry or lawyers have expressed concern that the proposed safe harbour provisions may increase the decision-making costs.[61] Correspondingly, the Law Commission's opinion is that, firstly, deciding a class of investment is actually a 'high-level' decision, which is mainly about the strategic direction of the activities of the partnership.[62] Thus the specific day-to-day managerial affairs are still in the control of a general partner. Secondly, in the situation that the limited partner acts as an employee, director or shareholder of a corporate general partner, the limited partner must demonstrate the limited partnership itself is acting in a capacity rather than the limited partner, otherwise the unlimited liability may be triggered.[63] Although the dual role of limited partners may make it possible for limited partners to control the management of the firm,[64]

[59] Ibid., para 2.111–2.112.
[60] Ibid.
[61] Ibid., para 17.10.
[62] Ibid., 283.
[63] Ibid., 284.
[64] R.C.I'Anson Banks (n 4)1021.

however, the requirement of demonstration at least can restrict the abuse of limited partners' managerial power.

2.3.3 The Self-regulation of PE Limited Partnerships in the UK

Private equity funds in the UK are commonly unregulated by the FCA. This raises the risk that the authority may not detect the financial activities of PELPs that may impact on the interests of the public, market stability and PE investors in time. To recap, the following risks in PE funds have been identified by the regulators: first of all, the excessive leverage used by PELPs may be a severe burden to PE-owned companies, which may give rise to a series of public problems, including corporate distress and massive layoff.[65] Second, owing to the long-term lockup period of PELPs, the lenders will be motivated to transfer their exposure to other market participants by, for example, credit derivatives, which means that the unregulated financing activities of PELPs may also significantly spread the risk to the public. In this regard, the lesson from the global financial crisis in 2008 has shown that the over-use of credit derivatives can make it hard to identify and judge the ownership of the risk of underlying assets.[66] As a consequence, default events of some individual transactions may result in the fall of the market. Third, the exemption of the disclosure requirement of PELPs may also harm PE investors. Because of the exclusion of limited partners' participation in fund management, the asymmetry of information between the limited partners and general partner will be serious, even though the limited partners are qualified sophisticated investors, it is also difficult to effectively monitor the general partner's investment decisions.[67]

The British Private Equity and Venture Capital Association (BVCA), which has been the leading self-regulatory body of PE and VC funds in the UK, was established in 1983. The membership comprises over 500 influential firms, including VC firms, professional consultancies and international associations.[68] The major mission of the BVCA is to promote integrity and transparency in the UK's PE and VC market, and enhancing communication between the members internationally. In response to the above public concern about the PE industry, the BVCA has been playing an increasingly important role in mitigating the risks in

[65] Financial Services Authority, 'Private Equity: A Discussion of Risk and Regulatory Engagement' (Discussion Paper 06/6, 2006)89–90.
[66] Ibid., 90.
[67] Iain G. MacNeil, 'Private Equity: The UK Regulatory Response' (2008) 3 Capital Market Law Journal 18, 22.
[68] See the official website of the BVCA: http://www.bvca.co.uk/AboutUs.aspx.

PE transactions. In terms of the regulatory functions of the BVCA, the Regulatory Committee of the BVCA plays an important role in the self-regulation of PE and VC firms in the UK, whose main mission is to ensure that all members can keep abreast of any changes of the regulatory and policy environment in a timely manner.[69] In order to guarantee the consistency between the practices of the PE and VC practitioners and authorities, providing regular consulting research with regulators or policymakers is another key function of the Regulatory Committee of the BVCA.[70]

In November 2007, under the leadership of Sir George Walker, the Guidelines for Disclosure and Transparency in Private Equity[71] were published which outlined the self-regulatory approach of PELPs in the UK. They are the leading self-regulatory rules of the BVCA. In the first place, PE and VC firms should timeously publish the details of their (i) investment strategies; and (ii) background of professional staff; and (iii) a description of UK portfolio companies in the portfolio of PE firms on their website, which should be accessible to the public and investors.[72] PE firms are also obliged to report on the record of the investment of their portfolios to the association, by which the BVCA can assess the performance of each PE firm both on an annual and industry-wide basis.[73] In the second place, the portfolio companies are required to disclose the composition of their board, including the representatives of the PE firms on the board,[74] which is in support of mitigating the information asymmetry between general partners and limited partners. In order to keep the flexibility and adaptability of the soft law regulatory system, the BVCA tends to regulate the PE funds on a 'comply or explain' basis, which means that the firms who do not comply with the above rules must provide an acceptable and reasonable statement to the BVCA.[75]

After the publication of the Walker Guidelines 2007 an independent monitoring committee, which plays a role in implementing the rules, namely the *Guidelines Monitoring Group*

[69] See the official website of the BVCA:
http://www.bvca.co.uk/AboutUs/CouncilCommitteesAdvisoryGroups/RegulatoryCommittee.aspx.
[70] Ibid.
[71] Hereinafter referred to as the 'Walker Guidelines 2007'. BVCA, *Guidelines for Disclosure and Transparency in Private Equity* (November 2007) <http://walker-gmg.co.uk/sites/10051/files/wwg_report_final.pdf> accessed 21 May 2015.
[72] Ibid., 26.
[73] Ibid., 27.
[74] Ibid., 24.
[75] Joseph A. McCahery and Erik P. M. Vermeulen, 'Private Equity Regulation: A Comparative Analysis' (2012) 16 Journal of Management & Governance 197, 222.

(GMG)[76] was established. In a practical term, the effectiveness of the self-regulation by the BVCA mainly works on the basis of a market reputation mechanism. For instance, the GMG will publish a Review of Conformity with the guidelines annually which will name the non-compliers for the public. In this scenario, both the limited partners and any other parties in the PE market can directly judge the reputation of the non-complying firms;[77] in other words, the market reputation deterrence will provide incentives for the PE management corporations who are covered by the Walker Guidelines 2007 to comply with the requirements of disclosure and transparency.

2.4 The Landscape of China's PE Limited Partnerships

2.4.1 Chinese Legislators' Early Attitude towards Limited Partnerships (1990s)

The history of business partnerships in Western countries has been as long as many hundreds of years. Nonetheless, the legislation regarding business partnerships in China did not appear until the mid-1990s. There were two main factors that delayed the introduction of limited partnerships in China. On the one hand, the establishment of VC investment enterprises was officially recognized by Chinese government as early as 1985 as an important policy for pushing scientific and technological reform in China,[78] Nevertheless, owing to the lack of non-legal person organizations in China at that time, VC investment enterprises were only formed as limited liability companies.[79] On the other hand, because VC investment enterprises in China were initiated and led by the government during the 1980s, the governance structure of limited liability companies guaranteed the governmental domination in the management of VC investment enterprises. Firstly, quite a large proportion of the VC investment enterprises were contributed by the Ministry of Finance of the Central

[76] MacNeil (n 67) 30.
[77] According to the Review of Conformity with the Guidelines 2014, two PE firms, namely Camelot (Ontario Teachers' Pension Plan) and Viridian Group (Arcapita) who failed to comply with the requirement of the Walker Guidelines have been disclosed. Guidelines Monitoring Group, *Seventeenth Report*, December 2014, 24 <http://walker-gmg.co.uk/sites/10051/files/141204_gmg_guidelines_final.pdf> accessed 20 May 2015.
[78] In March 1985, the Central Committee of the Communist Party of China issued the Decision on the Reform of Science and Technology Management System [中共中央.《关于科学技术体制改革的决定》], in which the concept of *venture investment* was officially stated for the first time in China.
[79] 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) [中华人民共和国中外合资企业法（1979）], which was the first statute recognizing the legal status of limited liability companies in China.

Government of China or stated-owned commercial banks. Secondly, the reform of Chinese public finance system in the 1980s made it possible to increase the fiscal revenue of local government by running public-owned business. Consequently, it is apparent that during the early stages of the Chinese VC industry, state power kept a firm hand on the management of VC funds by exercising the voting right as shareholder of limited liability companies. [80]

The above situation did not change significantly until the 1990s. With the establishment of the Chinese stock market in 1990,[81] 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 PE and VC fund was set up by IDG Partners, and the Committee of Science and Technology of China in Shanghai.[82] During the following years, other international PE and VC firms such as Walden International and H&Q Asia-Pacific also launched their Chinese VC funds.[83] However, the foreign PE and VC firms were extensively concerned that if PE and VC funds in China were only being organized in the form of limited liability company, the economic interests of foreign investors would be seriously threatened by political power of Chinese authorities.

In consideration of continually attracting international VC to support the development of China's scientific and technological industries, since mid-1990s more and more Chinese government 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 practical demand. The first partnership law in China was not enacted until early 1997. Unfortunately, this statute excluded limited partnerships and corporate partners. [84] The

[80] Ruimin Zhong, 'Research on China's Venture Capital: From the Perspective of Contracting Theory' (Doctoral thesis in Economics, Fudan University 2011) 48 [仲锐敏. *中国风险投资研究：基于合约理论的分析*. 复旦大学 2011 年经济学博士学位论文，第 44–47 页].

[81] 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.

[82] The first cross-border PE and 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 March 2013) [连希蕊. '外资 PE/VC 的中国之路'. 财经界，2013/03/07] <http://pe.hexun.com/2013-03-07/151816907.html> accessed 22 May 2015; Biwen Lee, 'Why IDG Is Going Down: The Difficult Transition in China' (Money Weekly, 31 March 2014) [李碧雯. 'IDG 资本为什么暗淡了：转型之痛'.理财周报，2014/03/31] <http://www.licai.com/pe/201403/56807.html> accessed 22 May 2015.

[83] Beijing Docvit Law Firm, *Foreign PE in China* (CITIC Press 2011) 34 [北京道可特律师事务所. *外资 PE 在中国的运作与发展*. 中信出版社，2011，第 34 页].

[84] According to the Law of Partnership Enterprises of the PRC (1997), *all* the partners shall bear unlimited joint and several liabilities for the debts of the limited liability partnership enterprise (Article 8) and all the partners must have complete civil capacity (Article 9), in other words, only natural persons can be the partners of a

question here is that although the basic reason and motivation for legislating partnership law in the mid-1990s was to encourage international PE and VC investment in China, ironically, the final version of the law excluded limited partnership which is the most favourable organizational structure for PE and VC investment.

In fact, in several versions of legislative drafts of the Law of Partnership Enterprises (1997), the provisions regarding limited partnerships have been included. In consideration of the lack of a partnership enterprise registration system in China, however, the legislators had eventually deleted the provisions of limited partnerships in 1997.[85] Besides the exclusion of limited partnerships, most legislators also strongly feared that the limited liability of corporate partners might threaten domestic creditors, therefore, in the final version of the law only natural persons were permitted to invest in general partnerships in China.[86] Finally, in political terms, at such very early stage of the market economy reform in China, the Chinese government was greatly reluctant to waive powerful control of enterprises. That is to say, the ideology of the authority was ‘state entrepreneurism’ but not really in the spirit of the free market, thus the rapidly developing PE and VC funds were regarded as a threat to state-owned enterprises.[87] As a result, the proposed limited partnership law eventually died on the vine: most Chinese PE and VC funds in the 1990s (including domestic and international funds) were organized as corporations but not limited partnerships.[88]

2.4.2 Early Practices of Limited Partnerships in China’s PE Market (2001–2005)

Although in China’s legal system there was no general law[89] recognizing limited partnerships as a kind of business organizations in China before 2006, some local governments

partnership. Finally, the statute clearly prohibits any use of terms such as ‘limited’ or ‘limited liability’ (Article 5), which means that at that time there was no possibility of legally establishing limited partnerships in China. The full text of the Partnership Law (1997) is available at http://www.gov.cn/banshi/2005-08/31/content_68746.htm.

[85] Xiaotao Zhang, ‘The Significant Necessity of Introducing Limited Partnerships in China’ (People’s Daily, 21 November 2005) [张晓涛. ‘在我国建立有限合伙制度大有必要’. 人民网，2005 年 11 月 21 日] <http://theory.people.com.cn/GB/49154/49155/3873914.html> accessed 23 May 2015.

[86] Ibid.

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

[88] Zhang (n 85).

[89] According to the Law on Legislation of the People’s Republic of China (2015 Revision) [中华人民共和国立法法（2015 年修订）], in the legal system of the PRC, 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

innovatively broke the prohibition in the Partnership Law (2007) and promulgated a series of administrative regulations that permit the use of limited partnerships in the PE industry. For instance, as early as January 2001 the Rules of Beijing Zhongguancun Science and Technology Park (2000),[90] the first legislation that clearly permitted both PELPs, came into force and shortly afterwards, another similar regulation legislated by the local government of Zhuhai Special Economic Zone[91] also recognized the basic principle of limited partnerships. In addition, both of the above two regulations permitted the corporation to be a partner in a partnership enterprise. Sky-Green Investment L.P., the first practice of PELPs in China was established in July 2001. However, owing to the conflict between the local regulation and the Partnership Law (1997), this PELP was banned by the China Securities Regulatory Commission[92] in 2002.[93]

These legislative activities have shown that the limited partnership as a kind of efficient financing instrument has been highly in demand in China. However, any disregard for 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 PELPs in China, namely the Provisions on Administration of Foreign-invested Venture Capital Investment Enterprises (2003) [94] and Interim Provisions for the Administration of Start-up Investment Enterprises (2005).[95] 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, the FIVCIE is allowed to be formed as an unincorporated organization, 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

should not conflict with the Constitution, and the regulations should not conflict with any general laws (ss 78 and 79).

90 [中关村科技园区条例, 2000]. The full text of this regulation is available at http://baike.baidu.com/view/4077953.htm.

91 The Interim Provisions on Science and Technology Venture Capital of the City of Zhuhai (2001) [珠海市科技创业投资暂行规定 (2001)]. Available at http://china.findlaw.cn/fagui/p_1/90932.html.

92 Hereinafter referred to as the 'CSRC'.

93 Jun Zhang & Fengqiao Wei, *The Governance of PE Limited Partnerships: The Game Between General Partners and LPs* (Wuhan University Press 2012) 28–29 [张钧、韦凤巧，*有限合伙制 PE 治理：LP 与 general partner 的博弈焦点*，武汉大学出版社，2012，第 28–29 页].

94 Hereinafter referred to as the 'FIVCIE Provisions 2003'. The full English version is available at: http://wenku.baidu.com/view/3f08912358fb770bf78a5548.html.

95 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.

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'.[96] Similarly, the Interim Provision 2005 also clearly permits start-up investment in the form of non-legal person enterprises and encourages the start-up investment enterprises to establish suitable incentive systems for the management of the enterprises.[97] In fact, the two experimental regulations were the preparation for the official recognition of limited partnerships in the later legal reform.

2.4.3 The Limited Partnerships under the New Partnership Law (2006–2010s)

2.4.3.1 Basic Principles of Limited Partnerships in China

The most significant legal reform of China's PE and VC industry is the new Partnership Law (2006 Revision) which officially recognised the legal status of limited partnerships and provided detailed guideline of the governance of limited partnerships. According to Chapter 3 of the Partnership Law (2006 Revision), firstly, to prevent illegal fund-raisings, s 61 provides that the number of partners of any limited partnership shall be between 2 and 50 persons. Secondly, pursuant to s 67 of the law, the business of limited partnerships should be managed and operated by general partners only[98] and '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'.[99] Thirdly, the law also clarifies that the partners who do not participate in the execution of partnership affairs have the right to supervise the managing partner's implementation of these duties. The stipulations above have outlined the fundamental governance structure of China's

[96] Sections 4 and 7(6) of the Interim Provision 2003.
[97] Sections 6 and 18 of the Interim Provisions 2005.
[98] It should also be noted that the Partnership Law (2006 Revision) also illustrates that the following conduct of limited partners will not be 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' (s68).

[99] Section 76.

PELPs which mainly aims to enhance the professional management of the enterprise and prevent limited partners' unprofessional intervention.

Moreover, this revised partnership law is also encouraging PELPs 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.[100] This means that ever since the Partnership Law (2006 Revision) came into force in June 2007, much more capital controlled by institutional investors can be contributed to the PE and VC funds. In the second place, this revised statute clarifies that the taxation of PELPs is only imposed on partners and the partnership enterprises are exempted from corporate income tax,[101] which also makes the limited partnership more attractive than the corporation. Finally, some of the special rules for limited partnerships also break some of the general prohibitions: (i) in any general partnership agreement, the stipulation that all the profit will be distributed to some of the partners is not permitted.[102] By contrast, because practically most partners of PELPs are likely to agree on a 'hurdle rate'[103] which serves as a part of the incentive mechanism for general partners, the law particularly permits partners of limited partnerships to autonomously determine the specific rules regarding profit distribution;[104] (ii) because in most circumstances limited partners do not manage the partnership affairs, the law therefore particularly permits limited partners to deal with the limited partnership[105] or run their own business which may compete with the limited partnership enterprise.[106]

2.4.3.2 An Overview of the PE Limited Partnership in Contemporary China

Since 2006, with the continual improvement in the legal and policy environment of the PE and VC industry, especially due to the obvious advantages in respect of an efficient

[100] Section 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 (s 3).
[101] Section 6.
[102] Section 33.
[103] The so-called hurdle rate is the minimum rate of return on a project that the manager or investment company is willing to accept before starting a project. In PE and VC practices it is quite common that if the actual return rate is below the hurdle rate, then the general partner has no right to gain any profit from the investment.
[104] Section 69.
[105] Section 70.
[106] Section 76.

governance structure, taxation and relatively loose regulatory environment,[107] PELPs have gradually replaced limited liability companies as the primary organizational structure of PE funds. The charts in Figures 2.1 and 2.2, which are based on the National Development and Reform Commission's[108] official statistics,[109] show the dramatic change in the practices of PE and VC funds in China during the recent decade.

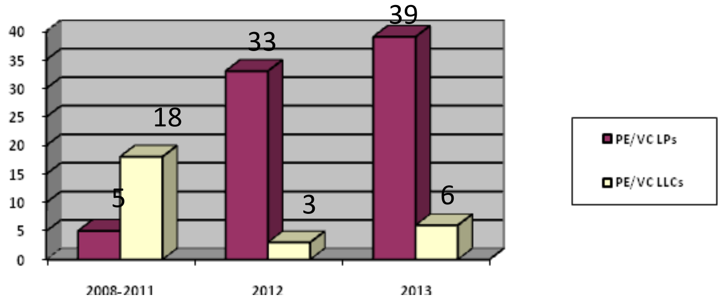

Figure 2.1: The number of private equity and venture capital limited partnerships and private equity and venture capital limited liability companies filed with the National Development and Reform Commission (2008–2013)

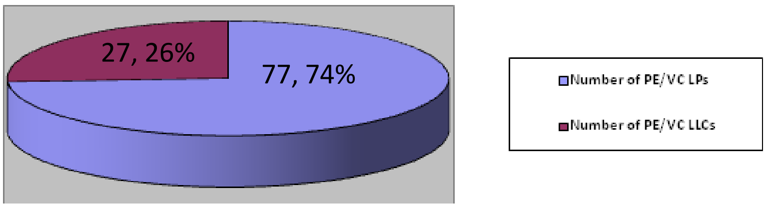

Figure 2.2: The proportion of private equity and venture capital limited partnerships and private equity and venture capital limited liability companies filed with the National Development and Reform Commission (2008–2013)

107 Although since 2012 the regulatory system of PELPs has been stricter than before, compared with other types of collective investment vehicles such as investment trusts, the statutory requirement of the governance structure and information disclosure of PELPs is still quite loose. This point can be better illustrated by comparing the analysis in Chapters 2 and 3 of this thesis.
108 Hereinafter referred to as the 'NDRC'.
109 The original statistics of Figures 2.1 and 2.2 are available at:
http://cjs.ndrc.gov.cn/qytzycyjj/gqtzbanew/2011batzgs/201203/P020120319323138833521.pdf and
http://cjs.ndrc.gov.cn/qytzycyjj/gqtzbanew/2012batzgs/ and
http://cjs.ndrc.gov.cn/qytzycyjj/gqtzbanew/2013batzgs/ accessed at 12 December 2014.

In general, the governance structure of PELPs consists of three sections, namely (i) partners' general meeting,[110] (ii) limited partners meeting[111] and (iii) investment decision-making committee,[112] each of which has different functions through the entire process of fund management.[113] Firstly, the PGM is composed of all the limited partners and general partners, in the circumstance where any partner is an incorporated body, its representative should be a member of the PGM. According to s 31 of the Partnership Law (2006 Revision), the matters regarding altering the name, business scope of the PELP or assigning or disposing of the real estate and intellectual property of the PELP should be subject to the unanimous consent of all 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) the mutual conversion of general partners and limited partners are also commonly determined by all the partners of the PELP.[114] Generally speaking, the decision-making power of the PGM does not involve the specific investment or professional management affairs of PELPs.

Secondly, in principle, for the purpose of the professional management of PE funds, the investment decision-making of PELPs should be exclusively decided by general partners. However, practically some PELPs also allow a limited number of limited partnerships' representatives to be the members of the IDMC. For example, in the IDMC of the Oriental Fortune Capital Private Equity Fund (2007), which was the largest Chinese PELP in 2007, any investment decision must be voted by three representatives from the general partner and one representative of the ranks of the limited partners, any of whom has a one-vote veto in any decision-making.[115] Although the above practice may, to some degree, reduce the efficiency of fund management, this alternative decision-making model, which can partly enhance the trust relationship between general partners and limited partners, has been widely adopted in present-day China.[116]

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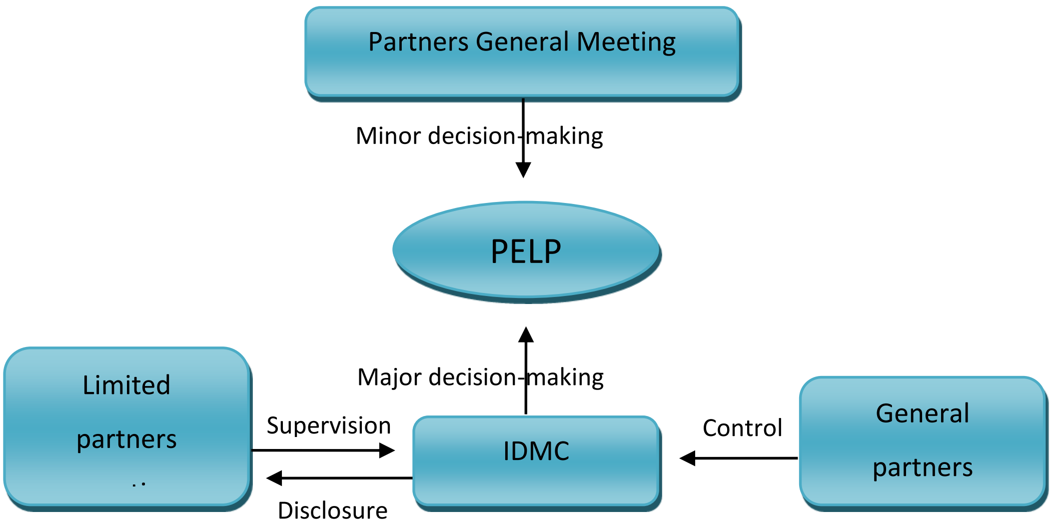
110 Hereinafter referred to as the 'PGM'.
111 Hereinafter referred to as the 'LPM'.
112 Hereinafter referred to as the 'IDMC'.
113 A typical governance structure of PELPs in China can be illustrated as in Figure 2.3.
114 Zhang and Wei (n 93) 111.
115 Ibid., 114; 'Oriental Fortune Capital: Establish Trust with Limited Partners in Special Ways' (Southern Metropolis Daily, 26 March 2012) ['东方富海：破解本土 PE 困局两招让 LP 放心'， 南方都市报, 2012 年 03 月 26 日] <http://finance.sina.com.cn/chuangye/investors/20120326/102511677667.shtml> accessed 17 December 2014.
116 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 (ed), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014) 73–77 [张伟. '律师如何为 PE 提供法律服务——私募

Finally, if the representatives of certain limited partnerships consider that there may be potential conflicts of interest, affiliated transactions or competitive businesses between general partners and limited partners, then the limited partner representatives are entitled to convene the LPM to determine the related issues, and 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 PELPs is only a protective mechanism for limited partnerships, but not a major decision-making body in fund management.



[117]

Figure 2.3: Private equity limited partnership governance structure

2.5 The Main Drawbacks in the Governance of PE Limited Partnerships in China

Although the basic legal system and governance structure of PELPs have been established in China, and an increasing number of investors tend to prefer PELPs to other organizational structures to organize PE and VC investment, there are still, however, some noteworthy drawbacks regarding the regulation of the general partners in Chinese PELPs. These

股权实务操作中的法律问题' 载 人民大学律师学院组（编），*风险投资与私募股权律师实务*，法律出版社，2014，第 73 至 77 页].

[117] This model is summarised from a series of materials, including Xin Liu, 'The Investment Banking and Legal Services of Private Equity' Renmin University of China School of Law (ed), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014) 197–198 [刘新. '投行视角的 PE 及其法律服务' 载 人民大学律师学院组（编），*风险投资与私募股权律师实务*，法律出版社，2014，第 197 至 198 页] and Jiyong Feng, 'The Legal Issues in the Practices of Private Equity' in Renmin University of China School of Law (ed), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014) 69 [冯继勇. '私募股权基金实操中的法律问题' 载 人民大学律师学院组（编），*风险投资与私募股权律师实务*，法律出版社，2014，第 69 页].

drawbacks can be summarised as legal issues in three respects: (i) the liability mechanism, (ii) incentives and the (iii) efficiency of governance. Finally, all the problems mentioned above have seriously weakened the economic advantages of limited partnerships.

2.5.1 The Ineffective Unlimited Liability Deterrence of the Practitioners of GPs

As mentioned above, the deterrence of unlimited liability of general partners is widely regarded as one of the important advantages of limited partnerships that could effectively prompt the fund manager to perform diligently and prudently for the sake of the fund. In terms of PELPs, theoretically, in the circumstance where a PELP goes bankrupt, limited partners only assume liability to the extent of their respective contribution in the fund. In the meantime, the general partner should assume unlimited liability to creditors which may cause losses to the general partners' private fortune. In this way, the extreme pressure can, to some extent, mitigate the opportunism in investment activities and enhance the safety of transactions.

In practice, however, the vast majority of general partners of PE funds are corporations rather than natural persons, which means that in reality the general partner practitioners can always be protected by limited liability in an incorporated body.[118] In this situation, the deterrence of unlimited liability of individual managers of PE firms must be weakened. Moreover, at present some PE firms even establish wholly-owned subsidiaries which usually play a role as general partner of certain PE funds, and the director (s) of the board of the subsidiary firm will be nominated as the representative (s) of the managing partner who are actually in charge of managing the PE fund.[119] The problem here is that if the representative of the subsidiary is not a shareholder of the general partner, the unlimited liability mechanism may not impose effective restrictions on the managing partner's overly risky investment activities.

[118] In fact, since the company law was revised in 2005, the one-member company has been recognized legally (Section 59 of the Company Law (2005 Revision) provides that 'The minimum amount of registered capital of a one-person limited liability company shall be RMB 100, 000. The shareholder shall, in a lump sum, pay the capital contributions as specified in the bylaw.'). In practice, more and more general partners who are actually natural persons try to register a one-man company as the general partner for avoiding the risk of unlimited liability under the partnership law system. Wei Zhang (n 116) 76.

[119] Zhang and Wei (n 93) 188.

2.5.2 Inefficiency of the Incentive Mechanism of PE Limited Partnerships

As mentioned above, the alignment of residual control and residual ownership is an effective approach to mitigate the agency problem. Accordingly, the Partnership Law (2006 Revision) makes it possible to freely entitle general partners to performance awards or carried interest, which can play a crucial role in motivating general partners to perform well for the purpose of maximizing the interest of the PELP. This is also one of the reasons why after the promulgation of the new partnership law, the number of PELPs in China dramatically increased by nearly seven times within only one decade.[120]

Generally speaking, the profit for general partners of PELPs in China is composed of a management fee, capital gain and carried interest, each of which plays a different role in motivating general partners to fulfil the duties and diligently manage the fund. Firstly, in most cases, PE and VC firms will contribute around 1% of total capital in a PELP.[121] If the PELP is successful in future, the general partner can make profit from the proportionate capital gains. Secondly, PE firms also unconditionally earn a management fee in the amount of 1.5 to 2.5% of the fund[122] as their fixed income. Finally, the major profit of PELPs for general partners is the carried interest priced in the rate of around 20% of the whole earnings of the fund, which can be gained only when the profit of the PELP is higher than a hurdle rate. From an economic point of view, the above profit model can effectively motivate general partners to perform well and bind the interests of general and limited partners together. Practically, however, owing to the lack of specific legal arrangements and restrictions, the incentive of general partners is still inadequate.

[120] For accurate statistics, refer to Figure 2.1.
[121] In practice, however, some of China's domestic PE and VC firms tend to contribute much more than this basic rate, for example, Fortune Venture Capital Management Company Limited, which is one of the most successful in China's VC industry, usually contributes 5% of the fund and Stone Venture Capital Management Company Limited, a Shenzhen-based PE and VC firm even contributes 10% of each fund. This kind of approach is mainly attributed to the immature market environment in which PE and VC firms have to contribute more into the PELPs to win the limited partners' trust and then raise enough capital within a certain period. Zhang & Wei (n 93) 160; 'The Wise Strategies of Stone Venture Capital' (Private Equity Daily, 9 July 2014) ["基石资本的'PE 生意经'"，投资界，2014 年 7 月 9 日] <http://pe.pedaily.cn/201406/20140606366773.shtml> accessed 22 December 2014.
[122] According to the latest survey of China's PE and VC market, the statistics show that 77% of limited partners who were interviewed will pay the management fee to general partners at the rate of 1.5 to 2.5%. See details in China Venture. *The Annual Prospect of Limited Partners in China's Private Equity and Venture Capital Market* (2014), 14/03/2014 [投资中国. *2014 年中国 LP 调查研究报告*，2014 年 3 月 14 日] <http://research.chinaventure.com.cn/report_840.html> accessed 21 December 2014.

As for the management fee, because the level of the fee is not dependent on the general partners' performance but determined by the scale of the capital, once the full amount of contribution is raised from limited partners, the fixed management fee will be unconditionally earned by the general partners. Therefore, the management fee can hardly motivate the general partner to perform optimally. Moreover, as one of the results of the negotiation between general partners and limited partners, in some PELPs the actual amount of the management fee is charged by the fund that has been invested. Although, to some extent, this approach can mitigate limited partners' short-term financial burden, this sort of pricing approach may motivate the general partner to urgently and carelessly select new projects in which to invest the remaining capital as soon as possible, which will obviously increase the risk of the upcoming investment.[123]

As for the carries for general partners, the common practice is that all the expected carried interest will be paid to the general partner when all the investments of the fund are ended. In this way, investors can get all the expected income all at once. However, owing to the long-term duration of the fund, it may hardly motivate the general partner to concentrate on the management of each individual project continually. To solve this problem, some limited partnership agreements (LPA) stipulate that the carries for the general partner should be paid respectively when each project ends.[124] It is obvious that this kind of distribution approach can continually motivate the general partner to diligently and carefully manage each transaction. However, in the circumstances where the gross return of the PE fund is negative, the general partner in fact has gained the income to which the limited partners are entitled before the fund is cleared. The above analysis indicates that the current approaches to income distribution of Chinese PELPs are imperfect so that the incentive mechanism of PELPs does not work well by constantly motivating fund managers or properly maximizing investors' benefit.

[123] Wei Zhang (n 116) 82.
[124] Zhiwei Zhang, 'An Analysis of the Profit Distribution Provisions in Private Equity Fund Limited Partnership Agreements' (8 April 2013) [张志伟. '私募股权基金有限合伙协议之投资收益分配条款分析'，2013 年 4 月 8 日] <http://www.360doc.com/content/13/0408/23/10557422_277029349.shtml> accessed 26 December 2014.

2.5.3 LPs as Replacement for GPs: A Governance Model with High Transaction Cost

2.5.3.1 Limited Partners' Intervention and General Partners' Response

As mentioned above, owing to the lack of trust between limited partners and general partners, to enhance the protection of limited partners' interests, a large number of PE investors participate in the managerial affairs of PELPs. However, in practice this sort of alternative approach can hardly play a positive role in protecting investors' interest. In most cases, the general partner is able to weaken limited partners' active intervention by making a series of arrangements in the decision-making procedure of the IDMC. Firstly, the general partner may employ several external experts as members of the IDMC in the name of professionalizing fund management, most of whom are, for example, partners of law firms and accounting firms or scholars from academic institutions. Nonetheless, because most external experts are selected by the general partner and do not represent the majority in the IDMC,[125] 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 general partner.

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

2.5.3.2 The Governance Collapse of PE Limited Partnerships: A Case Study

Although sometimes general partners can actually control the decision-making process by adjusting specific voting rules of the IDMC, for the purpose of raising enough capital, those PE and VC firms who have not established a good professional reputation have no other

[125] Zhang & Wei (n 93) 125.

choice but to allow limited partners to substantially manage and 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).[126]

As one of the earliest practices of PELPs in China,[127] OVC was established in July 2007, nine limited partners and one general partner, the James & Hina Capital Management Corporation jointly contributed.[128] It was difficult for such an inexperienced fund manager to raise as much as RMB 1 billion in such a short period, as J&H was a very young player in China's PE market,[129] and the Partnership Law (2006 Revision) was only effective on 1 June 2007. As a compromise with limited partners, the general partner agreed to set a so-called 'joint meeting of partners' (JMP) as the supreme decision-making body of the fund,[130] whereby any investment decision would be subject to the capital majority rule.[131] In such a situation, since the general partner only contributed around 1% of the total amount of funds, the OVC fund was directly controlled by the limited partners. As a consequence, owing to the stalemate among all the partners in decision-making process, the OVC was dissolved by all the partners in October 2007 after only three months since its establishment.[132]

From this typical failed case, one can see that the lack of effective remedial and protective approaches under the current Chinese partnership law system have not only increased

[126] Hereinafter referred to as the 'OVC'.
[127] The first domestic PELP in China was the Shenzhen South Sea VC Fund which was established in June 2007. Zhang & Wei (n 93) 129.
[128] Hereinafter referred to as 'J&H'.
[129] J&M was established in March 2007, for a brief period of four months before it became the general partner of the OVC. See the official website of J&M: http://www.jhcapital.cn/.
[130] Yu Zhao, 'Private Equity Funds in China's Legal System' (Doctor of Law thesis, Jilin University 2010) 38 [赵玉. 我国私募股权投资基金法律制度研究, 吉林大学, 2010, 年法学博士学位论文，第 38 页].
[131] 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 RMB 5 million's contribution. 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 limited partner should not participate in the governance of the partnership. In the circumstances where there are two or more general partners in a limited partnership, the decision-making rule between the general partners depends on the related clauses in the limited partnership agreement, 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' (s 30). Fengling Hao. 'The Blurry Boundary between general partners and LPs in China's PELPs: A Case Study Of Oriental Venture Capital' 21st Century Business Herald (Beijing, 1 September 2009) [郝凤苓. '从东海创投封盘事件看中国 LP 与 GP 角色模糊问题'，21 世纪经济报道，2009 年 9 月 1 日] <http://www.investide.cn/news/6282.html> accessed 28 December 2014; Zhang & Wei (n 93) 129.
[132] Zhang & Wei (n 93)129–130.

supervisory and negotiation costs, but have also led to the failure of fund operation. In addition, it has been more serious that such an abnormal governance model in the aforementioned case has been adopted by many other PE funds in China. For example, in some cases, the entrepreneurs will incorporate a 'private equity asset management firm' as the general partner in which he/she is the sole shareholder, and then his/her industrial company invests in the PE fund as the sole limited partner[133]. In such an extreme case, actually there has been no any separation of ownership and control, however, most of such entrepreneurs are unprofessional in financial investment, only reason for doing so is the very low level of trust between GPs and LPs in Chinese PE market.

Although some lawyers from a pragmatic point of view suggested that the 'LP activism' in the governance of Chinese PELPs is a more realistic and practical response to the imperfect institutional environment in contemporary China[134], the above analysis potently proves that the LP activism will give rise to huge risk of inefficient governance or even the failure of investment. Even though to some extent, the activism seemingly is a pragmatic way to solve the agency problem in PE limited partnerships, however, the economic functions and the inherent advantages of the limited partnership have been unduly disregarded. Again, it has been emphasized at the outset of this research that the emergence and development of a given form of business organization has its corresponding social demands. If the unique governance structure of an organizational form is unduly distorted in doing the same business, the transaction cost inside such business organization will be increased. Therefore, the legal reform of the partnership law and its associated regulatory regime should be an unshakable direction of the reform for Chinese PE industry.

2.6 A Proposal for the Legal Reform of China's PE Limited Partnerships

According to the analysis above, it can be seen that the inherent legal features of the limited partnership, namely the unlimited liability deterrence and super-profit incentive for general partners, limited liability protection and specified 'safe harbour' rules for limited partners, can construct an effective risk control regime for not only protecting limited partners'

[133] Ibid., 133.
[134] Zhang & Wei (n 93)128; Also see Yubin Shi, *An Interest Protection Guide to China Private Equity Investors (LP) in China* (Law Press China 2012) Ch 3 [石育斌，*中国私募股权投资人权益保护指南*，法律出版社，2012，第三章].

interests, but also guarantee the efficient management of limited partnerships. Particularly, owing to the unregulated and private legal status of PELPs, the problem of information asymmetry between general partners and limited partners will be serious. Correspondingly, the self-regulatory system that fills the gap between hard law and the market by establishing a professional reputation in the PE market is also necessary. In terms of the legal system of PELPs in China, further reform should also be proposed based on the above key features of limited partnerships and the self-regulatory system.

2.6.1 Improve the Effectiveness of Corporate General Partners' Unlimited Liability

As discussed above, the potential high return of PE and VC investment may motivate the general partner to exhibit opportunistic behaviours. Furthermore, the limited partners' lack of power to control will incentivise the limited partners to interfere in the decision-making of the limited partnership. As a result, it is significant to make sure that the general partner's unlimited liability can be effectively enforced. To this end, the following two points are recommended for establishing the unlimited liability of general partners in Chinese PELPs.

First, some general partners in PELPs are the subsidiaries of PE management corporations. In this circumstance, the unlimited liability will only be imposed on the affiliated entities of the PE firm, whereas the actual management team of the PELP is delegated by the parent PE firm. It is obvious that the liability of the PE firm will be reduced. However, the fund management is actually in the hands of the parent PE firm. To enhance the protection function of general partners' unlimited liability regime, it is recommended that if the PE firm insists on authorising its associated entity to be the general partner of a PELP, the LPA should require the PE firm and its associated entity to assume joint and several liability. In this way, if the fund eventually goes bankrupt, both the PE firm and its associated entities (GP) will be obliged to repay the debt of the limited partnership fund. More importantly, as the buyout fund in China has emerged in latest years, such contractual arrangement can effectively press the management team of the GP to decrease leverage ratio of the buyout fund, by which the unreasonable or overly risky investment will be discouraged. Otherwise, the unlimited liability will be imposed on the parent PE firm and in such scenario, the shareholders of the PE firm will have strong motivation to avoid such high risk investment.

Second, as mentioned previously, in most cases the general partners of PE funds are corporate bodies, at the same time the decision on fund management is made by the individual representatives who are delegated by the PE firm. Therefore, in fact, in the circumstance where the PELP becomes insolvent, the unlimited liability can hardly be enforced on the responsible individuals.[135] With reference to the experience of the UK, introducing a series of clearer and more practical judging rules of directors into Chinese company law practices may be a cost-efficient way to impose individual liability on individuals which can play a role in restricting opportunism.

According to the Company Law of the PRC (2013 Revision), '[d]irectors, supervisors and senior officers shall abide by laws, administrative regulations and the articles of association of the company, and have a fiduciary obligation and obligation of diligence to the company'[136] and '[i]f a director, supervisor or senior officer violates the provisions of laws, administrative regulations or the articles of association of the company in the execution of company duties, thereby causing losses to the company, he shall be liable for compensation,'[137] the shareholders of the company are entitled to request the board of supervisors in writing or, in the case of a limited liability company without a board to institute proceedings, to a people's court.[138] In other words, if the director makes a decision that violates the duty of care and thus causes loss to the company, the company law makes it possible to order the director to make good the losses.

The problem here is that although above stipulations provide a framework to implement the director's individual liability, in practice, however, it is still quite difficult to judge and measure a director's personal liability for the losses incurred by a company in China. Pursuant to the above provisions, the determination of a director's personal liability in

[135] At present, there is still no specific statute stipulating a personal bankruptcy system in China. In consideration of the social cost, the proposed reform mainly focuses on amending existing laws and optimizing internal governance of limited partnerships in China, rather than enacting new legislation.
[136] s 147 of the Company Law (2013 Revision).
[137] Ibid., s 149.
[138] s 151 of the Company Law (2013 Revision) provides that

> Where a director or senior manager is under the circumstance as stated in Article 150 of this Law, the shareholder(s) of the limited liability company or joint stock limited company separately or aggregately holding 1% or more of the total shares of the company may require the board of supervisors or the supervisor of the limited liability company with no board of supervisors in writing to file a lawsuit in the people's court. If the supervisor is under the circumstance as stated in Article 150 of this Law, the aforesaid shareholder(s) may require the board of directors or the executive director of the limited liability company with no board of directors to in writing to file a lawsuit in the people's court.

decision-making is based on (i) the violation of law, administrative regulation or the articles of association of the company and (ii) the incurrence of losses to the company. However, such a rule of liability omits the specified subjective judgement benchmark of director's behaviours in decision-making; in other words, if a decision made by certain director(s) causes losses to the company, how can the court judge whether or not the responsible director has violated the duty of care? The current company law of China provides no direction for this.

In this regard, the Companies Act 2006 in the UK provides some useful inspiration for China to establish a practical standard for judging directors' behaviour and liability. In the first place, it is recommended that the standard of duty of care in decision-making should be classified in accordance with different positions of the respective directors.[139] For example, some directors are executive directors who are in charge of corporate management, therefore the duty of care on them should be higher than non-executives. Similarly, if a director who has specific professional skills such as a solicitor or certified accountant, such a director may be expected to perform as competently as a person who has the same professional qualification, skills and experience.

Furthermore, in order to vest discretionary judgment on the court, the company law in China should also add the provision clarifying the power of the court to grant relief to directors in certain circumstances. With reference to s 1157 of the Companies Act 2006, in some specific circumstances the court can relieve the director who has been found to be in breach of a duty of care.[140] In practice, the liability relief for a director who breaches the duty of care should be given by the court considering the following requirements: (i) the director must act

[139] According to s 174 of the CA 2006,

> (1) A director of a company must exercise reasonable care, skill and diligence. (2) This means the care, skill and diligence that would be exercised by a
> reasonably diligent person with—(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has,

which means that the judgment of a director's fulfilment of his or her duties is based on his or her particular position on the board of directors. It is obvious that the standard of 'reasonable care, skill and diligence' will differ from person to person.

[140] Section 174 (1) of the CA 2006 provides that '[i]f in proceedings for negligence, default, breach of duty or breach of trust against—(a) an officer of a company, or (b) a person employed by a company as auditor (whether he is or is not an officer of the company), it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit.'

honestly; (ii) his or her decision should be reasonable and (iii) in respect of all the circumstances in a certain case, the director ought to be excused. Moreover, the court will presume that the director has acted faithfully and reasonably, unless evidence to the contrary is provided by the claimant (the company or shareholders).[141] By adding similar rules to Chinese company law, in the circumstance where a corporate general partner causes losses to the PELP in China, the responsible individuals who were delegated by the PE firm can be enforced to assume personal liability.

In sum, it is argued that in the situation where a PELP goes bankrupt, the corporate general partner should repay the debt to the creditors, and only then is the PE management corporation, namely the PE firm, entitled to assess whether the losses to the PE firm were caused by the responsible individuals who are in charge of or substantively participated in the related decision-makings. By means of introducing a clearer and more practical judging rule into the company law of China, the responsible individuals delegated by the corporate general partner can be restricted by deterrence of personal liability. In the meantime the specified benchmark of personal skills, experience, qualifications or the positions in the decision-making process can also guarantee the responsible individuals' flexibility in fund management.

2.6.2 Rearrange the Fee Flows and Profit Distribution System for GPs

In terms of the profit distribution system of PELPs in China, the main problem is the lack of continuity in motivating the general partner to perform well on behalf of the LPs. Inspired by the structured profit distribution system in the PE funds in the UK, the following improvements are recommended for the general and limited partners in China's PELPs, which can be achieved by contractual autonomy in certain limited partnership agreements.[142] Specifically, the improvements can be carried out by structuring the payment systems of both management fees and carried interest.

[141] Kershaw (n 17) 453.

[142] The contractual autonomy of general and limited partners is recognised by the Partnership Law (2006 Revision), s 67 of the law stipulates that '[t]he partnership affairs of a limited partnership enterprise shall be executed by the general partners. The partners to execute the partnership affairs may request for determining their remunerations and the way of obtaining the remunerations in the partnership agreement.'

2.6.2.1 Structured Payment System of Management Fees

First of all, if the management fees are calculated on a pre-fixed percentage of invested commitment, the general partner would be incentivised to efficiently search target projects and carry out investment. However, the pursuance of short-term interest may give rise to insufficient due diligence before the decision-making. Therefore, the restructuring of the fee flows of PELPs is necessary. In order to guarantee the quality of investment decision-making, the management fee in the early period of the fund can be calculated on the committed capital, instead of invested capital. In this way, the general partner will have sufficient funds to support the operation of the PELP, and does not tend to select and invest the funds hastily into projects that may be risky. At the second stage when the portfolio companies have been targeted, the management fees can be calculated on the basis of invested commitment, by which the general partner will be motivated to invest the capital of the PELP in the projects efficiently.

2.6.2.2 Structured Distribution System of Profit between GPs and LPs

In motivating the general partner to perform well, the carried interest plays a more important role that constitutes the main body of the general partner's return. At present in China, the most common contractual restriction on profit distribution between general partners and limited partners is that the general partner will be granted carried interest only when limited partners have gained a given rate of return (namely the 'hurdle rate'), otherwise all the profit will be distributed to the limited partners.[143] As a measure for optimizing the protection of limited partners, by reference to the Explanatory Note of Limited Partnership Agreement issued by the BVCA,[144] a structured allocation system of profit may guarantee the priority of limited partners in profit distribution. Firstly, it is advised that before the general partner gains the carried interest, the limited partners should be repaid with the capital that they have contributed to the PE fund and then receive the hurdle rate of return. In the second stage, the remaining profit (if available) will be distributed between the general partner and limited

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[143] Dongsheng Zhao, *The Legal Practice of Private Equity Funds: Fund-Raising, Financing, Corporate Governance and Listing* (Shanghai Academy of Social Sciences Press 2011) 99 [赵东升, *私募股权基金法律实务大全: 募集・融资・企业改造・上市*，上海社会科学出版社，2011，第 99 页].

[144] BVCA. *The Explanatory Note of Limited Partnership Agreement*, 2002. <http://www.bvca.co.uk/Portals/0/library/Files/StandardIndustryDocuments/LPAgreement.pdf > accessed 30 May 2015.

partners on a set ratio.[145] Moreover, for encouraging the general partner's on-going good performance, it is also advised that a floating rate of carried interest would be useful in this regard, which means that the rate of carried interest will depend on the actual return rate of the PELP by the end of the fund or each individual investment. For instance, if the internal rate of return[146] is lower than the hurdle rate (e.g., 8%), all the profit will belong to the limited partners; if the IRR of the fund or project is between the hurdle rate and another pre-agreed rate (e.g., 8% to 10%), limited partners get the hurdle rate of profit. The rest will be distributed to the general partner. In the circumstances where the IRR is above a certain interval, all the profit will be distributed between the general partner and limited partners on a set ratio, mostly around 80% and 20%. In this way, the interest of the general and limited partners will be better aligned.

Secondly, as discussed above, the 'deal-to-deal' model may more effectively encourage the general partner to diligently manage the investment in each individual portfolio. This notwithstanding, the claw-back provision is necessary for PELPs in China, which ensures that the limited partners can be prioritised to get the hurdle rate of return to which they are entitled. In practice, it is advisable that a proportion of profit generated from each individual deal be deposited into an escrow account. In the circumstances where any loss occurs by the end of the PELP, the monies in the escrow account should be returned to the limited partners, until the limited partners' contribution is paid back.

2.6.3 Specify the Liabilities of Active Limited Partners

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 PELPs, which may cut down the costs of negotiation in decision-making processes. To this end, when limited partners intervene in the management of the limited partnership, their unlimited liability will be triggered. In addition, it can be seen from the experience of limited partnership law in the UK that the proposed 'safe harbour' provisions intended to permit limited partners to participate in the management of limited partnerships without losing limited liability protection, are mostly in consideration of the increasingly stronger lobbying

[145] Ibid.; Black and Gardner (n 50) 533–534.
[146] Hereinafter referred to as the 'IRR'.

effort among investors in the PE and VC industry.[147] Therefore, the basic function of the safe harbour provisions of PELPs is mitigating the tension between the general partner and limited partners in fund management, whereas the substantive power of fund management is still controlled by the general partner.

In terms of the relationship between general partners and limited partners, the immature market environment and imperfect liability and incentive mechanisms of the limited partnership law of China jointly causes the lack of trust between the general partner and limited partners. As a consequence, the managerial intervention by limited partners is quite common in Chinese PE funds. Problematically, assuming that the proposed reform of the incentive and liability mechanism of Chinese limited partnership law is achieved, whether the limited partners' intervention in fund management can be prevented or reduced effectively? The answer here is probably in the negative.

In fact, as an exception to the exclusion of limited partners' participation in limited partnership management, similar 'safe harbour' provisions exist in the partnership law of China.[148] However, the statute does not clarify in the circumstance where a limited partner takes part in limited partnership management that is not within the scope of above 'safe harbour' clauses what the legal consequence of the active limited partner is; in other words, if no adverse legal consequence will be triggered when a limited partner participates in the management of a limited partnership, how can the law effectively restrict limited partners' intervention in executing partnership affairs? Based on the current Chinese partnership law, the only provision that associates the unlimited liabilities and acts of limited partners is s 67 of the Partnership Law (2006 Revision) which stipulates that '[w]here it is reasonable for a

[147] MaCahery and Vermeulen (n 56) 79.
[148] Section 68 (2) of the Partnership Law (2006 Revision) provides that the following acts of limited partners in a limited partnership should not be deemed as execution of partnership affairs: 'A limited partner may not execute the partnership affairs, nor may he represent the limited partnership enterprise before outsiders.'
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.

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 accepted in China that in the situation where the limited partner participates in executing the business of limited partnership with a third party who believes that the executive partner is the general partner of limited partnerships, such an active partner should assume the same liability as the general partner.[149] The outstanding issue here is that if a limited partner 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 uncertain.

By contrast, the Limited Partnerships Act 1907, the loss of limited liability protection for limited partners is not contingent upon a third party's knowledge of who enters into deals with the limited partnership.[150] Although in some other jurisdictions such as Delaware in the US,[151] the trigger of an increased liability burden of limited partners depends on the position of third parties. However, in the UK both the Limited Partnership Act 1907 and the Law Commission and Scottish Law Commission's report[152] do not regard the knowledge of third parties who enter into transactions with the limited partnership is a prerequisite for increasing the liability of a limited partner, because the 'management' is 'primarily internal issues that do not undermine the positions of third parties'.[153]

Similarly, the intervention by limited partners in Chinese PELPs is one of the most serious problems in relation to PE funds in China. As a proposal for reform in future, the legal

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[149] Hui Zhang, 'The Liability Shielding for Limited Partners: The Experience of the US and Practice in China' (2010) 25 (6) The Rule of Law Forum 122, 127 [张辉. '有限合伙人的责任庇护: 美国经验与中国实践'，法制论丛，2010（6），第 127 页]; Wei Zhang (n 116) 85.

[150] Section 6(1) of the PLA 1907 provides that '[i]f 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', which means that the trigger of unlimited liability of the limited partner only depends on the participation in management regardless of any third parties.

[151] Sections 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. However, if the limited partner does participate in the control of the business, he or she is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.'

[152] The Law Commission and the Scottish Law Commission (n 58) 282.

[153] Timothy Spangler (n 56) 138.

consequence of a limited partner who executes the partnership affairs beyond the scope of the 'safe harbour' provisions it should be clarified that such a limited partner shall bear the same liability as the general partner. In this way, the deterrence of unlimited liability may particularly make limited partners reluctant to intervene in the decision-making of PELPs, by which the cost of fund governance can be decreased.

2.6.4 Enhance the Self-regulation of PE Limited Partnerships: Reform in Progress

It is widely recognized that due to the inadequate disclosure of PE, the external protection for investors in PE and VC funds is necessary. In China, currently the regulatory system of PELPs can be discussed in two domains: (i) official regulation and (ii) self-regulation. On the one hand, at present the functional regulatory system in China is not established and official regulation over private investment funds is controlled by different regulatory bodies,[154] thus the compliance cost in the Chinese financial sector is relatively high. On the other hand, although the self-regulatory system of PELPs has been established, however, owing to the inadequate reputational mechanism in the market, the further reform of the self-regulation of PELPs is also needed. In this section, the inherent conflict between different financial regulators of Chinese PE and VC will be discussed in comparison with the experience of the BVCA. This chapter argues that the establishment of a unified self-regulatory body is a feasible way to enhance the protection of investors in Chinese PELPs.

2.6.4.1 The Competition between Official Regulators: High Regulatory Costs

Basically, the official regulatory system of PELPs in China is structured on two levels: the regulation of VC funds led by the NDRC, the general regulatory system of private investment funds controlled by CSRC. Nonetheless, owing to the political conflict between the NDRC and CSRC in financial regulation, actually the current Chinese regulatory regime of PELPs to a great extent fails to satisfactorily normalize the PE and VC market or effectively protect limited partners' interests. Fortunately, the reform of the regulation over PELPs has been launched since 2012 and further reform is expected.

[154] Owing to the separated financial regulatory system in China, PE and VC funds are not regulated by a single regulator. Specifically, the regulation of private equity investment trusts (PEITs) is separately regulated by the China Banking Regulatory Commission (CBRC), which will be discussed in the Chapter 3 of this thesis.

Prior to discussing the implementation of the regulatory power, one should roughly consider the legal status of the NDRC within China's economic and political regimes. In fact, the predecessor of the NDRC was the National Planning Commission,[155] which was established in 1952. The main function of NPC was (i) to create macro-economic policy for different industries and (ii) to supervise the implementation of national economic plans of Chinese government at all the levels. From a legal perspective, before the institutional reform of the Chinese economy was launched in the late 1970s, the legal status of the NPC was that it was actually the most powerful department of the State Council of China; almost any proposed economic or industrial activities (e.g., industrial planning, foreign investment, price control, financial activities and infrastructure) had to be approved by the NPC; in other words, historically, the nature of the NPC was as a very general social administrative body but not a special or professional regulator of specific economic activities. With the liberalization of the economy, however, the over-broad administrative power of the NDRC has been a barrier to Chinese economic reform. To reduce the administrative intervention in the market economy, two waves of reform of the NPC led by the State Council were launched in 1998 and 2003 respectively.[156] At present a series of the most substantive approval powers associated with financial regulation are still in the hands of the NDRC. Accordingly, the NDRC's regulation over the PE and VC industry is also not specialised, and the protection of investors is insufficient as well.

Since the promulgation of the Interim Provisions for the Administration of Start-up Investment Enterprises (2005),[157] the domestic PELPs in China are regulated by the NDRC[158] who has the power to examine and supervise the operation of PELPs at any time. In the situation that a PE and VC firm does not comply with the law, the NDRC has the power to revoke its licence (s 27). However, the Interim Provision (2005) does not clarify any legal liability or substantive punishment imposed on fund managers who carry out inappropriate

[155] Hereinafter referred to as the 'NPC'.
[156] During the 2000s, the State Council of China cancelled or simplified 2614 administrative approvals and the further simplification of the administrative approval power of the NDRC was proposed. For more detail, see Youliang Yan, 'A Leviathan? The NDRC is Being Powerful Again' Sina Finance News (Beijing, 30 May 2013) [严友良, '发改委被指越改革权力越大:副省长不敢反驳处长'. 新浪财经， 2013 年 5 月 30 日]. <http://finance.sina.com.cn/china/20130530/082015636012.shtml> accessed 22 April 2015.
[157] Hereinafter referred to as 'the Interim Provisions 2005'.
[158] According to the Interim Provisions (2005), all PE and VC funds shall be filed with the NDRC or other related administrative departments of the provinces (s 4) and registered with the State Administration for Industry and Commerce (SAIC) or local departments of the SAIC (s 8).

behaviours. In such a loose policy circumstance, many unqualified fund management firms were motivated to raise funds from unqualified investors and invest in risky projects.[159]

Since 2012, however, the CSRC has been actively competing with the NDRC in regulating PELPs. The revision of the Securities Investment Fund Law of China (2003) was completed by the end of December 2012. One of the key debates in the process of amending this law was whether PELPs should be officially regulated by the Securities Investment Fund Law.[160] According to the first version of the Consultation Draft issued by the Standing Committee of the National People's Congress,[161] the new law tries to regulate PE and VC funds formed as limited liability companies or limited partnerships.[162] It is evident that if this Consultation Draft can be successfully enacted into a statute, the regulator of PELPs will be changed, which means that the CSRC and courts will be able to substantially share the power of regulation over PELPs. More importantly, because the legal status of statutes issued by the National People's Congress is in the top position in the Chinese legislative system, both the legal force of the Provisions (2005) and the NDRC's regulatory authority of PE and VC may be ended in the short term.[163] Therefore, the NDRC was dissatisfied with this Consultation Draft. In the process of the second and final rounds of discussion on revising the SIFL, as a consequence, the NDRC and the 25 professional associations in the PE and VC industry

[159] For instance, the so-called *First Judicial Case of China's PE Funds* was adjudicated by the First Intermediate People's Court of Shanghai in 2010, in which a 28-year-old fund manager, Hao Huang, was accused of fraud in financing and finally sentenced to 15 years in prison. In this case, Hao Huang the general partner of the PE funds, raised around RMB 0.178 billion from as many as 720 natural persons in China. This kind of unregulated PE scandal has been more common since China's Alternative Investment Market was launched in October of 2010. Yonggang Liu, 'The First Private Equity Case in China: A Chinese Ponzi Scheme?' *China Economy Weekly* (Beijing, 29 June 2010) [刘永刚, '中国 PE 第一案开审:揭密中国的"庞氏骗局"'. 中国经济周刊，2010 年 6 月 29 日] <http://finance.people.com.cn/GB/12001069.html> accessed 23 April 2015.

[160] Hereinafter referred to as 'SIFL'.

[161] Hereinafter referred to as the 'SCNPC'.

[162] In this early version of the Consultation Draft (July 2012), private investment funds (excluding investment trusts which have been regulated by the CBRC since 2007) was proposed to be regulated by the CSRC, according to Article 106 and 107 of the Consultation Draft, the investment funds whose fund managers shall bear unlimited liability will be regulated by the law and the content of the term *securities* includes all the stocks, bonds and any other types of financial derivatives that can legally be exchanged or circulated in China. This means that the equity of private companies that can be transacted privately is also expected to be regulated by the revised SIFL; in other words, not only public investment funds, but also privately raised investment funds, including hedge funds, PE and VC funds, will also be regulated by the new SIFL. [全国人大常委会, 证券投资基金法（修订草案）全文, 2012 年 7 月 6 日]. The official version of this interim legislative document is available at: http://www.npc.gov.cn/npc/xinwen/lfgz/flca/2012-07/06/content_1729072.htm.

[163] Clifford Chance LLP, 'The Amended Securities Investment Funds Law': Significant Changes but More expected' (25 January 2013) <http://www.cliffordchance.com/briefings/2013/01/the_amended_securitiesinvestmentfundslaw.html > accessed 28 April 2015; Dongying Wang, 'The Regulatory Power of PE/VC Funds: NDRC PK CSRC', *South Weekly* (2013) [王冬颖, 'PE 监管权：发改委 PK 证监会'，南都周刊，2013 年第 22 期] <http://www.nbweekly.com/news/business/201306/33414.aspx > accessed 28 April 2015.

across the country jointly signed a statement to the SCNPC arguing that the high-level regulation over PE and VC funds would cripple the development of the Chinese PE and VC industry.[164] As a result of the departmental competition in the jurisdiction, in the final revision of the SIFL (2012 Revision), PELPs were eventually excluded from the regulatory ambit of the SIFL (2012 Revision).[165]

Under the above circumstances, driven by the competition between the NDRC and CSRC, the further regulatory reform of China's PELPs continued. In June 2013, the State Commission Office for the Public Sector Reform of China[166] clarified the division of powers in the PE and VC regulatory affairs between the NDRC and CSRC: (i) the NDRC should be in charge of making macro industrial policies for development of PE and VC funds and coordinating the relationship between the government and PE and VC market; and (ii) the CSRC should be responsible for the regulation of PE and VC firms and the protection of PE and VC investors.[167] Based on this administrative order, the most important regulatory reform of PE and VC funds went further in 2014. On one hand, the NDRC has stated that the annual review of PE and VC funds with the NDRC was no longer required.[168] On the other hand, more importantly, the Interim Measures for the Supervision and Administration of Privately-

[164] Ibid.; Dong Liu, 'The New Law of Securities Investment Funds: Private Equity and Venture Capital Funds Are Still Free from Regulation' *China Business News* (Beijing, 25 December 2012) [刘冬, '新基金法三审：PE/VC 不入法 阳光私募如期纳入'，第一财经日报，2012 年 12 月 25 日] < http://finance.people.com.cn/fund/n/2012/1225/c201329-20003436.html> accessed 17 April 2015; Sha Xiao, 'The Rent-seeking Behind the Legislative Activities Regarding Private Equity Funds: The Intense Competition Between Administrative Departments' *The Rule of Law Weekends* (Beijing, 22 August 2012) [肖莎. 'PE 立法背后的角力：修法背后的部门博弈'，法治周末，2012 年 8 月 22 日] <http://finance.sina.com.cn/money/smjj/20120822/153112922035.shtml> accessed 17 April 2015.

[165] The material compromising the final version of the law is reflected in Article 95 of the SIFL (2012 Revision): the term *securities* therein refers to any *publicly issued* stocks, bonds and any other types of financial derivatives that can legally be exchanged or circulated in China. It is evident that the change in terms of the regulatory scope of private investment funds between the first draft and the final revision of the law, the limited definition of the term 'securities' frees PELPs from the CSRC's high level of regulation <http://www.pkulaw.cn/fulltext_form.aspx?Gid=191978> accessed 10 May 2015.

[166] Hereinafter referred to as the 'SCOPSR'.

[167] The Notice of the Division of Regulatory Functions Regarding Private Equity Funds issued by SCOPSR, June 2013 [中央机构编制委员会办公室. 关于私募股权基金管理职责分工的通知，2013 年 6 月] < http://www.scopsr.gov.cn/bbyw/qwfb/201306/t20130627_227855.html> accessed 10 June 2015.

[168] The Notice of the Issues Regarding Further Development of Venture Capital Investment Enterprises issued by the General Office of NDRC, May 2014 [发改委. 国家发展改革委办公厅关于进一步做好支持创业投资企业发展相关工作的通知，2014 年 5 月]. <http://www.ndrc.gov.cn/zcfb/zcfbtz/201405/t20140514_611509.html> accessed 10 June 2015.

Raised Investment Funds (2014),[169] which is the first detailed administrative regulation of PELPs issued by the CSRC, came into force in August of the same year.

According to the Interim Measures (2014), the CSRC is the general regulator of all kinds of private investment funds in China with the exception of investment trust funds which are regulated by the CBRC.[170] However, because the administrative hierarchy of the NDRC and CSRC is at the same level and the Provisions (2005) are still legally valid, currently any PELPs registered in China have to comply with the requirements issued by the two regulators. Obviously, such a dual-level regulatory system may reduce the efficiency and unnecessarily increase PE and VC practitioners' compliance costs. Further regulatory reform of PELPs is expected to reasonably simplify the compliance requirement of PELPs by enhancing the CSRC's regulatory power in the PE and VC market, and finally remove the unprofessional regulatory power of the NDRC.

2.6.4.2 Rearrange the Functions of the Industrial Associations of PE Funds in China

The above analysis indicates that owing to the lack of coherent and unified regulatory system of PE funds in China, the enforceability of the law and the effectiveness of the protection for investors of PELPs are imperfect. Although further reform of the official regulatory system is expected, in order to fill the gap between the regulation and practice, the self-regulation of the PE industry is especially necessary. Generally speaking, the self-regulatory system of PELPs is organized on both the national and provisional levels.

One the one hand, pursuant to the Interim Measures (2014), the Asset Management Association of China,[171] founded in June 2012, is the unified self-regulatory body of private investment funds in a nationwide scope.[172] As a self-regulatory body in financial market, the

[169] Hereinafter referred to as 'the Interim Measures (2014)'. CSRC, Interim Measures for the Supervision and Administration of Privately Raised Investment Funds (2014) [中国证券监督管理委员会. 私募投资基金监督管理暂行办法，2014 年 8 月] < http://www.amac.org.cn/cms/article/preview?ID=386993> accessed 10 June 2015.
[170] According to s 2 of the Interim Measures (2014), the assets of a 'private investment fund' includes, but is not limited to stocks, equities, bonds, futures, options and fund units, in consideration of the separated financial regulatory system, investment trusts which is exclusively regulated by the CBRC are excluded from the regulatory scope of the Interim Measures (2014).
[171] Hereinafter referred to as 'AMAC'.
[172] It is provided in Chapter 6 of the Interim Measures (2014) that AMAC is obliged to make self-regulatory rules and examine the performance of its member institutions and related practitioners (s 29); in the circumstance where any member institutions or related practitioners violates the laws, administrative regulations

primary function of the AMAC is improving information transparency and normalizing the managerial conducts of the Chinese asset management industry. As a subset of private investment funds, PELPs are also required to register with the AMAC, which means that any violation of laws or regulations by the fund management corporations (mostly general partners) or individual practitioners may be punished by the AMAC. At present, the AMAC developed a system of information sharing on its official website, where the public can directly access all information on violations, punishment and blacklisting of members and related individuals who have failed to comply with the laws, regulations or self-regulatory rules.[173]

On the other hand, the industrial associations of PE and VC led by the NDRC also play a role in the regulation of PELPs. By the end of March 2015, there were two main state-level self-regulators[174]and 23 local-level self-regulators.[175] Most of these associations are expected to perform as a platform for information sharing for the public and authorities. In terms of the self-regulation, however, the effectiveness of the professional associations' regulatory function is unsatisfactory. The substantive reputational mechanism of self-regulation is insufficient. For example, most articles of association only provide that in the circumstances where a member violates the law or the articles of association, the association may permanently revoke the membership of the non-compliant member.[176] In most cases the PE and VC associations are reluctant to expose any illegal, inappropriate or immoral behavior of the members. In other words, the reputational deterrence of the members of PE and VC

or self-regulatory rules, AMAC is entitled to take actions and publish the violations to the public via website (s 29); AMAC shall establish a complaint-handling mechanism to accept investor complaints and mediate disputes (s 30).

[173] Up to March 2015, four fund management firms and five individuals who fail to comply with the laws, regulations and self-regulatory rules have been blacklisted by the AMAC's. <http://www.amac.org.cn/xxgs/hmd/> accessed 15 June 2015.

[174] China Venture Capital and Private Equity Association (CVCA) [中华股权投资协会] and China Association of Private Equity (CAPE) [中国股权投资协会].

[175] The following provinces have established their local self-regulatory associations of the PE and VC industry: Hunan Province, Hubei Province, Henan Province, Guangdong Province, Zhejiang Province, Shanxi Province, Jiangsu Province, Anhui Province, Jilin Province, Sichuan Province, Yunnan Province, Liaoning Province, Inner Mongolia Province and Fujian Province. The following big cities also establish the local associations for PE or VC: Beijing, Shanghai, Shenzhen, Tianjin, Chongqing, Suzhou and Haerbin. Moreover, Beijing established ZhongGuanCun Private Equity and Venture Capital Association (ZPEVCA) in 2013. Shanghai also established a special professional association the Shanghai Private Equity Association (SHPEA) in 2004, which is mainly for PE and VC investors of international PE and VC funds.

[176] For instance, s 13 of the Articles of Association of Suzhou Association of Private Equity [苏州股权投资基金协会章程，第 13 条] <http://www.szape.org/CompanyConstitution.aspx> accessed 17 June 2015; s 12 of the Articles of Association of Beijing Association of Private Equity [北京股权投资基金协会章程，第 12 条] < http://www.bpea.net.cn/article/ljxh/xhzc/> accessed 17 June 2015.

associations is still insufficient. Although the two nationwide self-regulatory bodies of Chinese PE and VC industry were founded in 2001 and 2002, the function of standardization of the industrial self-regulation is also imperfect. For instance, the China Association of Private Equity[177] released the Principle Guidelines for China's PE and VC Industry[178] in November 2011, which is regarded as the official professional standard of the Chinese PE and VC industry. However, this guideline only provides a series of very general principles regarding the self-regulation of PE and VC funds, but no practical rules that can substantively establish a reputational mechanism in the market.

As a response to above shortcomings, the recommendation is that the main direction of reform should focus on the establishment of a nationwide reputation system in the PE and VC market, by which public investors can access information on any violations and immoral behaviors of general partners, as it has been tested and acknowledged that reputational record of PE and VC firms has a remarkable correlation with not only the scale of fundraising[179] but also the bargaining ability of GPs[180].

Specifically, owing to the existence of the dual-level regulatory system, the functions of the industrial associations of PE and VC and the AMAC should be differentiated, by which the self-regulation of PELPs can be more efficient. At the national level, the AMAC should play a leading role in the self-regulation of PELPs in a nationwide scope. According to s 7 and 8 of the Interim Measures (2014), all private investment funds (excluding investment trusts) are required to register with the AMAC and file the main legal documents including the articles of associations of corporate funds or partnership agreements of limited partnership funds, the basic information of senior managers[181] and the main information of the investment targets

[177] Hereinafter referred to as 'CAPE'.
[178] China Association of Private Equity (CAPE), The Principle Guidelines for China's Private Equity and Venture Capital Industry (2011) [中国股权投资基金协会，中国股权投资基金行业指导原则, 2011]. <http://files.cbex.com.cn/bpea/201111/20111111133220846.pdf> accessed 18 June 2015.
[179] Ching-Yi Chang et al, 'Analysis of the Factors that Influence Venture Capital Fundraising: An Empirical Study in China' (June 2011) 5 (12) African Journal of Business Management 4765.
[180] Stephen D. Prowse, 'The Economics of the Private Equity Market' (Third Quarter 1998) Economic Review 21.
[181] Section 7 of the Interim Measures (2014) provides that

> A manager of Privately-raised Funds of any type shall, in accordance with the provisions of the AMAC, apply for registration to the AMAC and submit the following basic materials: (1) Photocopies of the originals and duplicates of its industrial and commercial registration certificate and business license; (2) Its articles of association or partnership agreement; (3) The list of its major shareholders or partners; (4) Profiles of its senior management personnel; and (5) Other materials required by the AMAC.

and prospectus (if applicable).[182] Therefore, the AMAC is expected to collect the substantive information of each PELP, which means that the AMAC will have advantages in judging the violations of laws and regulations, and inappropriate behavior of fund managers of each PE and VC fund.

At the industrial level, the existing professional associations in the PE and VC industry can also play an ongoing role as significant platform for reputational regulation of fund managers within the PE and VC market. Firstly, it is recommended that the industrial associations should establish co-operation with the AMAC, by which all the information regarding the performance of the industrial associations' members should also be accessible on the websites or public information platforms. In this way, the reputational regime in the PE and VC market can be widely enhanced. Secondly, in a technical regard, more detailed and practical guidance such as model rules of profit distribution, the recommended practices of LPAs and the standard of judging the general partner's behaviors in fund management should be advised and developed by industrial associations of PE/VC of China, which may make a contribution to the standardization of the practice of PELPs[183].

[182] Section 8 of the Interim Measures (2014) provides that

> after the fund-raising of a Privately-raised Fund of any type is completed, the manager of the Privately-raised Fund shall, in accordance with the provisions of the AMAC, go through the record-filing procedures for the Privately-raised Fund, and submit the following basic materials: (1) Information on the main investment direction of the Privately-raised Fund and its fund category indicated according to the main investment direction; (2) The fund contract and the articles of association or partnership agreement of the company. The fund prospectus shall also be submitted if it has been provided for investors during fund-raising. Where the Privately-raised Fund is established in the form of an enterprise, such as a company or partnership, the industrial and commercial registration and photocopies of the original and duplicate of the business license shall also be submitted; (3) Where the Privately-raised Fund is placed under entrusted management, the agreement on entrusted management shall be submitted. Where the properties of the Privately-raised Fund are entrusted to a custodian, the agreement on custody shall also be submitted; and (4) Other materials required by the AMAC.

[183] Actually, ever since the establishment of the AMAC in 2012, the professional training programmes have been launched in each local and nationwide PE/VC association, the officers of the AMAC are regularly accredited to the PE/VC associations at provincial level. Attending a given number of hours of training courses is commonly required for each member of those local associations. Moreover, such regular communication may facilitate information sharing of the self-regulators and different practitioners of PE/VC market. Such activities will be beneficial for developing a series of coherent and widely applicable standards for PE/VC investment in China.

Chapter 3: The Protection for Beneficiaries in Private Equity Investment Trusts

3.1 Introduction

Though the limited partnership has been used as the dominant organizational form for conducting PE and VC businesses in China, prior to the promulgation of the new Partnership Law in 2006, there was no formal legal foundation for limited partnerships in China. Against this background, the legal structure of investment trusts has been applied by Chinese trust corporations to organize PE and VC funds which are strictly regulated by both the Law of Trusts of the PRC (2001) and China Banking Regulatory Commission (CBRC)'s regulations. Hence, owing to its relatively sound protective mechanism for beneficiaries, private equity investment trusts[1] have also developed rapidly since around 2006. However, because of a series of inherent economic and political factors, the governance structure of PEITs under the Chinese legal system is still problematic, which seriously impacts the effectiveness of the protective mechanism of business trusts.

In this chapter, the historical origins and economic features of English trust law will be reviewed. It is argued in this section that the nature of the equitable title of trust assets is actually judicial rights providing flexible remedies for beneficiaries. All the advantages of English trusts will not apply unless an independent, strong and professional judicial system exists. In the second section, the key protective mechanisms for beneficiaries in English trusts, namely the duty of care and the duty of loyalty rules, are examined by reviewing and comparing a series of leading cases throughout the development of English trust law. Owing to the conceptual incompatibility of the common law and civil law systems, the institutional functions of English trusts can only be transplanted partially by alternative approaches in the jurisdiction without an equity system. In the third section, the trust-like regimes in mixed and continental jurisdictions are discussed, followed by a comparison of the transaction costs generated from managerial and remedial approaches in the trust-like regimes of all the above-mentioned jurisdictions. In the next sections the basic legal structure and short history of China's PEITs are summarized, and the following problems in practice are discussed in detail: (i) the beneficiaries' power to intervene in general meetings; (ii) the zero-loss promises of trustees and the distorted trust market in China; (iii) the ineffective monitoring of custodian

[1] Hereinafter referred to as 'PEITs'.

banks; and (iv) the barrier to initial public offering[2] of PEIT-involved companies in China's domestic stock markets. Finally, withy reference to the financial regulatory system of collective investment schemes[3] in the UK, this chapter tries to put forward a series of advices for enhancing the protection of beneficiaries of PEITs in China.

3.2 The Institutional Features of Trusts: Origins and Economic Functions

3.2.1 The Origins of Dual Ownership in English Trusts

Trust as the most typical legal regime in common law jurisdiction sprung from a series of fortuitous products in medieval English law, the most important of which was the formation of equity system. During the medieval period in England, judicial or legal issues were regulated and organized by a writ system, which means that anyone who failed to get the proper writ for a specific type of remedy, any compensation was unable to be granted by common law.[4] As early as the fourteenth century, more and more individuals could not be fairly remedied by the courts. When such unfair circumstances became intolerable, the Chancellor was required by the King's decrees to grant remedies *in personam* to the parties in disputes,[5] which were gradually developed as today's so-called equity in England and Wales. The dual system of common law and equity was not born until the Court of Chancery was established by the fifteenth century.[6]

Most legal historians believed that English trust law originated from *Uses* in medieval ages, which was initially applied by Englishmen for some specific speculative purposes. The most important reason for the emergence of *Uses* is that in the middle ages lords had the right to sub-feu the lands to tenants. In turn, the latter were bound to render a variety of services and 'incidents' to the lords. One of these incidents was a duty to make payment to the superior on succession to the land after the death of a former tenant. To avoid this expense, tenants invented the so-called *Use* by which they alienated the land to a third person who promised to

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[2] Hereinafter referred to as 'IPO'.
[3] Hereinafter referred to as the 'CISs'.
[4] Jill E Martin, *Modern Equity* (18th edn, Thomason Reuter (Legal) Limited 2008) 6.
[5] Konrad Zweigert and Hein Kotz, *An Introduction to Comparative Law, Vol. Framework* (Tony Weir tr, 2nd edn, OUP 1992) 194.
[6] Frederic W Maitland, 'Trust and Corporation' in David Runciman and Magnus Ryan (eds), *State, Trust and Corporation* (Cambridge University Press 2003) 84.

manage the land and pass the benefit of the land on to the heir. As a consequence, the payment of feudal incidents could be prevented.[7] Secondly, as a great number of English knights went off to the Crusades in the thirteenth century, the *Uses* were also applied to maintain the life of the family members of the knights: for instance, the knight vested his estate in land to a trustworthy friend who had to possess the estate in the interests of the knight's family.[8] In addition, in English feudal law only the eldest son was entitled to be the heir; the Englishman could not leave the lands to other offspring by will, therefore, the application of *Uses* made it possible to leave the land to daughters and younger sons of the Englishman.[9] The typical English trust was not developed from medieval *Uses* until 1535 when the Statute of Uses was promulgated.[10]

The trouble with *Uses* or the trust-like relationship is that, under common law, the ownership of the managed estate is fully owned by the 'manager of the property' (or the trustee). Consequently, in the circumstance where the trustee unfaithfully transfers the managed property to a third party, neither the settlor nor the beneficiary could turn to the court for a remedy.[11] On the contrary, equity recognized beneficiaries' interests in the trust property; if the unfaithful trustee breaches the duty under the deed between him and the settlor, the beneficiary would be protected by the equitable remedies.[12] At the same time, the manager (trustee) still obtains the ownership fully under common law. This ownership structure in English law is known as the 'dual ownership structure' between the common law and equity.

In practical terms, on the one hand, since the beneficiary obtains the equitable ownership of the trust property, in principle the beneficiary is entitled to trace the interests in the trust against anyone who obtained the property through the trustee's improper disposition, unless the purchaser is *bona fide* and paid the true value of the trust property. On the other, the trustee obtains the legal ownership of the trust property and once the property is transferred to the trust fund, the trustee is the only party who has the power to dispose or administer the

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[7] Graham Moffat, Gerry Bean and Rebecca Probert, *Trusts Law: Text and Materials* (5th edn, Cambridge University Press 2009) 37; Zweigert and Kotz (n 2) 195–196.
[8] Alastair Hudson, *Understanding Equity and Trusts* (3rd edn, Routledge–Cavendish 2008) 13.
[9] Frederic W Maitland (n 6) 84.
[10] Alastair Hudson (n 8) 12.
[11] Jill E Martin (n 4) 8.
[12] Henry Hansmann and Ugo Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 New York University Law Review 434, 443–444.

trust property exclusively; neither the settlor nor beneficiary can meddle in the management of trust.

Based on the dual ownership structure, the nature of trust can be construed as follows: firstly, the beneficiaries' proprietary right of trust assets is a supplementary remedy for the loss of proceeds or 'benefits'[13] of trust assets but not for the loss of 'ownership' or control of trust assets. That is to say, the beneficiary's 'equitable ownership' is essentially a proprietary right of the advancement from trust assets but not the property right of the trust asset itself. Secondly, the 'legal owner' of the trust property means that the trustee's management should not be influenced by anyone including the beneficiary, unless the trustee breaches the duties.

3.2.2 The Functions of Trust Law

3.2.2.1 Fiduciary Duty as Flexible Protection for Beneficiaries

As discussed in Chapter one of this research, fiduciary duty rules are widely applied as default rules for cost-efficiently protecting beneficiaries' interests in a trust. In a modern economy, the division of labor in different professions makes it impossible to require market participants to understand all the details, techniques and knowledge in each deal; Particularly in professional financial activities, the complexity in assets management has increased risks and uncertainties in investment. To promote economic efficiency, fiduciary duty rules are developed as default rules in trusts, by which settlors and trustees can accomplish their deals more efficiently.

The fiduciary duty rules automatically provide gap-filling protection in drafting trust agreements. For example, when a settler entrusts capital to a fiduciary for investment, the duty of care requires the person who is acting as a fiduciary to make decisions prudently and the duty of loyalty is aimed at minimizing the conflicts of interest between the trustee and beneficiary. Although some scholars and judges have recently found that in practice investors have tended to agree to waive or at least mitigate the manager's (including trustees, directors of companies, etc.) fiduciary duty by clear contractual clauses in trust deeds for efficiency

[13]According to the adjudication in *Re C.L.* [1969] 1 Ch. 587, the definition of the term *benefit* in trusts is commonly referred to an 'advancement' for a beneficiary that does not require a financial advantage.

and flexibility[14] in present UK statutes, they insist on stringently enforcing the trustee's fiduciary duty for protecting public interests as a part of public policy.[15] In fact, the judicial attitude towards this issue reflects that the function of fiduciary duty in trusteeship induces the trustee to perform well by imposing the 'after-the-fact liability' for the failures of the trustee.[16]

In addition, the fiduciary duty in trust law provides a protective mechanism without the beneficiary's or trustor's active monitoring. Firstly, if the beneficiary spends inordinate amounts of time in self-monitoring the trustee, the efficiency of the trust may be reduced. Secondly, the exclusion of the beneficiary's active participating can avoid unprofessional and irrational intervention, which can also cut down the transaction costs in trust fund management.[17] Thirdly, if the transaction security is lodged by instructions in trust deeds or disempowerment, the trustee's managerial power would be overly restricted. By contrast, the fiduciary duty rules can entitle managers to a wide range of power deal flexibly with practical issues in different circumstances.

3.2.2.2 Bankruptcy Remote as Firewall against Trustees' Creditors

Another advantage of trusts is that the partitioning of different assets in a trust fund can better protect the beneficiary's interests from challenges of trustees' personal creditors. First of all, once the trust asset is transferred to a trustee, the ownership of the trust asset is separated from the trustee's personal property, which means that the beneficiary's interests in a trust fund can be protected from the fiduciary's creditors' claim when the trustee goes insolvent.[18] In the case of insolvency, the beneficiary is still entitled to obtain the interest of the trust asset. Second, the principles of bankruptcy remote of trust law also require the trustee to keep the independence between various trust funds that are managed by the same trustee. Specifically,

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[14] In the theoretical dimension of this point, see details from the related analysis and references in Chapter 1 and in practical terms, related cases: *Armitage v Nurse* [1998] Ch 241; *Alexander Forbes Trustee Services Ltd v Halliwell* [2003] EWHC 1685 (Ch).
[15] See Financial Services and Markets Act 2000 (FSMA2000), s 253; Pension Act 1995, s 33.
[16] Robert H. Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 Boston University Law Review 1039, 1043.
[17] Ibid., 1041.
[18] This point has also been accepted by the some EU regulators and scholars who have been trying to draft a Directive on Protected Funds in EU jurisdiction, the bankruptcy remoteness is regarded as one of the basic protection mechanisms of such a protected fund. S.C.J.J. Kortmann, David Hayton, N.E.D. Faber, K.G.C. Reid and J.W.A.Biemans (ed), *Towards an EU Directive on Protected Funds* (Kluwer Legal Publisher 2009) 21.

each trust fund should have its own independent account and should never be commingled with other trust funds. As a consequence, even if one of the trust funds becomes insolvent, the creditors have no right to claim compensation from other trust funds.

Similarly, the independence of trust assets is also applicable to the settlor. Once a certain amount of property is entrusted to a trustee, the settlor will have no right to dispose or utilize the trust property on his or her own. Any creditor of the settlor is not allowed to make any claim against the trust property. Generally, the trust property is not regarded as the settlor's heritage: when the natural person settlor dies, the beneficiary can still gain the interests from the trust fund. In the case where the settlor is a corporation, the beneficiary interests in the trust property can also be protected from the settlor's bankruptcy.

3.2.2.3 Beneficiaries' Enforcement against Trustees

One of the basic rules in trust law is that the beneficiary is entitled to enforce the trustee duly to manage the trust asset for the beneficiary's interests. By contrast, before the enactment of the Contracts (Rights of Third Parties) Act 1999, the third party in a contract under UK laws was unable to enforce the contracts.[19] Therefore, the English trust historically was and currently is providing more effective enforcement protection of the third party beneficiary than the law of contract.[20] In this term, the law of trust entitles a series of legal powers to the beneficiary to enforce the trustee to fulfil duties properly, namely the tracing right against a third party purchaser and claim right or judicial remedy against the trustee.

On the one hand, in the event where the trustee unduly transfers trust property to a third party, the transferee must be *bona fide* and have supplied a true value as the consideration, otherwise the beneficiary can directly compel the transferee to return the trust asset to the trust fund. This means that even a third party beneficiary is not a contractual party to the trust deed or enjoy a title under property law, he or she can keep the proprietary right in the trust property. The Chancellor's willingness to recognize the beneficiary's enforceability against an outsider is factually protecting 'the beneficiary's (and the settlor's) reliance upon the

[19] Neil H. Andrews, 'Does a Third Party Beneficiary Have a Right in English Law?' (1988) 8 (1) Legal Studies 14.
[20] Hansmann and Mattei (n 12) 445.

trustee's promise';[21] in other words, the enforceability by tracing creates protection for the beneficiary without resorting to the settlor or the trustee. Moreover, the direct tracing right for beneficiaries forces the third party purchaser to ensure that the trustee's disposition of the trust asset is legal and does not amount to breach of trust, otherwise the third-party purchaser will be at the risk of tracing,[22] which can be regarded as another low-cost monitoring mechanism for protecting the beneficiary's interests.

On the other hand, if the trustee breaches his or her duties and infringes on the beneficiary's interest, the beneficiary has the right to require the trustee to make good the losses caused by any breach of trust and return any profit gained from the trustee's misfeasance.[23] In addition, the beneficiary can also request the court to remove the unsatisfactory trustee to avoid further damage to the beneficiary's interests.[24] Specifically, because the trustee obtains powerful control of the trust assets and is conferred to discretionarily determine the utility and management of the trust fund, the trustee's discretion in managing trust assets may cause some potential damages to or reduce the profit for the beneficiary. In these circumstances, the court has the power to restrict the trustee's discretion or even appoint a new trustee to protect the beneficiary's interests.[25] Compared with the third-party beneficiary contract, beneficiaries in trusts can enjoy more direct and effective protection from the judicial system.

3.3 The Judicial Protection for Beneficiaries in Commercial Trusts of England

3.3.1 Duty of Care

3.3.1.1 Unprofessional Trustees: Ordinary Prudent Man Standard

The duty of care in English case law is not a subject that solely belongs to the law of trusts. Instead, duty of care also exits in tort law, partnership law and company law.[26] As for English

[21] John Langbein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 The Yale Law Journal 627, 647.
[22] Jill E Martin (n 4) 711–745.
[23] Graham Moffat, Gerry Bean and Rebecca Probert, *Trusts Law: Text and Materials* (5th edn, Cambridge University Press 2009) 568–569.
[24] Ibid., 154.
[25] Ibid., 165–166.
[26] According to the leading case of British fiduciary law, *Bristol and West Building Society v Mothew* [1998] Ch 1, in a general sense, a 'fiduciary' was defined as 'someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence', whose duty of care should arise when 'there was the requisite proximity between the parties, and there was

trust law, the clarification of the duty of care did not derive until the famous case *Speight v Gaunt* (1883),[27] where Jessel MR set out a practical standard for judging whether a trustee has duly fulfilled the duty of care, namely the 'ordinary prudence' standard. In this case, Gaunt, the defendant, who had no professional investment experience was appointed as a trustee of a family settlement. The beneficiaries instructed the trustee to invest in local government debentures by buying securities at regional stock exchanges. To carry out this instruction, the trustee appointed a stockbroker to manage the trust business. However, the trustee did not know that the stockbroker was nearly insolvent. Finally, the stockbroker presented a forged bought note as evidence that he had successfully invested the trust funds into the securities, but actually the stockbroker had embezzled the trust funds to pay off his personal debts and then vanished. The beneficiaries filed a lawsuit against Gaunt for the breach of fiduciary duty to preserve trust funds, because the trustee did not prudently verify the truth of the bought note.

In brief, the core debate between the Court of Appeal and Chancery was whether the trustee should be unconditionally and absolutely liable for the loss of trust funds through delegation. According to general equitable rules, any defaults by a trustee's agent or delegation will result in liability to the trustee. This is a compulsory rule that may not compromise with any market practice.[28] However, in this case the Court of Appeal did not accept this argument and held that 'if you once arrive at the conclusion that Gaunt was informed by the bought-note that the purchase had been made in that way, there was no obligation on him to make any further inquiry'.[29] The main two reasons for this decision were that first the defendant was not an expert in stock investment and second the strict duty of verification would be too high for him. Actually, in this case the plaintiff had previously known that the trustee was not a professional in investment. Accordingly, he was not entitled to expect performance by the trustee at as high a level as a professional. Consequently, the Court of Appeal held that '[a] trustee investing trust funds is justified in employing a broker to procure securities authorized by the trust and in paying the purchase-money to the broker, if he follows the usual and regular course of business adopted by ordinary prudent men in making such investments', if

foreseeability of damage.' The above descriptions of both fiduciary and duty of care have been widely accepted and cited both theoretically and practically in UK commercial law.

[27] *Speigh v Gaunt* (1883) 22 Ch. D 727 (CA).

[28] Ibid.

[29] *Speigh v Gaunt* [1883] 9 App. Cas. 1.

the legal liability of trustees is stricter than this standard, it would be impossible to employ any trustee to do anything.

Furthermore, commercial transactions were likely to be much more complicated than ever before, which means that the delegation of the employment of agents by a trustee is increasingly common and even inevitable. Moreover, practically any legal rules must give regard to business practice. In this case, if the court stuck to the rule that the trustee must verify every detail in transactions by a broker employed by him, the overly strict verification or supervision duty of trustee may destroy the basic trusteeship in commercial co-operations. In addition, the function of delegation is an amelioration of economic efficiency. If the law requires trustees to verify or supervise all the conducts by the employed agents, economic efficiency will be reduced seriously.

3.3.1.2 Professional Managers: Modern Expert Standard

With the development of professionalism and division of labor in modern business, the 'ordinary prudent man' standard that was commonly applied to unremunerated or unskilled trustees has not been suitable for those fiduciaries with particular skills or qualifications. Differently, a stricter standard was proposed for remunerated and professional trustees, such as solicitors, stockbrokers and real estate managers. In the past, trustees' duty of care mainly referred to an obligation to preserve the value of trust assets and prevent speculative conduct that might cause loss to the beneficiaries. In modern markets, the above 'prudent trustee' standard has been developed and extended, which means that 'trustees were obligated to maximize financial returns to trust funds as well as preserve the capital'.[30]

The leading case regarding duty of care in modern financial investment trusts, *Bartlett & others v Barclays Bank Trust Co Ltd (1980)*[31] shows a standard for judging the duty of care of professional trust corporations. The plaintiffs were the beneficiaries of a trust holding 99.8% shares of a company, Barclays Bank Trust Co., Ltd as the trustee committed to exercise the voting and managerial powers attached to the shareholding on behalf of the plaintiff. Therefore, the trustee would have the controlling interest in the company, but there was no

[30] Joshua Getzler, 'Duty of Care' in Peter Birks and Arianna Prettoed (eds), *Breach of Trust* (Hart Publishing 2002) 70.
[31] *Bartlett and Others v Barclays Bank Trust Co Ltd* [1980] 1 Ch 515.

representative of the trust corporation on the board of directors. To raise finance, in 1961 the board announced the policy that the company would invest in the real estate market, although the trust corporation had been advised by a merchant banker that the proposed investment was likely inappropriate. However, the trustee neither made more inquiries nor required the board to provide further information on this investment. One of the projects seriously failed and caused losses to the beneficiary.

Pursuant to the 'ordinary prudent man' standard, in general circumstances, the law does not require a trustee to verify the information provided by a 'trustworthy' party in trust transactions. However, here the court held that a trust corporation was different from an ordinary trustee, as it usually had specialised skills and relatively high-level professional experience in particular businesses. Hence, a trust corporation's duty of care should be higher and stricter than an ordinary trustee. In this case, Barclays Bank Trust Co., Ltd as a professional trust manager 'should not have relied only on information given at annual general meetings of the property company',[32] but ought to have made further consultation of the investment in person for the purpose of prudently safeguarding the interests of the trust. Therefore, the bank had breached the trust and should be liable for the loss suffered by the beneficiary.

Another question is if a trustee holds the majority of a company's shares, what the trustee should do in corporate governance to prevent being regarded as violating the duty of care. In *Re Lucking's Will Trusts* (1968)[33] a trust fund held 70% of a private company's shares and one of the two trustees was employed as one of the directors of the company. However, the business of the company was managed by an executive director but not the trustee director. The executive director wrongfully took £15,000 from the company's bank for personal ends and then went bankrupt, and the money was lost consequently. The trustees were eventually deemed in breach of trust for their failed supervision of the other directors' misconduct in corporate management. Cross J held that in consideration of the trustees that they had held the majority shareholding of the company; in other words, the trust fund was the major interested party in the corporate governance, and the trustee director as the single representative of the beneficiaries should have been involved in managing the company to

[32] Ibid.
[33] *In Re Lucking's Will Trusts* [1968] 1 WLR 866.

actively secure the beneficiaries' interests in the company.[34] Although the trustee director may not be an executive on the board, nevertheless, 'he may find someone who will act as his nominee on the board and report to him from time' or 'ought to ensure so far as they can that they have such information as to the progress of the company's affairs as directors would have'.[35] The duty of care rule requires the trustees who hold the controlling interest in a company act responsibly as possibly as he or she can for prevent any misappropriation or unauthorized disposition of the trust assets.[36]

From the above review of a series of leading cases in English trust law, the 'process-oriented' standard of duty of care can be labelled as one of the core features of English trusts. This point means that because the practical standards of fiduciary duty in English trusts were mainly developed from the judicial practices through a long history and in most situations the judges tended to consider the trustees' performance of the process of fund management instead of the rigid standard of the duties nor the result of trust management, thus the boundary of trustee's liability and the standard of performance can be adjusted flexibly in different circumstances and ages.

3.3.2 Duty of Loyalty

3.3.2.1 The Rules of Profit: Conflicts of Interest

In early cases that were concerned with the renewal of a lease by a trustee, if the trustee renewed a lease in his or her own name, then he or she might be deemed in breach of duty of loyalty and the profit of the new lease would be judged as the profits from a constructive trust that must be returned to beneficiaries.[37] This rule was gradually developed as a strict rule that a trustee should not make personal secret profit by means of his or her advantageous position in a trust, unless the beneficiaries had expressly authorized such action. The leading case that

[34] Ibid
[35] Ibid.
[36] In detail, in the above-mentioned *Bartlett and Others v Barclays Bank Trust Co Ltd* (1980), Brightman J specified Cross J's implication of the duty of care in the similar circumstance where a trustee represents a trust fund holding the majority shares in a company as follows: for example, the trustee may require the board to provide the copies of minutes of board meetings and financial statements regularly and inform the main information of each important trading in relation to the use of trust assets.
[37] *Keech v Sandford* [1726] Sel Cast King 61; *Knowles Will Trusts, Re* [1948] 1 All E.R. 866.

clarified the rule of profit is *Aberdeen Railway Co. v Blaikie* (1854),[38] in which the judge declared that both the director of a company and the trustee in a trust are the position of a fiduciary who should never make profits by contracting with the company or trust fund.[39] Although it is a case about the director's duty of loyalty in company law, its fundamental statement of duty of loyalty in commercial law is also significantly influential on trustees, especially in commercial trusts. Later, following the approach in the case *Aberdeen Railway*, Lord Wright opined in the case of *Regal (Hasting) Ltd v Gulliver* (1942) that 'if a person in a fiduciary relationship makes a secret profit out of the relationship, the court will not investigate whether the other person is damnified or has lost a profit which he otherwise would have received. The fact is in itself a fundamental breach of the fiduciary relationship'.[40] The same attitude towards this issue was also maintained by Lord Hodson's in his opinion in the case of *Boardman and Another Appellants v Phipps Respondent* (1967) that '[t]he proposition of law involved in this case is that no person standing in a fiduciary position, when a demand is made upon him by the person to whom he stands in the fiduciary relationship to account for profits acquired by him by reason of his fiduciary position and by reason of the opportunity and the knowledge, or either, resulting from it, is entitled to defeat the claim upon any ground save that he made profits with the knowledge and assent of the other person'.[41] Although the case law has established a bundle of strict rules to prevent trustees from making personal profits from the trust, the fiduciary may also be absolved from such obligations in the circumstances where the trust agreement permits a particular form of profit or the authorization has been sought for the profit.[42]

3.3.2.2 Self-dealing and Fair-dealing: No Third-party Involved

Having considered the rules of conflicts regarding a trustee's managerial discretion, the discussion now shifts to the conflicts of interest in transactions between the trustee and the trust fund or beneficiaries. One aspect of this is the self-dealing rule which aims to regulate the proposed purchase of trust assets by a fiduciary and the other is the fair-dealing principle which confines the fiduciary's purchase of a beneficiary's interests in a trust fund.

[38] *Aberdeen Railway Co. v Blaikie* [1854] 17 D (H.L.); hereinafter referred to as *Aberdeen Railway*.
[39] *Aberdeen Railway* note 38, 20.
[40] *Regal (Hasting) Ltd v Gulliver* [1942] 1 All E.R. 378.
[41] *Boardman and Another Appellants v Phipps Respondent* [1967] 2 A.C. 46.
[42] Alastair Hudson, *The Law on Investment Entities* (Sweet & Maxwell 2000) 85.

The self-dealing rule originally derived from the English case *Keech v Sandford* (1726),[43] in which a trustee was strictly prevented from renewing a lease regarding trust estate in his own name. The Lord Chancellor's basic reason for this verdict was that if the court allowed a trustee to make a deal involving the trust asset with the beneficiary, the trustee was on both sides of the deal, and he or she might hardly act to secure the best price for the beneficiary and himself at same time. This is the reason why self-dealing is commonly banned. The further question is that if a trustee who proposes to carry out a transaction with the trust fund in a fair price, whether such a deal is acceptable. In a series of traditional trust law cases the court tended to interdict any self-dealing regardless of whether or not the dealing price was fair. Again, in *Aberdeen Railway* it was held in the House of Lords that the prohibition of self-dealing between a director/trustee with the company/trust fund was a universal and strict rule regardless of the fairness or unfairness of the price of the deal. In the case of *Re Thompson's Settlement* (1986)[44] the proceeds of sale and rent of a series of certain estates were conveyed to a trust for the interest of the grandchildren of the settlor. The trustees then conveyed the lease of the trust property to the company and partnership in which the trustees were the directors and then the majority shareholders. The court held that although the company and partnership had agreed to pay the rent at a fair market price, the self-dealing rule still strictly prohibited the trustee from putting himself in the position where his duty and interest conflicted. Therefore, the transfer of the lease of the trust property was invalid. In fact, where a trustee makes a deal with the trust fund it means that the trustee will have an advantageous opportunity of knowing the true market value of the trust property. However, the beneficiary as the counterparty hardly gains such information pertaining to the deal; in other words, the trustee may have benefited at the expense of the beneficiary.

The basic reason for prohibiting self-dealings is the unavoidable conflicts of interest between a trustee's private interest and fiduciary duty when he or she is on both sides of any transaction concerning the trust property. By contrast, if a trustee just proposes to make a deal with the beneficiary of the trust, the law fair-dealing rule will apply which commonly limits, but not absolutely excludes such transactions. In the widely cited case of *Tito v Wadell (No.2)* (1977)[45], Megarry V-C held that 'if a trustee purchases the beneficial interest of any of his or her beneficiaries, the transaction was not voidable *ex debito justitiae*, but could be set aside

[43] *Keech v Sandford* [1726] Sel Cast King 61.
[44] *Re Thompson's Settlement* [1986] 2 All E.R. 720.
[45] *Tito v Wadell (No. 2)* [1977] 3 All E.R.129.

unless the trustee could show that he or she had taken advantage of his or her position and had made full disclosure to the beneficiary, and that the transaction was fair and honest'; in other words, if the procedure of the transaction proposed by the trustee was truly disclosed to the beneficiaries of a trust fund and the price of the deal was demonstrated as not unduly lower than a market price, then the transaction proposed by the trustee should be lawful. If the disclosure of the transaction was not given to the beneficiaries, then the transaction would be set aside by the court.

Overall, in English trust law, the biggest distinction between the nature of the fair-dealing and self-dealing rules is that (i) the cases falling within the fair-dealing rule are mostly where the beneficiary is directly involved in the transaction with the trustee, and the beneficiary is fully informed and expressly consents to this, whereas (ii) the cases falling within the scope of self-dealing are mostly where the beneficiary is not normally the counterparty of the transaction and the trustee does not faithfully disclose the information of the transaction, so the beneficiary may not make a fair judgment nor give consent to the deal.[46]

3.4 The Protection Mechanisms of Trusts in Mixed and Civil Law Jurisdictions

Historically, scholars in civil law countries insisted that any practice of property law must follow the unitary theory of property rights[47] and *numerus clausus*, which meant that in civil law countries (i) any property or estate could only have one sole owner and (ii) the content of ownership should only be stipulated by statutes but not discretionarily determined or contracted by the parties;[48] in other words, the civil law entitled the 'owner' of one property in Roman law countries to exercise his or her property rights exclusively in lawfully possessing, using, disposing and profiting from the property without any restriction by any other persons. As a consequence, the division of ownership between beneficiary and trustee in English trusts became a challenge to continental law systems. In trust law, once a settlor transfers the asset to a trustee, the trustee will obtain the legal title over the trust assets. However, the trustee can only manage trust assets in accordance with a trust deed, rather than

[46] Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) 138–139.
[47] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics' (1994) 3 International Review of Law and Economics 3, 9.
[48] Avihay Dorfman, 'Property and Collective Undertaking: The Principle of Numerus Clausus' (Summer 2011) 61 (3) University of Toronto Law Journal 467.

dispose of the asset on behalf of himself or herself. In English trust law, if a trustee unduly disposes of trustee assets, the beneficiary has the right to trace the property from the third party. Moreover, in a general sense, beneficiaries are not allowed to intervene in fund management. This particularity is also considered as unacceptable that if the beneficiary has ownership of trustee assets, he or she should not only have a tracing right, but also the right to control the management of the property, whereas English trust law avoids beneficiaries away from the trust management in most circumstances.

It is well known that the systemization of fiduciary rules in the Anglo-American legal system was developed from not only judicial practices, but also the dichotomy of equity and common law. By contrast, the above-mentioned legal structure in English trusts never existed in civil law jurisdictions. To a large extent, the dual ownership in English trust law is the main incompatibility with the legal institutions in continental law family. In consideration of the high level of flexibility of the trust structure in financial investments, more and more civil law countries attempt to import business trusts into their domestic private law. To remove the incompatibility between the two legal traditions, different countries invented different approaches based on their own legal traditions to construct equivalent functions for protecting beneficial parties.

3.4.1 The Protection Mechanism of the Trusts in Mixed Jurisdictions

3.4.1.1 Scotland: Segregation of the Trustee's Patrimonies

As one of the typical legal regimes in common law countries, Scottish trust law displays how the advantages of trusts can be reserved in a civil law system. Historically, the origins of Scottish trusts can be traced to the seventeenth century by common law rather than by legislation.[49] As discussed above, the dilemma of importing trust law into civilian legal jurisdictions is that there is no counterpart in the civil law tradition as the division of ownership between common law and equity. As a result, when the trustee unduly disposes of the trustee asset and causes a loss to the beneficiary, the beneficiary is unable to exercise the equitable tracing right to recoup from the third party. Accordingly, in Scots trust law, the

[49] George L. Gretton, 'Trusts Without Equity' (July 2000) 49 (3) The International and Comparative Law Quarterly 599, 619.

ownership of trust property is always in the hands of the trustee and dual ownership is never accepted.[50] The beneficiary's right is a kind of right *in personam*, but not a right *in rem*;[51] in other words, the function of the fiduciary duty regime in English case law is replaced in Scots law with a kind of remedial power against trustees without an equity system.

In terms of the bankruptcy remoteness of trust assets, Scottish trust law also forms a ring-fenced fund that can separate the trust assets from the trustee's private creditor's claim. Although there is no dual ownership structure in Scottish trusts, the separation of the trustee's patrimonies can provide an explanation for this phenomenon. The trustee of a Scottish trust fund has two separate patrimonies, the one is his or her private patrimony, which is available to his or her private claimant, the other is the trust patrimony that should only be liable for trust liabilities.[52] Therefore, in the circumstance where a trustee's creditor claims against the trustee, the trustee can only use his or her private property to repay the debt, but the trust assets will not be claimed. Additionally, if the trustee mixes the two kinds of patrimonies and the liabilities incurred by the trust patrimony, the beneficiary is entitled to require the trustee to transfer the corresponding amount from his or her private patrimony to the trust patrimony.

Because the trustee of a Scottish trust is the exclusive owner of the trust assets, the trustee may exercise the discretionary power to transact the trust fund with third parties. The beneficiaries will be at the risk of the trustee's breach of trust. The separation of the trustee's patrimony can also provide enforceability by the beneficiary to protect the trust interests from the trustee's misconduct. Based on the principle of contract, transactions between a trustee and third parties are lawful, because the trustee is the only owner of the trust assets and 'a contract cannot be set aside on the ground of breach of duties'.[53] If the trustee breaches the duties to transact the trust property with a third party, however, no matter whether or not the trustee discloses the trusteeship to the counterparty, the counterparty can only claim for the liabilities against the trustee's private patrimony but not the trust patrimony.[54]

[50] Ibid., 619.
[51] Ibid., 619; *Inland Revenue v Clark's Trustees* [1939] S.C.11.
[52] K.G.C. Reid, 'National Report for Scotland' in S.C.J.J. Kortmann, David Hayton, N.E.D. Faber, K.G.C. Reid and J.W.A. Biemans (eds), *Towards an EU Directive on Protected Funds* (Kluwer Legal Publisher 2009) 263–264.
[53] Ibid., 266.
[54] Ibid., 266–268.

In fact, the nature of the remedial mechanism in Scottish trust law is an allocation of liabilities between the trustee's personal and trust patrimonies. On the one hand, the dual patrimony structure in Scottish trusts effectively achieves economic functions of English trusts by establishing a 'transferring platform' between the liabilities of trustee's private property and the trust property for striking a balance between the protection of third parties and beneficiaries' interests. On the other hand, the protective mechanism in the Scottish legal system also reserves the unified ownership principle in the civil law tradition which reduced the costs in legal transplantation. For example, the beneficiary cannot directly manage the trust assets, because he or she has no proprietary right to the trust fund. In this way, the independent management of Scottish trusts is maintained by excluding the intervention of the beneficiary.[55]

3.4.1.2 Quebec: Real Right Nihilism

Another mixed jurisdiction in common law countries is Quebec in Canada where trust law was also adopted from the common law system but applied on the basis of continental law. Quebec has been a colonial province of France since the mid-seventeenth century as a result of the Seven Year War between Great Britain and France (1756–1763). Quebec was ceded to the British Empire. The transplanted French civil law in Quebec was reserved through the promulgation of the Quebec Act of 1774,[56] which was importantly regarded as the fundamental statute of Canadian politics. The Constitution of 1867 further established a

[55] In this regard, a famous case in Scottish trust law can illustrate how the divided patrimonies mechanism may decrease the intervention by beneficiaries: in the case of *Armour v Glasgow Royal Infirmary* ([1909] S.C. 916), the trustee of a testamentary trust wrongly paid the trust interests to the defendant, namely Glasgow Royal Infirmary, then the pursuers raised an action against the wrongly paid beneficiary and added the trustee as the additional defendant. The defendant argued that owing to the absence of equity in Scottish law, the legal relationship between a third party and the beneficiary could not be a kind of relationship in property law, therefore, the beneficiary could only sue the trustee, instead of the trustee's debtor. Lord Skerrington held that 'the testamentary trustees have been called as defenders, and they concur with the Infirmary in maintaining that the money was properly paid, and that the pursuers are not entitled to insist on its repayment. In these circumstances, I think that the pursuers have a good and sufficient title to maintain this action to the effect of demanding that the money shall be repaid to the trustees'; in other words, the beneficiary as an interested person in a trust has the right to cancel an unlawful transaction and then the asset can return to the trust patrimony, but the beneficiary is not allowed to directly trace the trust assets from a third party.

[56] Nancy B. Foulds, *Quebec Act* <http://www.thecanadianencyclopedia.com/en/article/quebec-act/>, accessed 27 March 2016.

federal system in Canada, the French civil law system in Quebec has been permanently admitted by the Canadian constitution.[57]

According to the Civil Code of Québec 1994,[58] a trust is defined as: 'A trust results from an act whereby a person, the settlor, transfers property from his patrimony to another patrimony constituted by him which he appropriates to a particular purpose and which a trustee undertakes, by his acceptance, to hold and administer',[59] which means that the trust property belongs to neither a trustor nor a trustee. Moreover, under Quebec Civil Code, the legal nature of a trust is regarded as 'a patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right'[60] and based on the French civil law tradition, a trust fund is established by (i) a contract/will between a settlor and a trustee and (ii) the acceptance of the trustee(s).[61] In sum, it can be concluded that the uniqueness of a Quebec trust is that the 'dual ownership' has been avoided and the key issue of a trust is the trustee's managerial obligations, which are commonly based on contractual agreements between the trustor and trustee.[62]

The remedies for beneficiaries under Quebec trust law are quite similar to Scottish trusts. Because the Quebec Civil Code repudiates any party's ownership of trust property, the remedy for a beneficiary cannot be a tracing right that is only valid based on an existing property right. Furthermore, since the law deems the relationship between a settlor and a trustee as contractual, the settlor is not allowed to trace the trustee property as well. Pursuant to s 1290 of the Quebec Civil Code, however, any of the settlor, beneficiary or even an interested third party of a trust is entitled to take action against the trustee and compel him or her to fulfil the obligation under the trust contract. As a consequence, any undue disposition of the trustee assets by a fiduciary must be recovered or corrected by the fiduciary; in other words, the Quebec civil law system has reorganized the legal relationship in trusts focusing

[57] Patrick Malcolmson and Richard Myers, *The Canadian Regime: An Introduction to Parliamentary Government in Canada* (4th edn, University of Toronto Press 2009) 58–65.
[58] The full text of the official version is available at http://www2.publicationsduquebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=2&file=/CCQ_1991/CCQ1991_A.html.
[59] Section 1260.
[60] Section 1261.
[61] Sections 1263, 1264.
[62] Maurizio Lupoi, *Trusts: A Comparative Study* (Simon Dix tr, Cambridge University Press 2000) 288.

on the trust property only, and both the settlor and beneficiary can exercise the claim right against the trustee to secure trust interests.

3.4.1.3 South Africa: A Contract Regulated by the Court

South Africa was governed by the Netherlands from the mid-seventeenth century until the early nineteenth century when the British Empire took over power from the Dutch.[63] Before the arrival of the British, the legal system in South Africa was mainly organized according to the principles of the Dutch law. The legal transplant of trusts in South Africa appeared as early as the 1800s. However, the legal features of today's South African trusts have been developed side by side with Dutch regimes[64] and differ from the typical English trusts. At present, the basic principles of South African trusts are outlined in the Trust Property Control Act 57 of 1988.[65]

The definition of a South African trust is different from an English trust in that the trust is a kind of legal 'arrangement' that is mainly determined by trust instruments.[66] The ownership of trust assets can be transferred to either a trustee or a beneficiary.[67] In the first circumstance the trustee is required to manage the trust property in the interest of a beneficiary, whereas in the latter circumstance, although the ownership of trust asset is directly possessed by the beneficiary, the trust assets can only be controlled by a trustee who must manage the trust asset in accordance with the trust instruction.[68] Moreover, a trust under South African law is revocable, unless the trust arrangement is accepted by the beneficiary.[69] Therefore, it can be seen that the legal nature of a trust in South Africa is based on the law of contract.

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[63] Ibid., 297.
[64] Ibid.
[65] Hereinafter the 'TPCA 1988'. The full text of this statute is available at http://www.justice.gov.za/legislation/acts/1988–57.pdf.
[66] TPCA 1988, s 1.
[67] This may be the most unique point of South African trusts which reflects the influence of Roman-Dutch law. In English trusts or even other civil law trusts such as Scottish trusts or French *fiducie*, the ownership of trust assets is never in the hands of beneficiaries. By contrast, the South African law makes it possible. In the Dutch trust-like legal regime (*bewind*), beneficiaries obtain the ownership of the fund assets, the trustee (*bewindvoerder*) is required to manage the fund on behalf of beneficiaries. Thus, in fact, the trustee acts as an agent of the beneficiary. Because the *bewindvoerder* is not the owner of the trust assets, the recourse of trustee's creditors cannot be taken against the trust assets. Sebastian Kortmann, Dennis Faber and Jan Birmans, 'National Report for The Netherlands' in S.C.J.J. Kortmann, David Hayton, N.E.D.Faber, K.G.C.Reid and J.W.A.Biemans (eds), *Towards an EU Directive on Protected Funds* (Kluwer Legal Publisher 2009) 344–345.
[68] TPCA 1988, s 1.
[69] H.R. Hahlo, 'The Trust in South African Law' (1961) 78 The South African Law Journal 195, 204.

With respect to the segregation of trust assets, however, South African law does not prioritize the interests of beneficiaries. In a case where the trust property has been (i) unlawfully assigned to a *bona fide* third party by the trustee or (ii) claimed by the trustee's private creditors, if the ownership of trust assets is in the hand of the beneficiary (a *bewind trust*), the beneficiary can get the assets back because he or she is the owner of the trust assets, whereas if the beneficiary is not the owner of the trust fund, the beneficiary can only file an action against the trustee for remedy.[70]

As regards the protection mechanism for beneficiaries' interests, the South African law entitles a wide range of powers to the court. Firstly, any trust instrument must be registered with a Master appointed by the Supreme Court of South Africa[71]who has the duty and power to monitor the management of the trust and intervene in certain particular situations. In addition, before a trusteeship commences, the appointment of a trustee must be approved by the Master[72] and the property of the trust assets must be registered with the Master.[73] In this way, the trust asset can be segregated from the trustee's private assets.[74] Secondly, according to the same legislation, in the application to the Master or any interested persons in the trust fund, the court is entitled not only to adjust trust provisions of fund management, but also to remove a delinquent trustee[75] if the trust instrument is regarded as inappropriate for reaching the trust purpose or the trustee has breached his or her duty to beneficiaries. In sum, it can be seen that under the South African legal system, the protective function of fiduciary duty can also be substituted by a strong judicial power without an equity system.

3.4.2 The Protection Mechanism of the Trusts in Civil Law Jurisdictions

3.4.2.1 France: The Protection of Trust Purposes

In continental Europe, the Roman the situation is different: the legal tradition has set up a barrier to import of trust law in civilian countries. Although Quebec civil law was transplanted from France, however, the import of trusts into the French Civil Code was much

[70] Maurizio Lupoi, *Trusts: A Comparative Study* (Simon Dix tr, Cambridge University Press 2000) 300–301.
[71] TPCA 1988, s 1.
[72] TPCA 1988, s 6.
[73] TPCA 1988, s 11.
[74] TPCA 1988, s 12.
[75] TPCA 1988, s 13 and 20.

later than Quebec. Before 2007, French lawyers still insisted that the division of ownership in English trusts were incompatible with the civil law inheritance. In consequence, any trust-like regimes in France were addressed by analogy, namely the 'fiduciary relationship' in testament or contract of mandate, a testamentary executor or an agent under contract would be regarded as trustees; in other words, under traditional French civil law, there was neither a separate rule of 'fiduciary duty' nor a uniform legal system dealing with the trust-like issues.[76] By 2007, a French legal term *fiducie* as a kind of independent institution was introduced into the French Civil Code, this was regarded as the first independent legal institution that established fiduciary rules in French legal system.[77] According to s 2011 of the French Civil Code, in a *fiducie* the settlor's asset is transferred to a fiduciary who must separately hold the entrusted assets for the benefit of a third person.[78] In addition, a *fiducie* must be established by contracts or statute[79] and there is no expression of the division of ownership between a trustee and beneficiary.[80]

Accordingly, in French law the remedial approaches for beneficiaries are also formed on the basis of obligation law. For instance, French law requires that any natural person trustor must assign at least one protector who will be responsible for securing beneficiaries' interests by supervising the trustee's conducts. As a result, the relationship between a protector and a settlor is contractual, the range of protector's supervisory power will depend on the trustor's authorization in the contract.[81] In the situation of breach of duties, French *fiducie* law allows the trustor to enforce the fiduciary to perform his or her duties on behalf of the beneficiary. Importantly, the French law also entitles the protector to judicial power, which means that the protector may exercise the power against the trustee for guaranteeing that the trustor's will can be properly satisfied.[82] In terms of the separation of trust property, if the trustee unduly disposes of the trust assets and incurs liabilities for the trust fund, the third party generally

[76] Jean C. Goldsmith, 'Trust in France' (1996) 2 (2) Trust and Trustees 5.
[77] Pierre Crocq, 'National Report for France' in S.C.J.J. Kortmann, David Hayton, N.E.D., Faber, K.G.C. Reid and J.W.A. Biemans (eds), *Towards an EU Directive on Protected Funds* (Kluwer Legal Publisher 2009) 99.
[78] Ibid., 106.
[79] James Douglas, 'Trusts and Their Equivalents in Civil Law Systems' (2013) 13 (1) QUT Law Review 19.
[80] Gary Watt, *Trusts and Equity* (6th edn OUP 2014) 27.
[81] Martin Gdanski and Tara Pichardo-Angadi, 'The French Law on *Fiducie* and its Application to Banking and Finance Transactions' (2007) 22 (8) Journal of International Banking Law and Regulation 434.
[82] Douglas (n 79).

has the right to claim against both the trustee's private and trust properties, unless the third party was aware of the trustee's limited power to dispose of or sell the trust assets.[83]

The above shows that in French law the rules of fiduciary duty and beneficiaries' right to claim have been integrated into the traditional obligation law. Therefore, it is clear that between the interests of the third contractual party and beneficiary, the French law tends to prioritize the former one and the beneficiary is not allowed to directly trace the trust assets from the third party. Compared with the legal reform in the Quebecan civil law, on the one hand, based on a similar tradition, the 'trust laws' in both jurisdictions do not entitle the beneficiary with any 'property right' or ownership. Therefore, the beneficiary may not directly exercise a remedial power to trace the property; in other words, the beneficiary right in France and Quebec is still a kind of right *in personam*, which can only be realized by compelling the trustee to fulfil his or her duty. On the other hand, however, under French trust law the trustee is the owner of the trust asset, but the Quebecan law denies any concept of an owner of trust assets.

3.4.2.2 Germany: Entitles Settlors with Strong Contractual Power

German private law is well known for its systematization. However, the 'trust' or 'trust-like' regime in Germany was not organized in separation. On the contrary, the German trusts, that is, the so-called *Treuhand*, was a special legal concept that was summarized from a series of judicial activities of the German courts and academic studies of traditional German laws since the nineteenth century.[84] The definition of *Treuhand* is a fiduciary relationship in which the settlor entrusts certain rights to a trustee (*Treuhänder*) and enables the trustee to exercise pre-agreed rights in the beneficiary's (*Treugeber*) interests.

In terms of the bankruptcy remoteness of the *Treuhand*, although the ownership of trust assets is assigned to the trustee *(Treuhänder)*, the trust assets under a *Treuhand* are generally not protected by a ring-fenced fund. In the case where the trustee goes bankrupt, the creditor

[83] Crocq (n 77) 112.
[84] Jing Sun, 'An Introduction to German Trusts Law' (2004) 1 Journal of Comparative Law 85 [孙静. '德国信托法探析'，比较法研究，2004年第1期，第85至95页].

of the trustee can obtain the access to the entrusted assets[85]. Where a trustee (*Treuhänder*) unduly disposes of trust assets or assigns trust assets to a third purchaser, the beneficiary is entitled to be compensated by suing the trustee. However, the transaction between the trustee and the third party is still valid;[86] in other words, if the trustee abuses his or her power to sell or dispose of the trust assets, the beneficiary's remedial power is only *in personam* instead of exclusive right *in rem*.

In respect of the beneficiary's (*Treugeber*) right, similar to the *fiducie* in France, German trust law also entitles the settlor to active powers in the management of *Treuhand* and the duties or rights of a trustee are also more flexible on the basis of contractual autonomy. If the beneficiary has been added as a contractor into a trust deed in advance, the beneficiary will have a power against the trustee and compel the trustee to fulfill the duties agreed in a contract. However, if the beneficiary is not a contractual party in the *Treuhand* contract, the beneficiary will not be entitled to any direct remedial power and can only obtain a remedy or compensation by resorting to the settlor. In addition, the Chapter of Delegation law (*Auftrag*) of the German Civil Code is different from English trusts in that any adjustment of German trust fund management should be approved by the settlor,[87] which means that the settlor can obtain a contractual right to influence the trustee's management.

In sum, it can be seen that the remedial regime for beneficiaries' trust interest under German civil law is organized according to the principles of contract. As a result, where trustees breach their fiduciary duty, only a contractual party can exercise a right of claim to obtain a remedy and protect the beneficiary's interests. In the meantime, the trustors' contractual power of intervention may have substantially removed the principle of independent management in trust law. The incompatible civil law system in German law also fails to adopt the concept of 'fund patrimony' to keep the trust assets away from the claims of the trustee's private creditors. Therefore, the regime of *Treuhand* under German law can hardly provide a protection mechanism and efficient governance structure for the beneficiaries' interests that are equivalent to English trusts.

[85] Dieter Krimphove, 'National Report for Germany' in S.C.J.J. Kortmann, David Hayton, N.E.D. Faber, K.G.C. Reid and J.W.A. Bieman (eds), *Towards an EU Directive on Protected Funds* (Kluwer Legal Publisher 2009) 117.

[86] Ibid., 117–119.

[87] German Civil Code, s 665 and 675. The English version is available at http://www.gesetze-im-internet.de/englisch_bgb/german_civil_code.pdf.

3.5 Legal and Economic Comparison of Protection Mechanisms for Trusts

The comparative analysis above shows that in the solution to the agency problem in trusts or trusteeship, the legal rules of fiduciary duty differ from one jurisdiction to the next. What is useful for legal practice is to discover the function of the fiduciary duty rules for business trust investments. In terms of English business trusts, the basic principle is that (i) for trustors/beneficiaries, prior to the establishment of a trust fund, trustors/beneficiaries will be required to carry out necessary investigation of the trustee's professional skills and commercial reputation in specific business and (ii) if a settlor rationally entrusts a fiduciary to carry out an investment on behalf of a beneficiary, the trustees are obliged to manage the trust property diligently and prudently in the best interest of beneficiaries, and in the circumstance of a breach of trust, the law will compel the trustee to be liable for the loss to the beneficiary.

From an economic point of view, the English case law has unconsciously admitted the 'principle of the rational man' in a free market. The consequence is that any investor of business trusts should be aware of, and liable for, the risk in the market. Correspondingly, if a 'rational trustor' is defined as an investor who has prudently considered the potential risk before making an entrustment and rationally believes that the trustee can competently manage the funds, then it may be true that the nature of the fiduciary duty rules is a legal mechanism that aims to save transaction cost of (i) irrational investment (the standard of fiduciary duty depends on what principal's expectation of a trustee's performance is) and (ii) contracting (fiduciary duty rules as default rules) and (iii) supervising the agent's performance (fiduciary duty rules act as deterrents to the fiduciary).

In contrast, owing to the lack of an independent system of equity, the trust laws in civil law jurisdictions are primarily established on the basis of obligation law or contract law. As a result, most civil law countries tend to (i) establish a dichotomy between trust patrimony and trustee's private patrimony (Scotland/Quebec); (ii) entitle settlers to direct intervention power (Germany) or (iii) compulsorily employ an external protector (France/South Africa) for the purpose of securing the interest of beneficiaries. In brief, the transaction costs of the civil trusts in various jurisdictions can be measured by two factors, namely (i) who is entitled to intervene in the trustee's management or claim a remedy; and (ii) at which juncture(s) would the intervention be allowed:

Table 3.1: The transaction costs of the remedial mechanisms of trusts in different jurisdictions

Jurisdictions	Actors of intervention	Time-points of intervention
England	Beneficiaries	Breach of trust
Scotland	Beneficiaries	Breach of trust
Quebec	Trustors/Beneficiaries	Breach of trust
South Africa	Interested Persons/Protectors	Breach of trust/Management
France	Trustors/Protectors	Breach of trust/Management
Germany	Trustors/Beneficiaries	Breach of trust/Management

Table 3.1 indicates that in order to secure the interests of beneficiaries, most civil law or mixed jurisdictions' laws tend not only to restrict trustees' discretionary power in the process of trust management, but also entitle both beneficiaries/trustors or external protectors to direct intervention powers. Consequently, on the one hand, fiduciaries in civil law countries have to compromise with trustors/beneficiaries' requirements in trust deeds to reduce unnecessary compliance risk. On the other hand, because the laws legislate that the duties and rights of trustees are basically determined by trust contract, trustors or beneficiaries will be motivated to argue for more direct intervention powers in the process of trust management.

To put it differently, it is clear that fiduciary duty rules in English trusts not only provide a series of expected and practical legal remedies for beneficiaries, but also impose substantial regulation on fiduciaries to reduce moral hazard. In fact, the economic effects of English trusts can be summarised as follows: (i) the exclusion of the trustor's/beneficiary's intervention in trust management reduces the cost of negotiation for both trustors/trustees and avoids the irrational decision making by unprofessional principals; (ii) the strict deterrence of fiduciary duty rules make it unnecessary to introduce external monitors to supervise trustees' conduct; and (iii) the 'process-oriented' standard of fiduciary duty rules effectively maintain the flexibility and efficiency of fund management, which can be regarded as the most advantages of English trust.

It can be concluded from the above comparative analysis that although the dual ownership in English law does not exist in other jurisdictions, there are still some cost-efficient approaches to introduce the protection mechanism of English trust law into Roman law traditions. The related experience in Scottish trusts offers a costless model for keeping the independent management by professionals and effectively regulating the agent's behaviour. In a civil law or mixed jurisdiction, the legal nature of the so-called equitable right should be regarded as a kind of *in personam* right, which is mainly a remedial power for the beneficiary. At the same, the ownership of trust assets must be completely conveyed to the trustee who is expected to remove the beneficiary's control of the trust assets. Meanwhile, unless the third party or trustee's private creditors are *bona fide*, the trust assets can be protected from the claims of the above persons and the beneficiary has the right to claim against the trustee in court.

At the same time, the judicial practices of trusts in England has provided a practical standard of manager's legal liability in different circumstances and some cases also show that for rational investors, the rational expectation of a trustee's performance and reasonable market risk is required; in other words, the fiduciary duty rules should reflect not only the legal requirement and regulation of a trustee, but also the basic awareness of commercial risk of an investor who is intending to engage in trust investment, both of which should always be the fundamental principles of any business legal systems.

3.6 The Private Equity Investment Trusts in China

3.6.1 An Overview of China's PE Investment Trusts Market: 1990s–2015

As one of the early achievements of the policy of opening up, the first trust investment company, namely China International Trusts Investment Corporation (CITIC) was established by China's State Council in 1979. Thereafter, hundreds of trust investment corporations were incorporated all around China. By late the 1990s, as many as 239 trust investment corporations (including the trust investment departments of commercial banks) were established in China.[88] After six waves of reorganization during the 1990s to 2007, most of those small-scale and unqualified trust investment institutions had been ordered to dissolve and currently the number of the licensed trust investment corporations has declined to 68,[89] all of which are currently regulated by the China Banking Regulatory Commission.[90] In a

[88] Hui Guo, 'Trust Industry in China: Theories and Practices' (Doctoral thesis, Southwestern University of Finance and Economics 2000) 8 [郭辉. 中国信托业：理论与实践，西南财经大学金融学博士学位论文，2000, 第 8 页].
[89] China Trustee Association's (CTA') official website: http://www.xtxh.net/About_Us/.
[90] Hereinafter referred to as the 'CBRC'.

practical respect, the first PEIT was issued by CITIC in 2007.[91] Afterwards, the quantity and capitalization of PEITs in the Chinese capital market were expanded at a high rate. By the first quarter of 2011, the proportion of PEITs in China's trusts industry had risen from 1.3% (March 2007) to 16.01% (March 2011).[92]

Generally speaking, during the 1980s to 1990s, the main business of most trust investment corporations in China included cross-border investment, real estate investment, international trade, finance leasing and trust loans, whereas collective investment did not emerge until 1991.[93] The first generation of collective investment funds was established in a trust structure in Beijing, Shanghai and Shenzhen. By the end of 1997, there were 79 collective investment funds in China with capitalization of RMB6.83 billion.[94] However, there was almost no real private equity investment trust in China until a series of laws and regulations were legislated in 2007. In 2001 and 2006, the Law of Trusts of China was enacted and the Partnership Law was revised respectively, which provided a legal system for investors to engage in private equity and venture capital in unincorporated forms. In terms of PEITs, the two specific regulatory documents established the basic legal structure for carrying out private equity and venture capital investments in China. The one is the Rules on Trust Schemes of Collective Funds by Trust Companies[95] (released in 2007 and revised in 2009)[96] and the other is the Guidelines for Trust Companies to Operate the Trust Private Equity Investment Business (2008),[97] both of which will be discussed in details in the next section.

3.6.2 The Legal Structure of China's Private Equity Investment Trusts

According to the Trust Law (2001), the Rules (2009 Revision) and the Guidelines (2008), the PEITs in China are commonly structured as follows: the licensed trust corporation issues the

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[91] The 'CITIC JINXIU Private Equity Investment Trust Scheme (Ⅰ)'[中信・锦绣一号股权集合信托投资计划] <http://trust.ecitic.com/upload/product/jxyh-1.pdf> accessed 14 April 2014.
[92] See the statistics from Benefit. *Private Equity Trust Fund Report* available at http://doc.mbalib.com/view/d4dcd0063dc7e271232a6682574dab44.html and CTA. *Main Business Data of Trust Companies(1st Quarter 2011)* which is available at http://www.xtxh.net/Trust_Statistics/7880.html.
[93] Hui Guo (n 88) 3–7.
[94] Ibid., 6.
[95] [信托公司集合资金信托计划管理办法(2009 年修订)]. The official English version is available at http://www.cbrc.gov.cn/EngdocView.do?docID=2008021460B29446D37C7BD8FF97A8A63BC79000.
[96] Hereinafter referred to as 'the Rules (2009 Revision)'.
[97] Hereinafter referred to as the 'Guidelines (2008)'. [信托公司私人股权投资信托业务操作指引 (2008)]. The official English version is available at http://www.lawinfochina.com/display.aspx?lib=law&id=7069&CGid.

private equity or venture capital collective investment schemes to qualified investors.[98] The trust corporation, as the trustee, should be responsible for prudently investing the funds in the equity of unlisted companies. In terms of the distribution of profit, the corporation has the right to charge management fee in the amount of 1% to 2% of gross trust assets. Only if the profit rate surpasses the hurdle rate, can the trust corporation enjoy 20% of the profit of the trust fund and the 80% profit will be allocated to the beneficiaries. The basic legal structure of PEITs under China's investment trust law can be illustrated simply by a classic PEITs project Hu Nan Trust Corporation–Venture Capital Collective Investment Trust Scheme (I) (2007)[99] as follows:

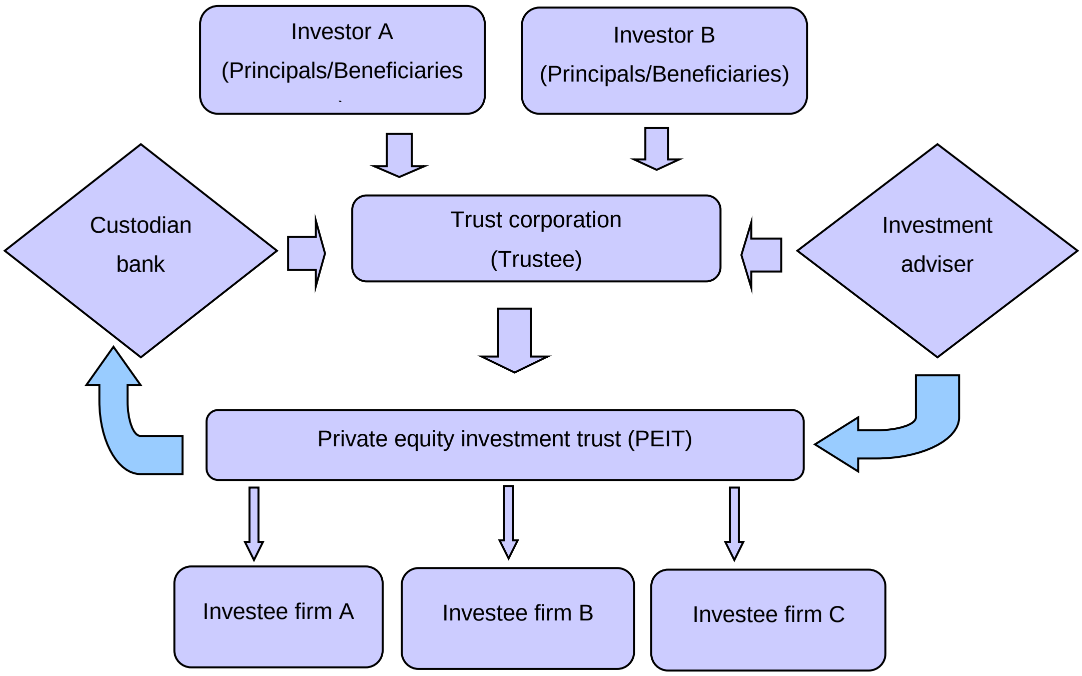

Figure 3.1: The legal structure of PEITs under China's investment trusts law

The Hu Nan Trust Corporation is the trustee who has the power to control and manage the trust capital independently for the interests of beneficiaries and the beneficiaries are not allowed to get involved in the daily business of the project. At the same time, because PE and

[98] According to s 6 of the Rules (2009 Revision), the so-called qualified investor refers to

(1) a natural person, legal person or an organization established according to law, whose minimum investment in a trust plan is 1 million Yuan or more; (2) a natural person whose total individual or family financial assets exceed 1 million Yuan at the time when he/she subscribes the trust plan and who can provide the relevant property certificate; (3) a natural person whose annual income exceeds 200,000 Yuan for the latest three years or whose annual income plus the annual income of his/her spouse exceeds 300,000 Yuan for the latest three years and who can provide the relevant income certificate.

[99] Hereinafter referred to as the 'Hu Nan Project 2007'.

VC investment is categorized as high-risk investment, the trust corporation employed Fortune Capital, a Shenzhen-based venture capital firm to provide professional consultation for trust investments, but any project screening proposed by the venture capital firm has to be approved by the trust corporation. In addition, the venture capital firm does not possess the funds directly, but deposits them into an independent account in the custodian bank, namely the Hunan Branch of the Industrial and Commercial Bank of China, which means that neither the trust corporation nor the venture capital firm is able to arbitrarily dispose of the funds, unless all the investment proposals have been approved by the custodian bank pursuant to the trust agreement.[100] Furthermore, the trustee sets up the beneficiaries' meetings to decide collectively on (i) proposals for reinvestment; (ii) termination and extension of the project; and (iii) the raising of fees for trustees. With the exception of the above matters, any conduct should be exclusively controlled and determined by the managerial team of the trust fund. According to the agreement, the management fees of the Hu Nan project was counted as (i) the fee for the trust corporation made up of 1% of the trust funds; (ii) the fee for the investment adviser (venture capital firm) took up of 2.5% and (iii) the custodian fee represented 0.6% of the trust funds. Finally, after deducting the aforementioned fees and tax, if the expected profit was realized, the venture capital firm was entitled to obtain 15% of the net profit of the project, while 85% of the profit will be distributed to each investor.[101]

3.7 The Legal Problems of China's Private Equity Investment Trusts

3.7.1 Beneficiaries' Intervention in the Beneficiaries' General Meeting

3.7.1.1 Beneficiaries' Voting Rights in the Decision-making Process

Although the Trust Law of China (2001) stipulates that the trustee must honestly and prudently deal with trust affairs in the best interests of beneficiaries,[102] the most serious problem is the lack of a practical standard of fiduciary duties for normalizing the trustee's conduct in China's PEITs. This shortcoming results in the investors being unable to foresee

[100] *See* details of the trust agreement of Hu Nan Trust Corporation Venture Capital Collective Investment Trust Scheme (Ⅰ) at <http://www.baike.com/wiki/%E2%80%9C%E6%B9%96%E5%8D%97%E4%BF%A1%E6%89%98%E5%88%9B%E4%B8%9A%E6%8A%95%E8%B5%84%E4%B8%80%E5%8F%B7%E9%9B%86%E5%90%88%E8%B5%84%E9%87%91%E4%BF%A1%E6%89%98%E8%AE%A1%E5%88%92%E2%80%9D%E6%A1%88%E4%BE%8B%E5%88%86%E6%9E%90> accessed 2 May 2014.
[101] All the information was summarised from the trust agreement of the Hu Nan project.
[102] The Law of Trusts (2001), s 25.

whether the loss of investment in PEITs can be repaid by the trustee and the trustees are also confused about what the boundary is between the losses caused by market risk or breach of trust. As a result, most PEIT investors require substantial power to intervene in the management of the funds for the purpose of securing interests in fund management.

One of the most famous PEITs in China is the Bo Hai Industrial Investment Fund[103] which was initiated in 2006. The investors of the Bo Hai Fund entrusted funds to the trustees, namely BOC International Holdings Limited and Tian Jin Tai Da Investment Holding Company Limited. The two corporations were responsible for managing the fund on behalf of all the investors. However, because the trustees did not shoulder unlimited liability for the loss of the fund and the risk in PE is at a high level in financial investment market, all the investors emphatically required direct decision-making power in the management of the fund. Finally, this demand was approved by an administrative order of the local government. The trustee of the funds and other investors agreed to establish the Bo Hai Industrial Investment Fund Management Company Limited jointly, which was supposed to be the actual trustee of the Bo Hai Fund. The problem is that the actual managers of the investment was the two investment management corporations holding 70% of the shares of the management company, while the beneficiaries obtained 30% shares of the company. Such shareholding structure has actually changed the PEIT to a corporate-type PE fund, in which the beneficiaries' voting right can weaken the efficiency of fund management.

3.7.1.2 The Inefficient Decision-making Procedures of Beneficiaries' Meetings

After the promulgation of the Rules (2009 Revision) in 2007, most PEITs established beneficiaries' meeting in practice. Section 42 of the Rules (2009 Revision) stipulates that if there is no rule of '1) Terminating entrustment contract ahead of schedule or extending entrustment term; 2) Altering entrusted property utilization approaches; 3) Changing the trustee; 4) Raising remuneration for the trustee; 5) Other items that need to be decided by the beneficiaries' meeting as prescribed in trust scheme documents' in trust agreements, a beneficiaries' meeting shall be convened to decide the aforementioned issues. Section 46 also

[103] Hereinafter referred to as 'Bo Hai Fund'. See The Official Introduction of Bo Hai Industrial Investment Fund Management Co., Ltd at <http://wenku.baidu.com/view/32e35c1ba300a6c30c229f97.html> accessed 14 May 2014; Jianfei Zhao, 'Bo Hai Fund: PE Made in China' (2007) [赵剑飞，‘渤海基金：‘PE 中国造’’, 2007] <http://futures.money.hexun.com/2009103.shtml> accessed 14 May 2014.

provides that 'any decision on the issues for deliberation shall be agreed by at least two thirds of the votes before it becomes effective, except for the decisions on changing trustees, altering entrusted property utilization approaches and terminating entrustment contracts in advance, which shall be agreed by all the beneficiaries present at the meeting'. These provisions actually entitle beneficiaries to extremely strict veto power to intervene in the management of PE funds. Practically, all the participants of PEITs have to negotiate all the provisions and details in fund operation, otherwise the trustees and all beneficiaries have to canvass or negotiate with one another to propose any alteration regarding fund utilization.

In recent years, several legal disputes regarding the inefficient voting procedure of beneficiaries' meeting have emerged in China. In the case of Zheng Da Jin Niu Investment Trust Scheme (2012), owing to the continual huge losses suffered by the trust fund, some beneficiaries required that the trust be terminated ahead of schedule by convening a meeting of the beneficiaries, but were refused by the trustee, namely CCB Trust Company Limited. Pursuant to the trust deed and the Rules (2009 Revision), if the trust corporation refuses to convene the beneficiaries' meeting, 'those beneficiaries who hold more than 10 per cent of the total trust units shall have the right to convene a meeting'.[104] However, the gross capital of the Scheme was as huge as RMB 400 million and most investors only held RMB 3 to 5 million, which meant that the beneficiaries' meeting could only be convened by at least ten investors' joint calling. Eventually, after protracted negotiation between the beneficiaries, up to the voting at the beneficiaries' meeting on January 2013, the gross losses of the investment was increased from 28% (April 2012) to 50% (January 2013). What's more, although the trust corporation provided a series of alternative investment plans, because the termination of trusts in advance or changing the utilization approaches of trust assets should be approved by all the beneficiaries, the final solution to this case was an 18-month extension of the scheme with specific redemption dates.[105] In a technical sense, it is obvious that the above decision-making procedure of the beneficiaries' meeting was unsatisfactory, the management of the fund was not improved and the long-term process of the meeting seriously increased transaction costs.

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[104] The Rule (2009 Revision), s 43.

[105] Shuo Zhang, 'CCB Da Jin Niu Scheme: Huge Losses, Few Remedy' (30 January 2013) [张硕，'建信证大金牛信托巨亏 50% 补救策略难落地'，腾讯财经，2013 年 1 月 30 日] <http://finance.qq.com/a/20130130/000326.htm> accessed 20 May 2014; Zosenda Group, 'A Case Study of CCB Da Jin Niu Scheme' (19 December 2012) [深圳中晟达基金, '建信证大金牛增长集合资金信托计划事件始末'，2012 年 12 月 19 日] <http://blog.sina.com.cn/s/blog_b565528c0101ay90.html> accessed 20 May 2014.

3.7.2 The Ineffective Monitoring of Custodian Banks

3.7.2.1 The Relationship between Custodian Banks and Trust Corporations in China

In English trusts the settlor generally is unable to control or supervise the trustee directly, the agency problems in trusts is more serious than partnerships and corporations. For settling this matter, most countries' investment trust law requires a qualified third party to safeguard the funds and supervise the trustee's management. Similarly, the existing Securities Investment Fund Law (2012 Revision)[106] and the Rules (2009 Revision) also require the investment fund manager or trust corporation to employ a commercial bank to be the custodian of the fund. Theoretically, for the effectiveness of the supervision, the basic requirement of a custodian bank is that the custodian should not be an affiliated enterprise of the funds management corporation. For example, s 28 of SIFL (2012 Revision) prohibits a fund custodian and a fund manager from making capital contribution to or holding each other's shares. Additionally, s 18 of SIFL (2012 Revision) also prevents the directors and fund managers from being in a position of a custodian of the fund or hold shareholding interests in custody. However, the Rules (2009 Revision) only require that 'in the duration of a trust scheme, the trust company shall choose a sound commercial bank as its custodian',[107] but does not restrict the affiliation between the trust corporation and commercial bank.

In comparison with other types of collective investment trusts, the management of PEITs is more complicated, hence the managers of PEITs are required to have special skills and experiences in PE or other related fields. However, since the early 1980s, most of China's trusts corporations were only allowed to invest in some particular low-risk markets, such as debt financing, finance lease or even international trading, and until 2007 the development of China's PEITs was officially admitted by the Chinese authorities; in other words, the trust corporations in China have not effectively established their own networks and commercial reputation in the private equity and venture capital market. Hence, at present quite a few PEITs are sold, raised and kept by commercial banks, and then managed by professional PE and VC firms. In this way, the trust corporations can economically use commercial banks'

[106] Hereinafter referred to as 'SIFL (2012 Revision)'.
[107] The Rules (2009 Revision), s 19.

network of clients[108] and establish their reputation by co-operating with PE firms. Accordingly, those trust corporations that are held by commercial banks[109] have been more competitive in China's PEIT market. This is the main reason why the laws and regulations in China do not forbid the connected relationship between the trust corporations and custodian banks.

3.7.2.2 The Legal Status of the Custodian Bank of Private Equity Investment Trusts

According to the Rules (2009 Revision), the statutory duties of custodian banks of a PEIT mainly include

> 1) Safely keeping the entrusted property in custody; (2) Opening different accounts for different trust schemes to ensure the independence of entrusted property; (3) Confirming and carrying out the trust company's order of managing and utilizing entrusted property; checking up the transaction records, funds and accounts of the entrusted property; (4) Recording entrusted funds transfers and keep letters of illustration for fund use delivered by the trust company; (5) Periodically working out custody reports to the trust company. (Section 21)

and

> In case that the trust company violates laws and regulations, or the entrustment contract, or the custody agreement, the custodian shall immediately notice in written the trust company to set right; where material violation or an event that seriously threaten the safety of entrusted property occurs, the custodian shall report to the CBRC promptly. (Section 22)

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[108] See Jianchun Zhang, Jingyi Yu, 'The Relationship between China's Monetary Trusts and Commercial Banks' 2005(4) China Urban Economy 24 [张建春、于敬一，'我国资金信托计划与商业银行的关系'，中国城市经济，2005 年第 4 期，第 24 至 27 页].

[109] Up to 2013, China Industrial International Trust Company Limited held by China Industrial Bank, CCB Trust Company Limited held by China Construction Bank and Bank of Communication International Trust held by Bank of Communication accumulatively managed RMB1,170 billion in China's trusts industry, represented 11% of the whole trust asset of China trusts industry. The stable and wide client base is the most important advantage of the above trust corporations. Zhuoqing Yang, and Huiru Zhong, 'Huge Strength Disparity of Trust Corporations, Bank-based Trust on the Top' (7 July 2014) [杨卓卿、钟惠茹，'信托公司直销实力悬殊大银行系信托优势明显', 证券时报，2014 年 7 月 17 日] <http://finance.china.com/fin/xt/201407/17/9486013987.html> accessed 22 August 2014.

In other words, the function of the custodian bank of PEITs is to be responsible for the security of the trust funds and to supervise the trustee's performance, but not to dispose of directly of the trust property.

However, according to the definition of a *trust* under the Law of Trusts (2001), a trustee's role in a trust is managing or disposing of the property rights.[110] A further question is whether the custodian bank is a joint trustee under Chinese law; in other words, although the custodian bank's functions of PEITs are unlikely to be regarded as 'disposing of trust property', but whether it should be regarded as 'managing trust property'? Although the current statutes of trust law and relevant regulations do not provide an express answer to this problem, the current Law of the People's Republic of China on Commercial Banks (2003 Revision)[111] excludes the possibility of trust investment businesses operated by commercial banks in China.[112] Therefore, it can be seen that the relationship between a trust corporation and a custodian bank of PEITs in China is not 'joint trusteeship', but a sort of general contractual relationship; that is to say, the employment of a custodian bank independently depends on the trust corporation's selection, and the rights and obligations of custodian banks in supervising the trustee's performance in PEITs has no direct legal relationship with settlors.

3.7.2.3 The Ineffective Supervision by Custodian Banks

As mentioned above, the prime function of the custodian is to keep the fund safe by virtue of supervising the trust corporation's utilization of the funds. Nevertheless, the current governance model of PEITs can hardly achieve this goal. The interested relationship of some trust corporations and commercial banks may benefit the managers or shareholders of the custodian banks from the trustee's opportunistic behaviors, which substantively weakens the effectiveness of custodians' supervision. And the trust corporations tend to select those commercial banks that are likely to compromise with trustees, as the employment and selection of custodian banks are absolutely determined by the trustees of PEITs; that is to say, the market of custodian banks in China's trust industry is distorted and lacks competition.

[110] The Law of Trusts (2001), s 2.
[111] Hereinafter referred to as the 'Law of Commercial Banks (2003 Revision)'. [中华人民共和国商业银行法（2003 年修订）].
[112] The Law of Commercial Banks (2003 Revision), s 43.

The custodian fee is the only income for the custodian banks in PEIT businesses, once the fixed custodian fees are earned, the custodians may have no further motivation to diligently supervise the performance of the trustees. In addition, owing to the unclear liability mechanism in Chinese laws, the custodian banks may also have very little pressure to supervise the trustees. Overall, the main problem regarding the custodian banks of PEITs in China is the lack of economic motivation and independent legal status, which results in custodian banks hardly being able to supervise the trust corporations in fulfilling their duties optimally in fund management.

3.7.3 The Economic and Social Factors linked to China's PE Investment Trusts

Compared with experienced PE and VC firms, the Chinese trust corporations' unprofessional management in private equity businesses finds it difficult to establish their own reputation in private equity and venture capital markets. As an alternative strategy, quite a large number of trust corporations choose to make 'zero-loss promises' to investors, by which the trust corporations successfully attract more investors, especially those individual investors who are unwilling to undertake high risk.[113] The Rules (2009 Revision) clarify the fact that trust corporations are not allowed to make any form of 'zero-loss promises' to investors,[114] with the result that the distorted PEITs market indulged and fostered numerous irrational investors. The rationalization in China's private equity and venture capital market was seriously eroded.

In fact, the law and regulations consistently position trust investment including PEITs, as high-risk financial investment activities. By the second quarter of 2014, besides those institutional investors, high net value[115] individuals had become the second-largest client base of trusts.[116] The problem is that even though those rich individuals have enough money to

[113] Miaojun Wang and Yanting Cui, 'Zero Loss Promises: the Dangerous Poison to China's Trusts Industry' (26 December 2013) [王苗军，崔彦婷, '信托"刚性兑付"是中国信托业发展的最大地雷'，2013 年 12 月 26 日], <http://www.zhongguoxintuo.com/xtxw/4046.html> accessed 12 May 2014; Tan Ye, 'Ponzi Scheme in China's Trusts Industry' (24 February 2014) [叶檀，'庞氏骗局谁都躲不过'，2014 年 2 月 24 日] <http://blog.sina.com.cn/s/blog_49818dcb0102fvta.html> accessed 12 May 2014.
[114] The Rules (2009 Revision), s 8 and 11.
[115] Hereinafter referred to as the 'HNV'.
[116] By the end of June of 2014, the CISs invested by qualified individual investors represented 26.36% of the total amount in CISs in China, ranking only second to the CISs invested by institutional investors (67.99%). Xiaoming Zhou, 'A Review of the Development of China Trust Industry during the Second Season of 2014-Stable Growth and Structural Optimization in Transitional Development' (11 August 2014) [周小明，'2014

invest in PEITs, due to their vocational and educational backgrounds, quite a large number of them may not have the necessary knowledge or experience[117] to rationally understand and predict the risks in the complex financial investment and corporate governance in private equity and venture capital businesses. Consequently, when some CISs defaulted, more and more individual investors irrationally or even violently required trust corporations to pay the full amount of principal and interests.[118] Therefore, the authorities also tend to require or encourage the trustees to provide zero-loss promises to investors[119] for the purpose of securing the social stability of China, which is always deemed by the CCP as the primary political assignment.

In addition, the shareholding structure of the 68 trust corporations in China is also a notable factor. According to the list of trust corporations released by the China Trustee Association,[120] 50 trust corporations are controlled by state-owned enterprises[121] and 5 are controlled by the bureaux of finance of local governments;[122] in other words, at present stage around 80% of China's trust corporations are controlled by national capital. Therefore, if the

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年 2 季度中国信托业发展评析——转型发展下的平稳增长和结构优化'，中国信托业协会，2014 年 8 月 11 日] <http://www.xtxh.net/xtxh/analyze/20279.htm> accessed 29 September 2014.

[117] According to the *Forbes China Private Wealth White Book* (2010), by 2010 the HNV individuals from Guangdong Province, Jiangsu Province, Zhejiang Province, Beijing and Shanghai represented 53% of all the HNV individuals in Mainland China. By 2010, more than 53% of China's HNV individuals came from (i) manufacturing industry (19.8%), (ii) trade (22.3%) and (iii) real estate (11.6%), and in terms of the educational background, as high a percentage as 31.4% of China's HNV individuals do not hold a bachelors or above degree from higher education institutions <http://www.forbeschina.com/upload/pdf-2.pdf> accessed 13 May 2014.

[118] For example, on 26 February 2014 owing to the default of the *Song Hua River Collective Investment Trust Scheme no.77* issued by JI LIN Province Trust Co., Ltd, dozens of investors jointly protested against the trust corporation and China Construction Bank at the gate of the custodian bank, requiring the trustee to fulfil the zero-loss promise. See 'Shanxi Branch of China Construction Bank Involved in the Default of JI Lin Trust Company Limited: Investors Protested at the Gate' (27 February 2014) ['山西建行陷吉林信托危局遭投资者堵门抗议'，大公财经，2014 年 2 月 27 日] <http://finance.takungpao.com/q/2014/0227/2306859.html> accessed 13 May 2014.

[119] As regards this issue, for instance, s 2(1) of The Direction on Risk Regulation of Trust Corporations (2014) [中国银监会办公厅关于信托公司风险监管的指导意见（银监办发 [2014] 99 号）] provides that '

> the shareholders of the trust corporation shall undertake or agree in the Articles of the corporation to provide necessary liquidity support in the circumstance where the liquidity risk take places. If any operating loss causes a loss to trust corporation's capital, the corresponding amount of capital must be reduced; and the scope of business shall be cut down or the shareholders of the trust corporation shall timely increase the capital funds to make up for the deficit
> <http://www.cbrc.gov.cn/govView_69DB963082914C498028012863245973.html> accessed 15 May 2014.

[120] Hereinafter referred to as the 'CTA' and 'SOEs' respectively.

[121] For instance, 85% shares of Bank of Communication International Trust Company Limited are held by Bank of Communication of China; 95% shares of Zhong Hai Trust Company Limited are held by the China National Offshore Oil Corporation.

[122] For instance, 97.5% shares of Ji Lin Province Trust Company Limited are held by JI Lin Provincial Department of Finance, and so forth.

trust funds default, those state-controlled trust corporations are able to repay the full amount of capital and interests to beneficiaries, as strong SOEs or governmental shareholders can provide adequate cash to do so. Against this background, it is obvious that the personal interests of the trust fund managers and the directors of trust corporations have a close relationship with the SOEs or local governments' nominating powers. Considering the above-mentioned relationship between the clients of China's trust investment and government, it is not unreasonable to argue that both the lack of private incentive in shareholding structure and the political pressure from the current Chinese political climate motivate the management layer of trust corporations to avoid any loss to investors, no matter whether or not the loss is caused by regular market risk.

In relation to the form of remedy for the losses of PEITs, because any zero promises have been identified as invalid by China's authorities, if the trust corporations fail to repay their promised profit to investors, trust corporations have to settle the disputes in private, rather than letting the investors file lawsuits. For example, trust corporations may sell the failing or bankrupted PEITs to asset management companies or negotiate with local governments to seek bailouts, or even use their own capital to repay investors' losses.[123] Moreover, in traditional Chinese culture, any litigation may have a negative impact on individuals, families and social community. Thus, trust corporations have to do their best to avoid lawsuits for the purpose of maintaining and protecting their vulnerable commercial reputation in China's private equity and venture capital market. Although the Trust Law (2001) and the regulations issued by the CBRC allow the participants in investment trusts to solve disputes by means of litigation, until now there have been very little litigation regarding disputes between the parties of trust investments.[124]

[123] In recent years, public attention has been drawn to a series of defaults in China's collective investment trust schemes, that is, Credit Equals Gold #1 Collective Trust Product (defaulted in January 2014) (中诚信托 ·诚至金开 1 号集合投资计划) issued by China Credit Trust Company Limited; *C.R. Trust-Stable and Benefit CIS (Ⅵ)* (defaulted in December 2013) (华润信托 ·稳益 6 号集合投资计划) issued by China Resources Trust Company Limited; Mineral Trust-Shanghai Rongteng Properties CIS (defaulted in July 2013) (五矿 ·上海荣腾置业集合投资计划) issued by Mineral International Trust Company Limited and Changbai Mountain #11 Nan Jing Joint Strength Collective Trust Scheme (defaulted in April 2012) (吉林信托 ·长白山 11 号南京联强集合资金信托计划) issued by Jilin Trust Company Limited and so forth. The losses of all the aforementioned default events have been covered by the trust corporations or a third party's bailout.

[124] For instance, An Xin Trust Company Limited, V Chun Gao Company Limited (2013) [安信信托投资股份有限公司诉昆山纯高投资开发有限公司等四被告信托纠纷案, (2013)沪高民五（商）终字第 11 号民事判决书].

Consequently, the 'zero-loss promises' in China's trust industry have seriously led to two main problems, the one is that the SOEs and governmental shareholders are actually using the money of taxpayers, who are mostly ordinary citizens, to inappropriately pay for the rich who only represent an extremely small part of the whole population of China.[125] The other legal problem is that until now the Chinese courts have not issued a practical standard or official judicial interpretation, and the widely accepted private settlements for disputes between trustees and beneficiaries also make it hard to convey or expose the real problems in China's PEIT market. Therefore, the authorities are not motivated to reform or improve the legislation for their own political concerns.

3.7.4 The Barriers to IPOs of the Investee Companies in Chinese Stock Markets

At present, in practice, PEIT-involved companies are generally prohibited by the CSRC from listing on the domestic stock markets in China for the reason that the shareholding structure of such listing candidates cannot satisfy the disclosure requirements. According to China's Securities Law (2013 Revision), the requirement is that any company that has been listed or is planning on being listed must disclose (i) the name list of the top 10 shareholders of the company and their respective shareholdings, and (ii) the persons in practical control of the company [126] for preventing the connected transactions problems. Because the trust corporations have the duty of confidentiality towards beneficiaries, the list and shareholding of beneficiaries in PEITs will not be disclosed to regulators and public investors. Therefore, the CSRC is likely to reject the application for the reason that if the shareholder of a listed company is in the name of a PEIT, public investors cannot identify who the actual controllers of the listed company are.[127] The issue in respect of the governance structure of PEITs is that actually the real shareholder of the listed company is the trust corporation, because the trust

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[125]According to *The Private Wealth Report of China (2013)* issued by China Merchants Bank (CMB) and Bain and Company China, by the end of 2013 high net value (HNV) individuals (the individuals who own investable assets worth no less than RMB10 million) in China are expected to reach 0.84 million, representing only 0.062% of the whole population (1.36 billion by the end of 2013) <http://www.bain.cn/news.php?act=show&id=451> accessed 1 July 2014;'The Data of the Population Growth by the End of 2013' (16 June 2014) [‘2014年最新中国人口数量至2013年年底数据’，本地宝，2014年6月16日] <http://gz.bendibao.com/news/2014225/content152598.shtml> accessed 1 July 2014.

[126] The Securities Law (2013 Revision), s 54 and 66.

[127] Yefang Qi, 'The Research of Private Equity Funds in Trust Form' (LLM Thesis, East China University of Political Science and Law 2012) 32 [戚叶芳，信托制私募股权基金法律制度研究，华东政法大学经济法学硕士学位论文，2012，第32页]; Li Guo, HongYuan Tang, '*The Legal Analysis of Trusts as Shareholders*: *focusing on Private Equity Investment Trusts'* 2010 (3) Securities Market Herald 9 [郭雳、唐宏渊，‘信托主体之股东身份的法律解析——以信托型私人股权投资基金为展开’，证券市场导报，2010年第3期，第9-14页].

under Chinese law does not have an organizational qualification as a shareholder in a limited liability company. The trustees of PEITs are the shareholder of such companies. However, in consideration of the governance structure of China's trust funds discussed above, the beneficiaries can, in fact, actively participate in the management of PEITs; in other words, if the unit-holding proportion of each beneficiary in a given PEIT is not fully disclosed, public investors will have difficulties in identifying the actual ownership structure of such listed companies and predicting the operation of such companies. Furthermore, the CSRC is also concerned that the PEIT may break the compulsory restriction on the number of promoters of listed companies.[128] As a result, to exit successfully from investee firms, trust corporations have to reorganize PEITs into other organizational structures, such as a corporation or 'trust–limited partnership' structure, both of which will increase the transaction costs in fund management.

3.7.4.1 IPO by Transferring Capital into a Company

In this way, the one approach is for the trust corporation to temporarily transfer the trustee funds into its own account. Therefore, the ownership of the trustee assets will be clarified and be approved by the CSRC. Once listed, the trust corporation returns the principal and profit of the PEITs to the beneficiaries. As the independence between the trustee's and principal's accounts is a basic rule in trust law, this transaction model is seriously violating this statutory requirement. Another widely used alternative strategy is that the trust corporation may establish a limited liability company or joint stock company and then transfer the funds of PEITs into the shell company's independent account for the purpose of making the new company a sole shareholder of the portfolio company. The problem is that, according to the current Company Law (2013 Revision), the numbers of promoters of an limited liability company or joint stock limited company should not exceed 50 and 200 respectively,[129] whereas the Rules (2009 Revision) does not limit the number of qualified investors in any PEITs. Therefore, this alternative way may not only unduly limit the scale of PEITs but also raise the transaction cost in the process of establishing the trust fund and exiting from the investee companies.

[128] Zhi Zheng and Wentao Wang, *Decoding the Trusts* (China Citic Press 2014) 297 [郑智、王文韬，*解码信托*，中信出版社，2014，第 297 页].
[129] Sections 24 and 78.

3.7.4.2 IPO by Altering the PE Investment Trusts into a Trust-Partnership Fund

Although currently PEITs cannot exit investee companies by IPO, by contrast, since 2009, the limited partnership has been allowed to invest in listed firms as an independent institutional investor.[130] As an alternative approach, in order to avoid transaction costs in the process of establishing a company, PEIT investors developed a new structure that combines the legal features of trust and limited partnership. In the first stage, the trust corporation establishes the PEIT as usual and then the trust corporation employs a professional private equity and venture capital firm to be the general partner of a limited partnership who will actually manage and determine the utilization of trust funds. At the second stage, the PEIT (limited partner) and the private equity firm (general partner) will respectively subscribe around 90% and 10% of the funds. In the process of the fund operation, the beneficiaries will be charged fixed fees by both the trust corporations and private equity and venture capital firm, and the general partner will earn carried interest.

Figure 3.2 indicates that the shareholding structure of the trust–limited partnership private equity fund is much more complicated than general PEITs. Because the trust corporation should pay an amount of fees to private equity firms (investment adviser), this transaction model will decrease the actual profit of beneficiaries. The problems are whether this type of private equity fund should be regarded as a trust or a limited partnership and who should be liable for the mismanagement of the fund? According to s 30 of the Law of Trusts (2001) and s 26 of the Measures for the Administration of Trust Companies (2007),[131] the trustee is allowed to re-entrust the business of the trust fund to other persons, but the trustee must be liable for all the legal consequences of the re-entrustment. However, s 21 of the Guideline (2008) stipulates that the investment adviser should only provide consultancy for the trust corporation and the investment decision should be independently and solely made by the trust corporation; in other words, any investment decision directly made by external private equity and venture capital firms in PEITs is invalid and illegal. In fact, the trust–limited partnership fund has considerably changed the function of investment trusts. Here the trust corporation

[130] According to s 19 of the revised Measures for the Administration of Securities Registration and Clearing (2009 Revision) [证券登记结算管理办法 (2009 年修订)，第 19 条], partnership enterprises which are registered in PRC are qualified to apply to establish securities accounts.

[131] [信托公司管理办法 (2007)]. The Full English version of this regulation is available at http://en.pkulaw.cn/display.aspx?cgid=83588&lib=law.

only plays a role as an intermediary or conduit between the investment adviser and beneficiaries, its profit only comes from the fixed management fee paid by trustors, which means that after the establishment of the fund, the trust corporation will have no motivation to supervise the private equity firm's management. Consequently, although this type of PEIT may temporarily make it possible to exit by IPO, the transaction costs in such a complicated organizational structure is evidently higher than the simple structure of private equity investment.

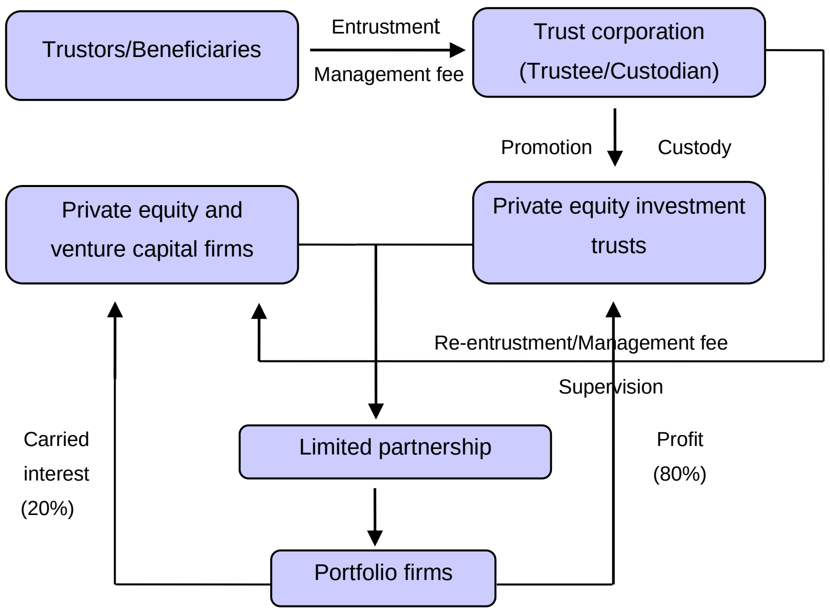

Figure 3.2: The legal structure of the PEITs with 'trust with limited partnership' form

3.8 A Proposal for the Legal Reform of China's Private Equity Investment Trusts

From the above discussion it is obvious that the current regulatory approaches and governance structures cannot effectively and efficiently secure the safety of trust funds nor enhance the trust corporation's management of PEITs. With reference to western countries' experience and lessons, this research tries to provide a proposal for further legal reform of China's PEITs, which mainly focuses on the following domains: (i) breaking the zero-loss promise and specifying the standard of qualified investors of PEITs; (ii) removing beneficiaries' active participation in management and clarifying the boundary of trustees' fiduciary duties; (iii) enhancing the custodian banks' supervision role in PEITs. Eventually, if the above problems can be solved, the barrier to IPO of PEITs-involved companies in Chinese stock markets may be solved.

3.8.1 Break the 'Zero-loss Promises': Privatization and Rationalization

As a result of the ongoing mixed ownership reform of Chinese SOEs, improvement in the governance structure of Chinese trust corporations can also be expected. Non-state and international investors will have a strong interest in improving governance within the Chinese trust industry, as it is the sole kind of financial sector without restrictions on investment. The privatization of trust corporations will accelerate the development of marketization and rationalization of the private equity investment trust industry and then, as a result, a more reasonable market entry standard will be highly demanded as well. Therefore, the first part of this reform proposal can be specified in two domains: (i) diversify the ownership structure of China's trust corporation, by which the motivation of 'zero-loss promises' will be inherently reduced in the PEIT market; and (ii) establish a more substantive approach (rather than the exercise of administrative discretion) for selecting qualified investors, by which the Chinese PEIT market will be rationalized. Both elements of the reform proposal are aligned with the current trajectory of reform in China and should therefore be feasible in the medium-term.

3.8.1.1 Mixed Ownership Reform of the Trust Corporations in China

Since the Decision on Major Issues Concerning Comprehensively Deepening Reforms[132] was issued by the Central Committee of the CCP in November 2013, a new wave of marketization reform of China's SOEs has been launched, in which the legitimacy and political foundation for mixed ownership reform of the SOEs was established. It has been proven in this research that the state-controlled ownership structure of China's trust corporations is one of the factors that causes the distorted governance structure of PEITs and the barrier to the IPOs of PEIT-involved companies in China's domestic stock markets. Therefore, this research tends to conclude that the mixed ownership reform of trust corporations is an essential way to break the zero-loss promise myth and rebuild the rationality of the PEIT market.

[132] Hereinafter referred to as 'Decision (2013)'. The Decision on Major Issues Concerning Comprehensively Deepening Reforms (12 November 2013) [中共中央关于全面深化改革若干重大问题的决定（2013 年 11 月 10 日审议通过）].

Specifically, strategic institutional investors should be positively encouraged to invest in or even control state-owned trust corporations, by which the diversified shareholders will have inherent motivation to refuse the zero-loss promise. In such a way, the non-state shareholders can also impose pressure on the managers of the trust corporations, by which the lack of owners of SOEs will be solved and the quality of corporate governance of the trust corporations will be improved. At present, the first pilot privatization of trust corporation was finalized by early 2015, the SDIC Trust Corporation Company Limited, one of the state-owned trust corporations, was invested by two non-state financial firms, and, as a result, the shareholding of non-state shareholders represented 35% of the ownership of the SDIC.[133] Therefore, it can be expected that the further mixed ownership reform of the trust industry in China will be promoted and encouraged in the near future for the purpose of improving the efficiency of corporate governance and breaking the zero-loss promise.

3.8.1.2 Test Qualified Investors in Substantive Approaches

As summarized at the beginning of this chapter, the nature of a trust is the trustor's true belief that a particular trustee's skills, experience and good will in particular businesses can independently guarantee the best interest of the beneficiary. From an economic perspective, one could say that the prime advantages of business trusts are the efficiency by excluding non-professionals' intervention and the fund safety by strict fiduciary duty rules. However, it should not be ignored that the legitimacy of all the above legal features of business trusts must be based on the trustor's necessary investigation of trustees' qualification before he or she decides to establish the trusteeship with the fiduciary; in other words, the chief requirement of a so-called qualified investor should focus on the necessary understanding of the risk in connection with a particular type of trust investments, and the prudent investigation of the trustee's reputation and experience in such areas.

In China's regulatory regime of PEITs, the qualified investors rule only sets the minimum investment amount or personal income threshold on PEIT investors and generally requires the trustee to fully disclose the relevant risk in business trust investments.[134] However, the

[133] Qingshan Liu, 'The Mixed Ownership Reform of SDIC Trust Corporation' *Finance Sina*, (Beijing, 26 January 2015) [刘青山，'国投信托混改破局'，新浪财经，2015 年 01 月 26 日] <http://finance.sina.com.cn/leadership/mroll/20150126/110921397351.shtml> accessed 24 June 2015.
[134] The Rules (2009 Revision), s 6 and 7.

substantive testing approaches of investors' ability to identify risk have not yet developed. The problem is that although most investors of PEITs are those high net wealth individuals and institutional investors, to enhance the rationalization of the market and reduce unnecessary losses to PEIT participants, the law should provide a series of substantial testing standards to recognize the qualification of PEIT investors and enhance the rationalization of the private equity and venture capital market.

In the UK's financial regulatory system of collective investment schemes CISs (including private equity funds), a series of specific testing standards are expressly provided. According to the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) Exemptions Order 2001,[135] qualified investors of an unregulated CIS can be tested by both the 'quantitative requirement' and 'qualitative requirement', which are aimed at judging a person's risk tolerance and ability to identify risk. In terms of the knowledge requirement, s 14 of the CIS Order (2001) only allows an investor who is (i) an authorized person; (ii) a person being exempted under s 38(1) of the FSMA (2000) in relation to one or more relevant scheme activities; (iii) a person carrying out daily activities involving unregulated schemes; (iv) a government, local authority or international organization; and (v) a director, officer or employee of the above kinds of 'persons', where the position may enable him or her to participate in unregulated schemes. Besides, s 23 of the CIS Order (2001) also allows an investor who has a certification signed by an authorized person for the purpose of showing that he or she obtained enough professional knowledge of risk identification of a particular private investment to be qualified as a 'certified sophisticated investors'.[136]

As discussed above, because China's trust corporations are not as sophisticated as professional private equity firms, the only way to cost-efficiently expand the business is to establish a co-operative relationship with commercial banks. As a consequence, unlike those limited partnership private equity funds both in China and international markets, the main clients of China's PEITs are not institutional investors, but wealthy individuals, many of whom may not have enough knowledge and experience in financial investment. This point can partly answer the questions why the beneficiaries of China's PEITs tend to intervene directly or even participate in the management of the funds.

[135] Hereinafter referred to as 'CIS Order (2001)'. The full official text of this statute is available at http://www.legislation.gov.uk/uksi/2001/1060/contents/made.
[136] For more details are available in Timothy Spangler, *The Law of Private Investment Funds* (OUP 2008) 28–42.

With reference to the above statutes in common law jurisdictions, in order to reduce beneficiaries' irrational intervention, a practical testing approach should be established that can effectively select those qualified investors who are not only wealthy but also knowledgeable in risk judgment. For example, the authorities may provide a detailed basing-point system for trust corporations to screen PEITs investors. Firstly, the trust corporations may regard the senior professional practitioners[137] in certain investment-related careers as qualified investors, who can rationally judge the risk in private equity investment by their professional experience. Secondly, for non-professional investors, the regulator can require trust corporations not only to check the net wealth of individual investors, but also compulsorily interview, for example, or conduct background investigations into potential investors, all of which should be filed with the CBRC. The CBRC should then have the power to repeal the qualification of the investors who fail to self-prove the ability of risk judgment of PEIT investment. To enforce the trust corporation to fulfill the obligation of the above investigation, the CBRC should be empowered to punish trust corporations that willfully or negligently approved unqualified investors in PEIT investment. As regards institutional investors' ability to judge risk, the regulator should also expressly issue a specific testing direction that should focus on the members of the management layer's educational background and professional experience and, in terms of enterprises, trust corporations should assess the business performance within the past five years to judge whether the institutional investor is able to effectively consider the risk of PEIT investment.

In summary, although a potential investor's qualification generally can only be estimated on a case-by-case basis, the regulator of China's trust industry should establish a feasible testing guideline for trust corporations and specify strict legal liability and punishment of the trust corporations who fail to duly examine an investor's qualification. Only in this way, may the PEITs regulatory regime effectively eliminate irrational investors and push other investors to carefully consider the venture regarding PEIT investment. Furthermore, with the rationalization of clients of PEITs, qualified investors can understand the rationale for, and market risk of, PEITs, which can also push the trust corporations to promote their services competitively. Eventually, only when the trustees' professional management and services

[137] For instance, the (former) managers, (former) directors or senior business lawyers, analysts and consultants in commercial businesses, and so forth.

have been substantially improved, may the beneficiaries give up the irrational intervention and make the transactions more efficient.

3.8.2 Trustee's Independent Management and Establish Judicial Fiduciary Rules

3.8.2.1 The Efficiency of Using Fiduciary Rules for Reducing Agency Costs

At the outset of this section, an economic analysis of creating and applying fiduciary duty rules in comparison with detailed provisions in statutes will be helpful. To be more precise, the fiduciary duties is defined as a kind of 'standard', in which the content of law is given after individuals' acts, whereas detailed statutory provisions contain much more fixed and express detailed requirements of behaviors which is categorized as 'rule'.[138] Briefly, the frequency with which a law governs behaviors determines the choice of rules or standards. If a given conduct is frequent and recurring, enacting detailed provisions in legislations in one time will be more economical than using standards, as the prediction of how the adjudicator may practically interpret the vague words in standards will be costly for individuals[139]. In contrast, if a conduct is infrequent, a standard will be preferable for regulating or normalizing behaviors, as specifying all the contingencies of infrequent behaviors will be expensive and most of such prediction may be wasteful.[140] The economic analysis of fiduciary duties, both functionally and historically, has shown that the role of fiduciary duties is reducing moral hazard and providing remedies for principals when the agent has taken opportunistic behaviors. Hence, using a set of standards such as fiduciary rules which are continually developed in adjudication would be a wisdom choice, as addressing the agency problems in business trusts can hardly be specified *ex ante* in legislations.

Moreover, as noted in the first chapter of this work, the feasibility and transplantability of fiduciary law mainly depends on the quality of judiciary in a given importing country and the basic fact of China is that the political and social attitudes towards judicial intervention in business activities are conservative. At the same time, however, it also should be borne in mind that the economic efficiency and functional advantages of a certain type of business organization are inherently connected with particular sorts of business activities. Therefore, in consideration of the existing large scale market of business trusts in China, this work

[138] Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 Duke Law Journal 557, 560.
[139] Ibid., 621.
[140] Ibid., 621-622.

suggests that the economic efficiency of PEITs can be realized only if investors' unreasonable intervention is avoided, the trust corporations are able to and obliged to conform the fiduciary duties in practice. Of course, undoubtedly this may take time.

3.8.2.2 Remove Beneficiaries' Meeting's Inefficient Intervention

In terms of beneficiaries' right of intervention, when beneficiaries are dissatisfied with the performance of the trust corporations, according to both the Law of Trust (2001)[141] and s 42 of the Rule (2009 Revision), the beneficiaries are able to intervene directly in the management by exercising their voting right. As analyzed above, however, quite a large number of investors may hardly rationally and efficiently give practical advices on improving the decision-making related to trust funds. In this regard, the depositary and regulator may jointly make an effort to defuse investors' dissatisfaction efficiently. Pursuant to the FSMA (2000) in the UK, any proposals to alter the provisions of the trust deed or change its manager must be approved by the Financial Conduct Authority[142] and the trustee must submit a written notice stating the reasons for such a change to the regulator;[143] in other words, the intention to make any alteration to the fund must be verified by the professional institutions rather than unprofessional investors.[144] Accordingly, the rules regarding the power of beneficiaries' meeting of China's PEIT regulatory regime might be improved as follows:

Firstly, as the custodian banks are entitled to consistently monitor the manager's behavior, the most pragmatic and cost-efficient way to deal with beneficiaries' objections to the performance of trust corporations is requiring the beneficiaries who are unsatisfied with the trustee's management to claim from the depositaries (mostly the custodian banks in China).

[141] Section 21 of the Trusts Law (2001) prescribes that '[t]he trustor has the right to ask the trustee to adjust the methods of management of the trust property if the methods prevents the realization of the purposes of the trust or are not in accordance with the interests of the beneficiary due to special causes that are not foreseen when the trust was established'.
[142] Hereinafter referred to as the 'FCA'.
[143] Section 251 of the FSMA (2000).
[144] In terms of the rules of voting powers of investors' general meeting under the FSMA (2000), according to COLL4.3.4 of the FCA Handbook, only those 'Fundamental changes including '(a) changes the purposes or nature of the scheme; or (b) may materially prejudice a unit-holder; or (c) alters the risk profile of the scheme; or (d) introduces any new type of payment out of scheme property' need to be approved by the general meeting. While the Handbook also provides that the appointment or replacement of a manager of an authorised unit trust (AUT) is a 'significant change' which generally does not need to be approved by the investors general meeting and the law only requires the pre-event notification to all the investors (COLL 4.3.6A). Similarly, any change of a depositary is also only determined by FCA, the investors are not allowed to directly participate in the determination of such a change but are entitled to be notified pre- or post the event (COLL 4.3.9(e)). <http://fshandbook.info/FS/html/FCA/COLL/4/3> accessed 16 June 2014.

The custodian may determine whether the trust corporation's conduct should be adjusted on the grounds of its independent investigation of the issue. If the custodian bank agrees to adjust the management of the trust fund, in accordance with s 22 of the Rules (2009 Revision), the custodian must require the trust corporation to set right with a written notice and, in the meantime, if the trust corporation refuses to make any correction, the custodian bank must report it to the CBRC promptly. Where the beneficiaries still feel dissatisfied with the regulator's decision, they have the right to transfer their shares in the fund to other qualified investors.[145]

Secondly, in the case where the trust corporation breaches its fiduciary duty or unduly disposes of trust assets and causes loss to beneficiaries, the current regulatory system in China also overly entitles the beneficiaries' meeting to determine power to dismiss[146] or change[147] the trustee directly. However, neither the regulations legislated by the CBRC nor the Trust Law (2001) imposes a duty of approval on the regulator. Theoretically, the vast majority of investors must be risk-averse, hence any managerial behavior that can cause loss to investors is likely to be doubted or even intervened. The problem is that although it is possible that the trust corporations may have contravened the duties and failed to manage the fund in the best interest of the beneficiaries, it is also quite simple that the loss caused by market risk should be taken by investors themselves. In order to improve the efficiency of the decision-making process, it is recommended that the power of the beneficiaries' meetings to replace a trustee should be revised as 'submitting a proposal to the custodian'[148] and the latter has the duty to investigate the beneficiaries' complaint carefully. If the custodian also agrees to change the trust corporation, it must provide a detailed report to the CBRC and the final decision should only be made by the regulator.

[145] Section 29 of the Rules (2009 Revision) provides that '[i]n the duration of a trust scheme, the beneficiary can transfer its trust units to qualified investors. The trust company shall conduct procedures for the beneficiary with that respect.'
[146] Section 23 of the Trust Law (2001).
[147] Section 42(3) of the Rules (2009 Revision).
[148] Furthermore, it is also recommended that the current voting procedure of beneficiaries' meeting, which is prescribed in Article 46 of the Rules (2009 Revision), be amended as 'any proposal to alter the property utilization approaches or replace a trust corporation should be agreed by at a simple majority (but not all) of the votes present at the meeting'.

3.8.2.3 Establishing Judicial Rules to Clarify Trustee's Duties

As analyzed at the beginning of this chapter, the economic efficiency of trust law is on the ground of the separation between ownership and control of trust property and the fiduciary duty is a remedial mechanism for the principal to strengthen him-herself against the agent's discretionary power, which is mainly carried out and standardized by the courts. In Chinese trust law system, the court's statutory judicial power of intervention is quite limited. Up to now there are only two provisions that generally prescribe the court's role in trust businesses. Specifically, s 22 and 23 of the Law of Trusts (2001) respectively provides that 'if the trustee disposes of the trust property against the purposes of the trust or causes losses to the trust property due to violation of the management duties or improper handling of the trust affairs, the trustor has the right to apply to the people's court for withdrawing the disposition' and '[i]f the trustee disposes of the trust property against the purposes of the trust or is at serious fault when managing, utilizing or disposing of the trust property, the trustor has the right to remove the trustee according to the provisions of the trust documents or apply to the people's court to remove the trustee'. The function of both the provisions has made it possible for investors in PEITs to be relieved by the court where their interests are being or have been infringed by the trustee's behavior. However, owing to the undue intervention by beneficiaries' meeting, a similar remedial function of the court's power to withdraw has not been sufficiently exercised.

In fact, once the law and regulations have removed the beneficiaries' intervention power, the disputes between trust corporations and investors must be settled by a neutral third party. For the purpose of reducing litigation cost, the basic procedure of dispute settlement should be as follows: any disputes should be preliminarily settled by the CBRC and then if the parties are not satisfied with the decision, they should be entitled to file a lawsuit that should mainly involve the claim of compensation against the trust corporation that breaches its fiduciary duty and causes loss to investors, or the replacement of a trustee. Correspondingly, the court may exercise its judicial power to withdraw any misconduct of the trust corporation and compel the trust corporation to revert the trust property or compensate the beneficiaries. The court should also have an exclusive right to replace a trust corporation to protect beneficiaries' interests. Under the present commercial law of China, a system of practical standards of fiduciary duty rules can only be established by removing beneficiaries' direct intervention and encouraging the court to actively exercise the power of withdrawal or replacing a trustee for the purpose of addressing the disputes and protecting the beneficiaries' interests, as fiduciary duty is a kind of practical standard which must be developed on a case-by-case basis.

In comparison with the case law of both common law and civil law trusts, the above proposal for China's further reform regarding the establishment of fiduciary duty regime may, to some extent, successfully reflect the basic function of trust law. Similar to the Scottish legal system, it is also unrealistic to establish a divided ownership structure between the trustee and beneficiary in Chinese trust law. Alternatively, the exercising of judicial power to withdraw can also provide effective remedy for beneficiaries without irrational intervention. This point of view is reminiscent of the nature of a trust in Scotland. As the case of *Armour v Glasgow Royal Infirmary* (1909) shows in the circumstance where the trustee breaches a duty, the beneficiary cannot directly exercise a tracing right, otherwise the existence of an ownership for a beneficiary makes it possible to permit the beneficiary intervene in the management of the trust. Hence, the beneficiary has to exercise his or her claim right by resorting to the court. Correspondingly, the actual function of fiduciary duty rules of a civil law trust is that the beneficiary is entitled to enforce a trustee who has breached his or her fiduciary duty to cancel an unlawful transaction and claim a remedy against the trustee by resorting to a court order; in other words, the institution of the power of withdrawal can provide a sufficient remedy by correcting any misconduct on the part of the trustee without entitling the beneficiary to a proprietary right. In relation to the judicial practices regarding fiduciary duty rules in England, if the Chinese trust law regime can be improved to empower the courts with substantive remedial power, the institutional functions and advantages in English trusts may be transplanted and developed in China, because litigation can gradually develop a standard to the public that will be a practical guideline for both the trust corporations and investors.

In sum, if the regulator and court can play a leading role in dispute settlement regarding the PEITs in practice, trust corporations can clearly identify the ambit of legal duties from the verdicts by the court, and investors will also recognise in which circumstances the law and court may exempt trust corporations from the liability and investors must suffer the loss at their own risk. Only in this way can investors be educated to consider the potential risk and their actual risk tolerance more carefully and rationally before deciding to engage in private equity and venture capital investment, and trust corporations will also have a strong incentive and pressure to enhance their professional skills in private equity fund management diligently, and not only negatively play a role as the 'conduit of capital'.

3.8.3 The Legal Reform of Custodian Banks of PE Investment Trusts in China

3.8.3.1 Custodian Bank as the Co-trustee of PE Investment Trusts

One of the problems regarding the custodian bank of China's PEITs is that because the trust law system in China defines the relationship between custodian banks and trust corporations as a sort of contractual relationship and the nomination of custodian banks of CISs is exclusively determined by the trustee, there is no direct legal relationship between the custodian bank beneficiaries. In this situation, once the custodian fails to fulfil its duty of safeguarding, the beneficiaries are unable to claim against the custodian.

In this regard, the experience of the UK's CISs regulatory system may have some useful implications.[149] The FSMA (2000) provides that the application of a CIS registered in the UK must be made to the authority by the manager and trustee who should be independent of each other.[150] Pursuant to the Glossary of Financial Conduct Authority Handbook (2014),[151] the 'depositary'[152] is the trustee of an authorized unit trust[153] scheme and the main duties of a depositary are (i) safekeeping of the trust property and (ii) overseeing of the fund manager's performance.[154] Therefore, depositary trustees are required to fulfil their duties under the UK's trust law.[155] What is more, if the trustee violates the duties under the FSMA (2000), the FCA has the power to revoke an authorization made by the manager and trustee of an AUT[156] and if the FCA considers that the trustee has contravened or is likely to contravene the

[149] Under Part XVII of the FSMA (2000) 'Collective Investment Schemes (CISs)', there are three main types of CISs, namely (i) AUT schemes, (ii) open-ended investment companies and (iii) recognized overseas schemes. By functional comparison, the AUT is the legal structure ta tis the most similar to China's PEITs.
[150] FSMA (2000), s 242(1)–(2) and 243(4).
[151] This document is available at http://fshandbook.info/FS/html/FCA/COLL/6/2.
[152] The term 'depositary' under the FSMA (2000) is the same as both the 'custodian' in the Trustee Act (2000) in the UK and 'custodian bank' in Chinese law; both of which are mainly in charge of the safekeeping of trust assets.
[153] Hereinafter referred to as an 'AUT'.
[154] *See* details in the section on 'Collective Investment Schemes Sourcebook' of the *Financial Conduct Authority Handbook* <http://fshandbook.info/FS/html/FCA/COLL/6/6> accessed 16 June 2014.
[155] Furthermore, s 253 of the FSMA (2000) does not allow the parties to waive the trustee's duty of care, hence the trustee (depositary) of AUTs should comply with the requirement of the duty of care under the Trustee Act (2000).
[156] Section 254.

requirement imposed by the FSMA (2002),[157] the FCA has the power to require the trustee to wind up the scheme up.[158] In this scenario, the court has the power to issue an order to remove the trustee.[159]

In terms of the regulatory framework under the FSMA (2000), the further issue is: what is the relationship between the investor and the manager of a unit trust? Although the law of FSMA (2000) does not clarify the legal status of the manager of AUTs, at least the contractual relationship between investors and manager makes it possible to allow investors to claim against the manager for breach of duties under the contract. The difference between the manager of AUTs as trustee or contractual party is that if the manager is statutorily defined as the trustee of CISs, the manager must fulfil the duty in accordance with a higher standard. Moreover, some equitable remedial approaches (e.g., the tracing right) provided by equity and general trust law will apply, which means that if the fund manager is regarded as the trustee of investors, the legal protection of beneficiaries' interest will be sounder than a contractual relationship.[160]

Inspired by the above regulatory approaches, to protect the interests of beneficiaries and the supervising custodian's conduct in China's PEITs, the regulators of the CBRC should expressly define the legal status of a custodian bank of PEITs as a trustee, but not only a contractual party with the trust corporation. From a macro perspective, currently the business model of the Chinese financial market is separated; in other words, different financial sectors such as commercial banks, insurance companies and trust corporations are operated and regulated separately[161] and, generally speaking, other unprofessional financial institutions such as securities brokers and commercial banks are not permitted to engage in China's PEITs business. Thus, although the governance structure of CISs under the FSMA (2000) is providing a mixed regulatory model for beneficiaries, which means that beneficiaries are able to respectively exercise the remedial powers against both the trustee based on fiduciary relationship and the manager based on contract, in China, however, it may be costly to exchange the legal statuses of the trust corporations and custodian banks (actually the

[157] Section 257 (1) (b).
[158] Section 257 (2)(b).
[159] Section 258 (1) (a).
[160] Iain G MacNeil, *An Introduction to the Law on Financial Investment* (2nd edn, Hart Publishing 2012) 182–183.
[161] For more background information see Hui Guo (n 88) 93–98.

depositary). Therefore, under the current Chinese regulatory system, the trust corporation should still be the fund manager and trustee of PEITs.

Secondly, there is the possibility to allow custodian banks to be the joint trustee of PEITs, because s 43 of current the Law of Commercial Banks (2003 Revision) does not absolutely prohibit the Chinese commercial banks from engaging in trust investment.[162] It is recommended that the CBRC clarifies the legal status of the custodian bank under the Rules (2009 Revision) as the joint trustee of PEITs. In this way, the CBRC and the court can also impose the duties of care and of loyalty on the custodian banks[163] in accordance with basic trust law principles.

Thirdly, according to s 32 of the Law of Trusts (2001), if the trustee breaches the duties of the law or in the trust deed, the custodian bank may be jointly liable for the losses to the beneficiaries. This formal liability will motivate the custodian bank to carefully supervise every dealing instruction proposed by the trust corporation.

3.8.3.2 The Appointment Procedure and Incentive Mechanism of Custodian Banks

Accordingly, if the legal status of the custodian bank is a joint trustee, the appointment of the custodian should therefore also be determined by investors, instead of the trust corporation. However, considering the lack of professional knowledge of custodian banks, the investors may not be able to determine the selection of a custodian for PEITs properly. Alternatively, the authorities can entitle the final power to appoint to the CBRC who will make the commission on behalf of the beneficiaries of PEITs. Firstly, to establish a competitive custodian banking market, the trust corporation should draft a list of candidate commercial banks by way of an open tendering system and then submit the list of candidates to the CBRC for approval. The CBRC as the chief regulator of PEITs should carefully check each

[162] Section 43 of the Banking Law (2003 Revision) [中华人民共和国商业银行法（2003) 年修订）] provides that ‘No commercial banks may, within the territory of the People’s Republic of China, engage in trust investment or securities business, or invest in immovable property which is not for private use, in non-banking financial institutions or in enterprises, except where otherwise provided for in the regulations of the State.’

[163] In this regard, s 25 of the Law of Trusts (2001) prescribes that ‘[t]he trustee shall fulfil his duties and perform the obligation of being honest, trustworthy and cautious, and managing effectively’and s 4 of the Rules (2009 Revision) also requires that the trust corporations ‘shall be faithful to its duties and fulfill the obligation of being honest, credible, prudent and diligent, so as to best serve the beneficiaries’, both of which are the current legal basis of the trustee’s fiduciary duty regime under China’s trusts system.

candidate bank's documents, compare the records of each bank's historical performance and finally appoint one of the candidates as the custodian bank for a given PEIT. The advantage of this appointment procedure is that the employment of a custodian bank will no longer be exclusively determined by the fund manager, but a neutral regulator who can only make a judgment based on the professional performance and reputation of each candidate bank.

As some institutional economists properly argued: 'If owners of cooperating inputs agree with the monitor that he is to receive any residual product above prescribed amounts (hopefully, the marginal value products of the other inputs), the monitor will have an added incentive not to shirk as a monitor.'[164] If the statutes allow the custodian bank to earn a proportion of the performance fee from the profit of the funds, the custodian bank will have a motivation to secure the transaction, at least the custody will have incentive to prevent the trust corporation from engaging in overly high risk projects.[165] In more detail, it is recommended that the CBRC revise the Rules (2009 Revision) that after the appointment by the CBRC, the custodian bank should be in a position of a trustee and then the custodian fee and performance fee should be determined through negotiation between beneficiaries, the trust corporation and the custodian bank. However, in the meantime, the regulation may statutorily require that the 'performance fee' for custodians should not surpass the amount of the fixed custodian fee. Furthermore, with reference to the relevant provision of the Trust Law (2001),[166] the CBRC may consider adding similar provisions in the Rules (2009 Revision) that if the custodian bank fails to safeguard the security of trust property or does not properly supervise the instructions proposed by the trust corporation, the custodian will not be allowed to earn any custodian fee before the loss has been compensated. Finally, because the custodian is recognized as the trustee of PEITs, that is, where the custodian

[164] Armen A. Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organizations' (1972) 62 American Economic Review 777, 782.

[165] According to a self-regulated document for commercial banks' custodian business, namely the Guideline for the Price of Custodian Banking Products issued by the China Banking Association (CBA), the recommended rate of custodian fees for trusts business is 0.15–0.6% of the fund capital. By contrast, trust corporations who only play a role as the 'conduit of capital' but not a managing or active party in operating the funds, are entitled to gain the management of 1–2% of the fund. This fee structure may not provide adequate incentive to the custodian bank to work hard in the interest of beneficiaries. <http://www.chinaprice.gov.cn/fgw/chinaprice/free/redian/M_H_0_0898_100318.htm> accessed 17 June 2014.

[166] Section 36 of the Trust Law (2001) stipulates that 'If the trustee disposes of the trust property against the purposes of the trust or causes losses to the trust property due to violation of the management duties or improper handling of the trust affairs, the trustee must not ask for remuneration before he has reverted the trust property or made compensations.'

contravenes the duties, the beneficiaries' general meeting should have the power to replace the delinquent bank subject to the CBRC's approval.

3.8.3.3 Custodian Banks' Power of Intervention against Trust Corporations

According to the Rules (2009 Revision), in the scenario where the custodian finds the trust corporation in breach of duties in the trustee deed or under the law, the bank only has the right to notify the trustee or report it to the CBRC in good time.[167] However, the custodian bank does not have any substantive power of intervention to correct the trust corporation's misconducts, which has reduced the effectiveness of the custodian's supervision. By contrast, pursuant to part COLL 6.6.14(4) of the CIS Sourcebook of FCA,[168] the depositaries of CISs are entitled to notice or warn the trust corporation of the breach of duties.[169] If the request or instruction given by a managing trustee eventually results in the breach of trust, the depositaries should refuse to act under the managing trustee's direction. Therefore, part COLL 6.6.10 of the FCA Sourcebook expressly requires that any investment or disposition of the scheme property proposed by the fund manager must obtain the consent of the depositary and if the depositary does not believe that the manager's investment proposal is acceptable, the depositary has the power to request the fund manager to cancel or change the proposal.[170]

As for the custodians of PEITs in China, the regulation should additionally entitle the trustee to the power of refusing to obey any unjustified instruction from the trust corporation. If the trust corporation refuses to rectify its misconduct upon the custodian's notification, the custodian bank must inform the CBRC of the above issues immediately to prevent and minimize potential loss to beneficiaries. Furthermore, if the custodian bank fails to fulfil the above duties and then causes loss to beneficiaries, the trust law will require the custodian to be jointly liable for the loss caused by the trust corporation's default. In such a way, the custodian banks may play a more positive role in protecting beneficiaries of PEITs.

[167] The Rules (2009 Revision), s 22.
[168] Hereinafter referred to as the 'FCA Sourcebook'.
[169] For details, see the section on 'Collective Investment Schemes Sourcebook' of the Financial Conduct Authority Handbook <http://fshandbook.info/FS/html/FCA/COLL/6/6> accessed 21 June 2014.
[170] Ibid.

Chapter 4: The Protection for PE Shareholders in Corporate Governance

4.1 Introduction

With the rapid development of the private sector in China's economy in the period 1990s to 2010s, private equity institutions have been playing an increasingly influential role in the corporate governance of Chinese companies. Although the reform of Chinese company law is constantly evolving, due to the particular political-economic background of the public-owned sector of the Chinese economy, protection for private equity investors in portfolio companies is still inadequate. As a consequence, a series of corporate governance failures in PE-held firms in China have occurred during recent two decades, which reflect that the legal nature of the problems in the corporate governance of Chinese PE-held companies is the lack of legal mechanisms counterbalancing the interests of heterogeneous shareholders in corporate governance. By contrast, UK company statutes and judicial practices form a typical shareholder-centred company law system that provides much more contractual flexibility and protection for PE shareholders to safeguard their interests via active participation in corporate governance. From the perspective of legal transplantation, the legislative and judicial experience of UK company law may be referred to improve the protection of private equity and venture capital shareholders in the context of Chinese company law.

The first section of this chapter generally reviews the functions of PE and VC in corporate governance, and analyses the specific connection between the company law in common law jurisdictions and the development of the PE and VC industry. The second section analyses the three main dimensions of the protective mechanisms for PE shareholders under the company law in the UK. It is argued that the liberalization and contractualization of corporate entities, decision-making processes and capital structure under the UK's company law system have soundly entitled the shareholders (especially the minorities) a series of rights to effectively control the corporation and supervise the director's performance. The section that follows focuses on the practical issues in the leading cases regarding the corporate governance of PE-held companies in China. The main problems include the uncertainty about the controlling shareholder's power to amend the articles of association, contest for corporate control and variable interest entity (VIE) regime under the existing company law and capital regulations of China. Finally, compared with the related experiences and lessons from other transition economies, this chapter suggests that the substantial dilution of single controlling shareholders' control in the public-owned companies and an independent regulatory body of the securities market should be a precondition of introducing a shareholder-centred company law system. Based on the above comparison and analysis, this chapter recommends that the restrictions on the controllers' power in amending articles of association should be clarified further, where the judicial intervention will be quite indispensable. Owing to the immaturity of the Chinese entrepreneurs, however, encouraging the use of supplementary agreements between private equity investors and founder-controllers may not be proper nor efficient in the current situation. As a feasible and expected alternative, the preferred shares and dual-voting system should be highly recommended for enhancing the private equity shareholders' rights in the corporate governance of portfolio companies in China.

4.2 The Functions and Agency Costs of Private Equity in Corporate Governance

4.2.1 Private Equity and Corporate Control

Berle and Means stated that in modern corporations the owners' control over the corporation has been separated from their ownership.[1] In a corporation with a highly dispersed ownership structure 'the controlling group even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profit for it'.[2] Since then aligning the interests of the board of directors and the shareholders has been the core issue of corporate governance and the institutional economy. In Berle and Means' approach, it would be difficult for the shareholders who only hold a small portion of stocks to guard their interests in the shares of a corporation which is actually controlled by its managers. After more than half-a-century's development, although the dispersed ownership structure in public companies still dominates the business world in Anglo-American jurisdictions, the rise of institutional investor activism in the past three decades has been reshaping the landscape of corporate governance and even the developing path of company law.

[1] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers 1968).
[2] Ibid., 144.

Generally speaking, shareholder activism can be described as 'the way in which shareholders can assert their power as owners of the company to influence its behaviour'.[3] Firstly, shareholder activism means that the shareholders' actions are usually able to make some changes in the company.[4] Secondly, activism is a kind of governance model against the manager-centric model, which is mainly aimed at reducing the agency cost between the management and owners by enhancing the shareholder's control.[5] Thirdly, from a regulatory perspective, the errors and illegal business judgement made by the corporate management may not be restricted efficiently if the fiduciary duty system or negligence system is not established. In such a circumstance, the shareholders can actively participate in decision-making to correct the inappropriate behaviour of the management.[6] Moreover, from a social perspective, shareholder activism can also play a positive role in protecting public interest by avoiding the inefficient governance of public corporations.[7]

Shareholder activism is commonly categorised in two forms: (i) defensive shareholder activism and (ii) offensive shareholder activism. The former usually refers to the institutional shareholders such as pension funds and insurance companies who 'hold significant blocks of company stock and advocate for change only when company fortunes decline'.[8] By contrast, 'offensive activism is characterised by the motivation of profit-seeking and, more often than not, is followed by the prompt exit from the company when the returns have been generated, or if the campaign has not resulted in the expected returns'.[9] Private equity as one of the most typical activists in corporate governance is able to influence the management of companies significantly. It is not uncommon that the manager may have strong motivation to prioritise his or her personal interest by misappropriating the resources of the corporation. One of the effective resolutions to this is to give the management an incentive which can align the interests of the agent and owner.[10] As a kind of institutional controller in corporate governance, PE funds usually perform as the vehicle for leveraged buyouts (LBOs) which

[3] European Corporate Governance Institute (ECGI), 'Shareholder Activism' <http://www.ecgi.org/activism/> accessed 21 September 2015.
[4] Paul Rose and Bernard A. Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' (2015) 2014 Brigham Young University Law Review 1015, 1017.
[5] Edward B. Rock, 'Adapting to the New Shareholder-Centric Reality' (2013) 161 University of Pennsylvania Law Review 1907.
[6] Iris H-Y Chiu, *The Foundation and Anatomy of Shareholder Activism* (Hart Publishing 2010) 21.
[7] Ibid., 33–63.
[8] Rose and Sharfman (n 4) 1034.
[9] Iris H-Y Chiu (n 6) 71.
[10] Micheal C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) Journal of Financial Economics 305.

result in the management layer of the investee company involved in the transaction with a significant shareholding of the company. In this manner, the agency cost between the management and owners will be reduced[11] and the practice of corporate governance can be strengthened.[12] Compared with the stock options for chief executive officers (CEOs) of public corporations, the CEO or senior managers' stock in PE-held firms can only be cashed when the PE fund successfully exits from the company or liquidates, which can push the management to work more sustainably on the long-term interests of the company.[13] The high-level debt financing in PE-backed buyouts also acts as an effective disciplinary device on the behaviours of management.[14] Moreover, private equity funds as the owner with concentrated and significant ownership in the corporation commonly have a strong voice in the boardroom, by which the private equity shareholders are able to intervene in a timely manner in the significant decision-making process and monitor the performance of the management.[15]

In summary, from the above overview of shareholder activism and institutional investors in corporate governance, it is clear that in a general sense, the positive influence of institutional shareholders in corporate governance is based on the controlling status of the firm. In terms of private equity investors, the protection of private equity shareholders' interest is mainly realised by acquiring significant shareholdings in the capital structure of the corporation. In the circumstance where the private equity fund does not hold enough stocks in the ownership structure of the corporation, the agency cost between the entrepreneur and the private equity shareholders is likely higher.

4.2.2 Venture Capital Funds as Minority Shareholders in Corporate Governance

In a general sense, a special type of private equity, namely the venture capital takes a minority sum of shares of the investee firm.[16] Thus, owing to the lack of equity control power

[11] Mike Wright, Kevin Amess, Charlie Weir and Sourafel Girma, 'Private Equity and Corporate Governance: Retrospect and Prospect' (2009) 17 (3) Corporate Governance: An International Review 353, 355.
[12] Organisation for Economic Co-operation and Development (OECD*), The Role of Private Equity Firms and 'Activist' Hedge Funds in Corporate Governance* (May 2007).
[13] Harry Cendrowski et al, *Private Equity: History, Governance, and Operations* (2nd edn, Wiley & Sons, 2012) 172–173.
[14] Ibid., 173–174.
[15] Mike Wright, Donald S. Siegel, Miguel Meuleman and Kevin Amess, 'Private Equity, Leveraged Buyouts and Corporate Governance' in Mike Wright et al. (eds), *The Oxford Handbook of Corporate Governance* (OUP, 2013) 543; Wright et al (n 11) 171–173.
[16] Wright et al (n 11) 20–22.

in corporate governance, the operation or the VC-held company and the legal protection mechanism for venture capital funds is mainly established on a contractual basis,[17] by which the agency problems between the management and the VC investors can be attenuated. The VC fund invests in the high-growth but those small start-up companies which usually lack mature experts of business operation. Moreover, the centralised ownership structure of start-ups may also bring disadvantages in monitoring the managers of the firm.[18]

From the perspective of value creation for corporations, the contractual mechanism in VC-involved companies contributes to improvement of corporate governance in the following respects: on the one hand, the contractual provisions between the entrepreneur and venture capitalist can restrict the manager's discretionary power and enhance the monitoring of the management layer. For instance, venture capitalists can hold the power to replace the founder-CEOs when their performance is unsatisfactory and [19] exercise a veto right to prevent inappropriate decision-making.[20] The venture capital investors commonly use a series of covenants to limit the entrepreneur's power in assets or purchase of sales, for example, mergers and acquisitions and the issuance of shares.[21] At the same time, the professional representatives of venture capital firms can provide more accurate advice for decision-making and improve the quality of corporate governance of investee companies.[22] On the other hand, venture capital contracts adopt multi-level capital financing instruments to prioritize cash flow to VC investors in different circumstances. In most cases, venture capital shareholders hold the preferred stocks in portfolio companies[23] which can have precedence over ordinary stocks in the event of bankruptcy and dividend payment.[24] In addition, convertible securities such as convertible preferred stock or convertible bond also provide the

[17] Douglas Cumming and Sofia Johan, 'Venture Capital and Corporate Governance' in Mike Wright et al. (eds), *The Oxford Handbook of Corporate Governance* (OUP, 2013) 516–538; Franklin Allen and Wei-ling Song, 'Venture Capital and Corporate Governance' (2002) The Working Paper Series of the Wharton Financial Institutions Center #03-05/2003, 18 < http://fic.wharton.upenn.edu/fic/papers/03/p0305.html > accessed 20 September 2015.
[18] Maik Kleinschmidt, 'Venture Capital, Corporate Governance, and Firm Value' (DPhil thesis, Universität Hamburg 2006) 1.
[19] Tim Pollock and Ted Baker, 'Who's Minding the Store? Venture Capitalist Styles and the Replacement of Founder-CEOs' (The Frontiers of Entrepreneurship Research, Babson College, Massachusetts, 2005) <http://fusionmx.babson.edu/entrep/fer/2005FER/chapter_xiv/paper_xiv4.html> accessed 28 September 2015.
[20] Cumming and Johan (n 17) 526.
[21] Ibid., 524–525; Brad Feld and Jason Mendelson, *Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist* (2nd ed., Wiley 2012) 63–67.
[22] Wright et al (n 11) 9.
[23] Feld and Mendelson (n 21) 33–34.
[24] Cumming and Johan (n 18) 522.

VC fund with the right to safeguard the economic interests in investment, by which the flexible capital forms can help the VC shareholders reduce the agency costs through the process of corporate governance of portfolio companies.[25]

From the overview of the main provisions in the contracts between the VC funds and investee companies, it can be concluded that the legal protection of the VC minority shareholders is based on a special corporate law system providing both the constraints on the majority shareholder or CEO's governance power and preference in capital allocation for minority shareholders, by which the outside shareholders' risk in the whole process of investment can be hedged or reduced. In fact, to some extent, the practical effect of venture capital contracts can be compared with the loan agreement in banking finance.[26] For example, the preferred right in liquidation provided by preferred shares can be compared to the senior or secured short-term debt lent by banks, both of which preferentially safeguards the economic interests of suppliers in the event of liquidation.[27] In addition, similar covenants restricting the entrepreneur's decision-making power are also used in bank financing. For instance, the entrepreneur may be required to pre-negotiate the consent of the bank creditor before making particular kinds of business decisions and further borrowing against the collateral assets may be limited by the loan agreement as well.[28]

4.2.3 The Foundation for the Corporate Governance in PE-held Companies

Although it has been stated that judicial intervention is playing a core role in protecting investors in business organizations, from the above analysis it is clear that in both the buy-out funds as controllers and venture capital funds as minority shareholders in investee companies, the legal protection for private equity and venture capital investors is mainly based on the shareholder primacy principle, rather than external mechanisms such as judicial intervention. As for the private equity fund as majority shareholder in the corporation, the control power can directly undergird investor protection, whereas the interests of the venture capital fund are mainly safeguarded by both the restrictive rules on founder-CEO and multi-level capital

[25] Michael A. Woronoff and Jonathan A. Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities' (2005) 74 Fordham Law Review 101, 104–106.
[26] George G. Triantis, 'Financial Contract Design in the World of Venture Capital' (2001) 68 University of Chicago Law Review 305.
[27] Ibid.
[28] Ibid.

structure in corporate law which can provide a balanced benefit pattern within the corporation. Overall, in consideration of decreasing transaction costs in corporate governance, especially for those transitional economies without strong and sophisticated judicial tradition, a well-balanced internal governance structure under company law and contractual autonomy should be a more feasible approach to protecting private equity and venture capital shareholders in corporate governance.

4.3 The Organizational Protection for Shareholders in UK Corporate Governance

4.3.1 Dispersed Ownership and the Rise of Institutional Investors in the UK

During the second half the twentieth century, the ownership structure of corporations in the UK experienced a transformation from a concentrated pattern to a dispersed pattern which was driven by a series of legal and economic factors. As regards the legal regime, it has been argued that the corporate laws and financial regulation system in common law countries, especially the US and UK, can provide more powerful protection for minority shareholders, in which the controlling shareholder's threat to the outside investors will be restricted by the courts or regulators.[29] Furthermore, in the light of non-governmental factors, the new listing rules enacted by the London Stock Exchange (LSE) throughout 1960s to 1980s[30] and the high-quality services of professional intermediaries organizing the public offerings in the City of London also provided a protective and friendly institutional environment for outside investors.[31] Against this background, the dispersed ownership structure in the UK's corporations was not established until the 1970s.[32]

As mentioned above, the high-level divorce of ownership and control will increase the agent costs in corporate governance, and due to the inefficient decision-making process, the high-

[29] For details, see Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny (LLSV), 'Corporate Ownership around the World' (1999) 54 Journal of Finance 471; Rafael La Porta et al., 'Law and Finance' (1998) 106 Journal of Political Economy 1113; Rafael La Porta et al., 'Legal Determinants of External Finance' (1997) 52 Journal of Finance 1131.
[30] For example, the Listing Rules of the London Stock Exchange (hereinafter referred to as the 'LSE') started to require companies to disclose their annual turnover figures and issue interim financial reports quarterly or half-annually. Furthermore, after the promulgation of the Financial Services Act 1986, the LSE had the power to cancel or suspend transactions of the stocks of non-complying listed corporations. Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed* (OUP, 2008) 358.
[31] Brian R. Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' (2001) 30 Journal of Legal Studies 459.
[32] Ibid.

level dispersion of ownership gives no single shareholder enough incentive to engage in 'collective action' to monitor the management.[33] As a response to this, there was a high demand for professional institutions to actively engage in corporate governance on behalf of the individual investors in British companies.[34] At the same time, the tax-advantaged policies for institutions considerably directed the money flowing from individuals to institutions, especially insurance companies and pension funds.[35] Against this background, institutional investors have emerged since the second half of the 1970s and developed fast during the following decades.[36] Moreover, during the 1950s to 1960s, a large number of state-owned enterprises controlled the social capital and resources in the UK and the economy was significantly directed by governmental intervention. As a policy dealing with the economic decline, the mass-scale privatization of public sectors in the UK's economy was directed by the then Prime Minister Margaret Thatcher's government during the late 1970s and 1980s, the ownership of state-owned companies was effectively transferred to the hands of private institutional investors.[37] In such economic milieu, the institutional investor as a kind of active player in corporate governance brought new challenges to shareholder protection in the UK.

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[33] Iain G. MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' (2010) 5 (4) Capital Markets Law Journal 419, 421.

[34] Ibid., 421.

[35] In detail, for example, the tax treatment of the investment of shares held by intermediaries was more favourable than the direct investment by individuals during the 1970s. Therefore, the insurance companies benefited significantly. Similarly, if a pension fund was approved in the sense of statutory criteria, all the contributions of employers were excluded from the income of recipients for the purpose of tax relief. Brian R. Cheffins (n 31) 346–352.

[36] Tables 4.1 and 4.2 in this chapter show the significant change in the ownership structure in public corporation in the UK during recent decades. The statistics are excerpted from *A Report on the Ownership of Shares at 31st December 1997* (The Office for National Statistics, 1999) 8; *Ownership of Quoted Shares for UK Domiciled Companies, 2014* (The Office for National Statistics, 2 September 2015) 4.

[37] Darryl J.Cooke, *Private Equity: Law and Practice* (3rd ed., Sweet & Maxwell, 2008) XXI; Marjan Petreski. 'The Determinants of Inflation in Post-War Britain: an empirical study' (2006) SSRN Electronic Journal <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=935348 > accessed 10 September 2015; Mike Wright et al., 'Leveraged Buyouts in the U.K. and Continental Europe: Retrospect and Prospect' (July 2006) ECGI: Finance Working Paper No. 126/2006.

Table 4.1: The beneficial ownership of public corporations in the United Kingdom (1963–1997)

Beneficial ownership, 1989-1994 1963-1997

	Percent of total equity owned, 31 December										
	1963	1969	1975	1981	1989	1990	1991	1992	1993	1994	1997
Rest of the World	7.0	6.6	5.6	3.6	12.8	11.8	12.8	13.1	16.3	16.3	24.0
Insurance companies	10.0	12.2	15.9	20.5	18.6	20.4	20.8	19.5	20.0	21.9	23.5
Pension funds	6.4	9.0	16.8	26.7	30.6	31.7	31.3	32.4	31.3	27.8	22.1
Individuals	54.0	47.4	37.5	28.2	20.6	20.3	19.9	20.4	17.7	20.3	16.5
Unit trust	1.3	2.9	4.1	3.6	5.9	6.1	5.7	6.2	6.6	6.8	6.7
Investment trusts					1.6	1.6	1.5	2.1	2.5	2.0	1.9
Other financial institutions	11.3	10.1	10.5	6.8	1.1	0.7	0.8	0.4	0.6	1.3	2.0
Charities etc	2.1	2.1	2.3	2.2	2.3	1.9	2.4	1.8	1.6	1.3	1.9
Private non-financial corporations	5.1	5.4	3.0	5.1	3.8	2.8	3.3	1.8	1.5	1.1	1.2
Public sector	1.5	2.6	3.6	3.0	2.0	2.0	1.3	1.8	1.3	0.8	0.1
Banks	1.3	1.7	0.7	0.3	0.7	0.7	0.2	0.5	0.6	0.4	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. The apparent trends in these series are affected, particularly for the earlier data, by sampling errors and varying degrees of success in the identification of nominee holdings.
2. Unidentified holders have been allocated proportionately across all beneficial sectors.
3. For 1989 to 1994 holdings in SEPON were allocated one-quarter to other financial institutions with the remaining value allocated proportionately across all benficial sectors. Prior to 1989, SEPON was included in other financial institutions.
4. Data for Pension Funds and Insurance Companies were partially estimated in 1992 and 1993, see annex C.6 for further details.

Table 4.2: The beneficial ownership of public corporations in the United Kingdom (1998, 2010, 2012, 2014)

	Per cent				£ billion			
	1998	2010	2012	2014	1998	2010	2012	2014
Rest of the world	30.7	43.4	53.6	53.8	460.9	760.9	862.4	928.6
Individuals	16.7	10.2	10.1	11.9	250.8	179.0	162.0	206.2
Unit trusts	2.0	8.8	9.5	9.0	30.1	153.8	152.0	155.2
Other financial institutions	2.7	12.3	6.6	7.1	40.4	215.0	105.6	123.0
Insurance companies	21.6	8.8	6.2	5.9	325.5	153.8	99.6	101.8
Pension funds	21.7	5.6	4.7	3.0	325.8	98.7	75.7	51.7
Public sector	0.1	3.1	2.7	2.9	1.4	54.4	44.0	50.2
Private non-financial companies	1.4	2.3	2.4	2.0	20.9	40.1	38.5	34.7
Investment trusts	1.3	2.1	1.7	1.8	19.2	37.5	27.9	31.1
Banks	0.6	2.5	1.9	1.4	8.4	44.3	30.3	24.3
Charities, church, etc	1.4	0.8	0.6	1.2	20.4	14.9	9.8	20.1
Total[2]	100.0	100.0	100.0	100.0	1,503.7	1,752.3	1,608.0	1,726.8

Table source: Office for National Statistics

Table notes:

1. Data in 1998 was collected on a different basis compared with more recent years
2. Components may not sum due to rounding

4.3.2 The Inconvenience of Judicial Intervention in Corporate Governance

In addition to the market demands, before the official company law reform launched in 1998, the legal protection for shareholders was mainly rooted in the system of fiduciary duties of equity, and the statutory regulation in company law usually played a supplemental role.[38] However, the costly and complex procedures of judicial intervention in corporate governance have become unfavourable, and more and more impractical to the economic development of the UK.[39] According to a series of official consultation documents and consultation papers prepared for the new legislation in company law, it was widely agreed that the judicial intervention in corporate governance should be simplified and, correspondingly, the shareholders' active control should be encouraged: the strict restriction of derivative actions should be significantly simplified;[40] the directors' duties should be clarified in the written law which can effectively reduce uncertainty in judging the directors' fulfilment of their duties;[41] shareholders general meeting should operate not only as an organ of decision-making, but also an effective mechanism for communication between the board and owners. Especially in the era of institutional investors, the demands of institutional investors' active participation in corporate management should not be ignored. The shareholders should be encouraged to vote by electronic means or proxy approach.[42] At the same time, the majority shareholders' power to amend corporate charters should be limited by special resolutions and entrenched provisions.[43] It was also suggested that the compulsory judicial approval of the alteration of capital such as capital repurchase was overly strict as well, and that, alternatively, the special resolution on the change of capital could fulfil the same function more efficiently.[44]

[38] David Kershaw, *Company Law in Context: Text and Materials* (2nd ed., OUP 2012) 317–318.
[39] Margaret Beckett, President of the Board of Trade (1998), *Foreword to Modern Company Law: For a Competitive Economy*.
[40] Law Commission, *Shareholder Remedies* (Law Com. No. 246, 1997).
[41] The Law Commission and the Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Com. No. 261, Scot Law Com. No. 173, 1999); Department of Trade and Industry, *Company Law Review* (March 2005).
[42] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: General Meetings and Shareholder Communication* (1999); Department of Trade and Industry, *Company Law Review* (March 2005).
[43] The Company Law Review Steering Group, *Company Law for a Competitive Economy: Company Formation and Capital Maintenance* (October 1999).
[44] Ibid.

4.3.3 The Self-protection Mechanisms for Shareholders under UK Law

In response to the above new challenges in the capital market of the UK, the Companies Act 2006 is making a series of progress in improving the internal protection for shareholders, especially minorities. Moreover, to empower shareholders in corporate governance has been adopted as main values of UK company law.[45] In such a way, the powers of particular individual directors or executives in corporate governance are restricted,[46] and shareholders' communication with, and participation in, the board are also strongly encouraged by the law.[47] In addition, institutional investors' active role in corporate governance has also been officially recognized as a due principle in UK corporate governance.[48] In the practical respect, however, without the basic support of self-protection by the company law, it would be impossible to make the above standardised principles of UK corporate governance work well. In the section that follows shareholders' self-protective mechanisms under the Companies Act 2006, all of which are highly important for private equity investors to attenuate agency problems in the corporate governance of investee companies, will be illustrated.

4.3.3.1 The Shareholder's Power in Relation to Corporate Contracts

a. Restrictions on the Amendment of Articles of Association

Articles of association represent a contract between the company and shareholders,[49] in which the basic infrastructure of both the governance and ownership of the firm are fixed, and the rights and duties of each party involved in corporate governance are also clarified.[50] Because the Companies Act 2006 does not provide a clear framework for the power distribution between shareholders and board of directors,[51] the role of articles of association of a company should be especially significant in establishing basic rules of corporate governance of UK companies. Although the articles of association are regarded as a contract, the traditional freedom of contract principles in amending the articles are substantially

[45] See details of recent versions of *The UK Corporate Governance Code* (2010, 2012, 2014, 2016) published by the Financial Reporting Council.
[46] Ibid., s A.2 and B.1.
[47] Ibid., s E.
[48] Schedule C of *The UK Corporate Governance Code* (June 2010).
[49] Companies Act 2006, s 33.
[50] Cooke (n 37) 269.
[51] Kershaw (n 38) 80.

restricted by the statutes and courts which, to a large degree, has diluted the contractual features of the articles of association. Firstly, the articles of association are not absolutely a private agreement between the parties. On the contrary, the law may require the company to disclose the articles to the public by registering with the Companies House.[52] Secondly, the legal force of the articles of association will automatically bind the shareholders who become the parties within the company later, which means that the relativity of contract is also broken through in regard to the articles of association. Thirdly, according to the principles of contract, a contract should not be altered unless all the parties to the contract consent to do so. In contrast, the articles can be altered by special resolution, instead of the full consent of all the shareholders.[53]

The Companies Act 2006 provides that the alteration of the articles of association is subject to the special resolution agreed to by a majority of not less than 75% of the votes.[54] Therefore, there is an obvious risk that the power of altering the constitution of the company might be handled by majority shareholders. Especially in PE-held companies, in the case of the private equity investor as the minority shareholder in the investee company, the private equity shareholders' right may be oppressed by the founder-CEO who is able to determine the alteration of the constitution. As a response to this problem, the constraint against the controlling shareholders in amending the articles of association is really important.

One of the most noteworthy progresses made in protecting minority shareholders' interests in corporate contracts is the permission to using entrenched provisions in drafting articles of association. Pursuant to the Companies Act 2006, an 'entrenched provision' refers to some specified provision in the constitution of the company that can only be amended or repealed if a higher threshold is matched or stricter conditions are met, where the amendment of such provisions is more restrictive than the one applicable to the special resolution.[55] The entrenchment in articles of association may enhance the protection of minorities. For example, the entrenched provisions can only be made at the moment when the articles of association are formed or agreed to by all the members of the company to amend the company's

[52] Ibid.
[53] Companies Act 2006, s 21(1).
[54] Companies Act 2006, s 21(1), 283(1).
[55] Companies Act 2006, s 22(1).

articles.[56] In practical terms, the entrenched provisions can also provide that the amendment of particular issues in the articles is invalid unless the particular member(s) approve it.[57] In such a case, the minority shareholders can better exercise their voting right to counterbalance the majority's oppression and protect their interests in the company.

b. The Shareholder's Agreement as a Constraint on Majority Shareholders

The constitution of a company is a contract between both the members and company, which must be filed with the Companies House and be publicly disclosed.[58] By contrast, in the circumstances where some or all shareholders want to contract privately with respect to particular issues, the shareholders' agreement may be created. Moreover, although the minority shareholder's right can be strengthened by applying entrenched provisions in creating the articles of association, those shareholders who hold very small sums of shares may be oppressed by other shareholders. In such a situation, the specified minority shareholder's rights can be safeguarded by entering into a shareholders' agreement which cannot be altered or repealed unless all the contractual parties of the agreement agreed to do so.[59]

The legal issue that needs to be considered is the limit of the contractual freedom in creating the shareholders' agreement. The basic principle in the practice of this area is generated from the leading case *Russell v Northern Bank Development Corp Ltd* [60] decided by the House of Lord. The four executive managers and the defendant who are the majority shareholder jointly owned a company, and all the shareholders and the company entered into an agreement after the incorporation of the company. One provision of this agreement stipulated that the company was not permitted to create or issue new shares without the written consent of each party to the agreement. Nonetheless, the company summoned a general meeting at which a resolution of creating new shares was proposed. Russell, one of the shareholders of the company, filed a lawsuit attempting to prevent other shareholders from voting in favour of the resolution.[61] The Court of First Instance and Appeal Court dismissed the application,

[56] Companies Act 2006, s 22(2).
[57] Kershaw (n 38) 84.
[58] Ibid., 93.
[59] Sean FitzGerald and Graham Muth, *Shareholders' Agreements* (5th ed., Sweet & Maxwell, 2009) 4.
[60] *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R. 588.
[61] Kershaw (n 38) 94.

but finally the House of Lord supported the claimant holding that the shareholders' agreement was not allowed to fetter the statutory power of the company, whereas the shareholders as contractual parties of the agreement could freely exercise their voting rights and in this context the agreement was enforceable.[62]

The nature of the *Russell* principle is that the court actually permits the shareholders to enhance their protection indirectly by means of altering or restricting the functions of companies.[63] The problem in relation to the *Russell* principle is that if the law does not set a boundary to the shareholders' power in altering the company's statutory power, the legal force of articles of association or even the corporate law would be substantially eroded. Thus, after the *Russell* case there was a call to change the statutes so as to remove this principle in judicial practices[64] or at least the general law should set out the circumstances in which the shareholders are permitted to sanction the covenants fettering companies' statutory powers.[65]

4.3.3.2 The Shareholder's Power in relation to Corporate Governance

a. The Shareholder's Power in Decision-making

It is quite surprising that there is no statute specifying the distribution of power between directors and shareholders in UK companies among more than one thousand articles of the Companies Act 2006; in other words, there would be a very wide range of contractual freedom for the members of the company to allocate the decision-making power and therefore the articles of association plays a pivotal role in specifying the basic structure of corporate governance under UK company law. Theoretically, shareholders are able to substantially exert influence on decision-making and to decide the power of the board by setting and amending the articles of association. In practice, however, the Model Articles issued by the Secretary of State at least give a few clues to find the boundary between the managers and owners. At first, s 3 of the Model Articles for both private and public companies provides that '[s]ubject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers

[62] *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R. 588.
[63] Andrew Hicks and S.H. Goo, *Cases and Materials on Company Law* (6th ed., OUP 2008) 196.
[64] L. Sealy and Sarah Worthington, *Cases and Materials in Company Law* (8th ed., OUP 2008) 206.
[65] Eilis Ferran, 'The Decision of the House of Lords in *Russell v. Northern Bank Development Corporation Limited*' (1994) 53 The Cambridge Law Journal 343, 366.

of the company', according to which the directors are entitled to fully exercise their managerial power within the limits of the corporate constitution. At the same time, the Model Articles also permit the shareholders to direct the board to do or refrain from carrying out specific actions by passing special resolutions, only if such actions have not been taken by the board of directors.[66] It can be summarised that the current company statutes of the UK strongly empower the shareholders to fundamentally shape the governance structure of each company.

Specifically, as the response to the reform proposals overviewed above, the Companies Act 2006 encourages shareholders, especially minorities, to effectively participate in the firm management. For instance, for private companies, a resolution can be passed in a written form and a calling of the general meeting of shareholders is not required by the law.[67] Moreover, in order to enhance the protection of minorities, the law also provides that the members who represent 5% of total voting rights or a lower percentage as specified by the articles are able to require the company to circulate written resolutions.[68] As regards public companies, resolutions must be passed at shareholders' general meetings. Previously, the shareholding threshold for the members to requisition directors to convene a general meeting was 10%, whereas for consistency with the European Union Companies (Shareholders' Rights) Regulations promulgated in 2009, this required percentage was decreased to 5%,[69] which means that it would be far easier for minority shareholders to participate in decision-making in general meetings. Additionally, in the circumstances where the companies listed on the Main Market of the LSE tend to carry out transactions amounting to 25% of the value of the firm, they must also be approved by the shareholders' general meeting before such deals are approved.[70]

[66] Model Articles for Private Companies Limited by Shares 2008, s 4; Model Articles for Public Companies 2008, s 4.
[67] Companies Act 2006, s 288.
[68] Companies Act 2006, s 292(4) and (5).
[69] Companies Act 2006, s 303(2); Iain G. MacNeil (n 33) 423.
[70] Under the Listing Rules, the transactions proposed by the listed companies on the LSE is categorised into three classes, Classes 1, 2 and 3 transactions respectively amount to 25%, 5–25% and less than 5% of the company value and only the Class 1 is required to be approved by shareholders. *See* the Listing Rules, s 10.4 and 10.37.

b. Shareholders' Power of Supervising Directors

Although shareholders have a wide range of power in decision-making in UK companies, in respect of the appointment of directors, the Companies Act 2006 says almost nothing with the exception of the stipulation that for public companies two or more directors should not be elected by a single resolution of the general meeting of shareholders.[71] That is to say, the law allows large leeway for members to arrange the method of electing directors. According to the Model Articles for both private and public companies, the directors may be appointed by an ordinary resolution passed at a general meeting or directors[72] and the Corporate Governance Code further requires that directors of UK companies be re-elected at intervals of no more than three years.[73] Even though the two model documents have been widely adopted by UK companies,[74] it is still possible for UK companies to arrange their governance pattern opting out of the official recommendations.[75] In a general sense, the minority shareholders are at risk of majority shareholders' oppression in nominating directors, despite the concentration of minority shareholders' voice in such issue being highlighted by the regulator in recent years.[76]

In order to counterbalance the weak power of shareholders in supervising directors, the statute clearly entitles the general meeting to strong power to remove directors from their offices. According to section 168 (1) of the Companies Act 2006, '[a] company may by ordinary resolution at a meeting remove a director before the expiration of his period of

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[71] Companies Act 2006, s 160(1).
[72] Model Articles for Private Companies Limited by Shares 2008, s 17; Model Articles for Public Companies 2008, s 20.
[73] *The UK Corporate Governance Code* (April 2016), B.7.1.
[74] Kershaw (n 38) 82, 255.
[75] Ibid., 83; *The UK Corporate Governance Code* (April 2016), 'Comply or Explain'.
[76] Considering the compliance requirements of the Corporate Governance Code, it is proposed that in the companies with controlling shareholders, the minority shareholders' voices in electing directors may be enhanced by applying the following approaches: firstly, the circulars in relation to the election of independent directors should be sent out timely to shareholders and all detailed pertinent information, including the transparency of the election process, should also be accessible to shareholders. Moreover, to ensure the independence of the director candidate, the previous and existing relationships or agreements between the director candidates and the company, the directors or controlling shareholders should be truly and fully disclosed in the circular to all the shareholders. Secondly, in order to ensure that all the elected directors can adequately represent the interests of the company as a whole instead of the controllers' private stake, the dual vote and the cooling-off period regime are recommended, by which any elected director's legal status may not be effective, unless there is no any challenge or query put forward by shareholders in a 90-day cooling-off period. Otherwise, the elected director(s) may be removed at the second round of voting by shareholders. Financial Conduct Authority (FCA), *Feedback on CP12/25: Enhancing the Effectiveness of the Listing Regime and Further Consultation* (Consultation Paper CP13/15, November 2013) 44–49.

office, notwithstanding anything in any agreement between it and him', which means that shareholders have the absolute power to remove directors regardless of any contractual arrangement between the company and director(s). Moreover, the law actually imposes heavier pressure on the directors by at least two institutional devices: the one is that the shareholders can remove a director at any time within the tenure of the directors, which means that in practice this section makes the tenure of the employment contract between the company and directors meaningless. To keep their seats in the boardroom, the directors must constantly satisfy the owners of the firm. Another is that the shareholders' strong power of removal can indirectly enhance the shareholders' power of decision-making, because the directors have to seriously consider the shareholders' opinions when they make decisions, otherwise they may be removed by dissatisfied shareholders at the general meeting.

4.3.3.3 The Shareholder's Power in relation to Class Shares

a. The Contractual Nature of a Share

Although there is no accurate definition of a share in academia, the basic legal features of a share in a company are relatively common and clear. A share can be regarded as a kind of financial instrument, by which the holder can claim his or her residual interests in the company.[77] At the same time, when the shareholders agreed to contribute a sum of money to the company,[78] it is treated that the shareholders have voluntarily accepted the risks and liabilities to the extent of their limited contribution to the pooled capital of the company.[79] From the perspective of the shareholders themselves, the share can be considered as an official legal certificate, and an identification of their voluntary expectation of return and acceptance of liability. Moreover, in practice a series of legal rights attached to shares such as voting rights and dividend allocation also establish the mutual covenants between all the shareholders,[80] by which the rights and obligations attached to a given class of share can be clearly detected by both incumbent and potential owners of the company. In the context of British company law, shareholders can freely determine the specific properties of shares, such

[77] Kershaw (n 38) 709.
[78] According to s 541 of the Companies Act 2006, the nature of shares in a company is regarded as the member's personal property.
[79] *Borland's Trustee v Steel Brothers & Co., Limited* [1901] 1 Ch 279.
[80] Ibid.

as the nominal value[81] and transferability[82] by creating specific terms in the articles of association. In a general sense, with the exception of some mandatory restrictions such as capital maintenance, 'the contract contained in the articles of association is one of the original incidents of the share'.[83]

b. Class Share as the Protective Mechanism in Corporate Governance

In terms of the role of shares in corporate governance, especially in the situation where a series of different shareholders exist in a company, the shares with different rights attached will play a significant role in determining the governance structure in the company. According to s 629 of the Companies Act 2006, the law permits the shareholders to perform differently in decision-making and the allocation of interests by arranging different rights in shares. The two most common typologies of shares are ordinary share and preference share.[84] In most cases, the holders of ordinary shares can fully exercise their voting rights in general meeting, but in the case of insolvency, the holders of ordinary shares are paid only if creditors and preference shareholders have been liquidated. By contrast, the holders of preference shares will usually be prioritized in dividend payment and insolvency liquidation, but their voting right in a general meeting is limited.[85]

In relation to PE-held companies, the class shares are particularly important for improving the efficiency in corporate governance. With the increase of outsider ownership in the shareholding structure, the founder shareholder can use class shares to keep his or her control over the firm.[86] At the same time, outsider institutional investors, especially venture capitalists who commonly hold tiny portion of shares, can also, to a large extent, decrease their risk by applying preference shares. Furthermore, the contractual freedom in arranging class shares will be favourable to the diversification of the capital market and expansion of

[81] Companies Act 2006, s542.
[82] Companies Act 2006, s544.
[83] *Borland's Trustee v Steel Brothers & Co., Limited* [1901] 1 Ch 279.
[84] Eilis Ferran, *Principles of Corporate Finance Law* (OUP 2008) 163.
[85] In this regard, the relationship between the preferred shares and the voting rights are quite complex. For example, in a common sense, the holders of preferred shares do not have voting rights in the general meeting. However, if the preference rights attached to the preference shares haves been altered, infringed or removed, the voting rights in preferred shares may arise. In addition, if the dividends are not paid to the holders of preferred shares by a pre-agreed date, the voting right may also automatically recover. Darryl J. Cooke, (n 37) 109–110.
[86] For example, in order to prevent being diluted in control, the articles of association can entitle the founder shareholders to a class of shares with enhanced voting rights, such as three or five votes per share, while the other shareholders only enjoy the shares with one vote per share.

financing channels for enterprises. For instance, during the growth process of start-ups, the risks and potential returns in different stages may vary remarkably; the existence of class shares can attract investors with different risk-preferences to constantly provide capital for the companies.

As discussed above, the legal nature of shares in UK company law is basically contractual. Nevertheless, the problem arises whether the law should set a boundary on arranging class rights in corporate contracts. One of the leading cases on this issue, *Bushel v Faith*,[87] decided by the House of Lords, provides some implications. In this case, the defendant, Faith, was the director and shareholder of the company at the same time who held shares with three votes per share and could outvote other shareholders in general meetings. As a result, the other shareholders, including the claimant, could not remove the defendant from the boardroom, although s 184 of the Companies Act 1948[88] granted the power of removal. The plaintiff requested the court to invalidate such class rights of the defendant. The House of Lords dismissed the appeal, reasoning that although shareholders' removal power was mandatory, the court was unwilling to arbitrarily fetter a shareholder's statutory voting rights only if such a shareholder was also a director.[89] This opinion can also be understood that the class rights as a contractual right specified in the corporate charter should be primarily respected, the occasional overlap of director and shareholder is not a necessity that deprives shareholders of their statutory rights. In a long term, the *Bushel* case has been one leading case in the area of shareholders' removal power against directors. It is noteworthy that in case of large public-held corporations, the rules in *Bushel* case, however, may not be correct, as the over-powerful voting rights which are held only in hands of very small group of shareholders may be a threat to public investors. Consequently, concerning about the risks of distorting corporate governance mechanism and unfair market for corporate control, such super-voting rights are not quite preferable in large companies in the UK[90] and the use of super-voting in the companies which are listed at the LSE is not encouraged.[91] Nonetheless, it is acknowledged that the dual class share can play a positive role in the quasi-partnership start-ups.

[87] *Bushel v Faith* [1970] AC 1099.
[88] The predecessor of s168 of the Companies Act 2006.
[89] *Bushel v Faith* [1970] AC 1099.
[90] Cooke, (n 37) 54.
[91] And this is why those large internet companies such as Google, Facebook and Alibaba do not list in London. Ferran (n 84) 426.

4.3.4 The Contractual Nature of Self-protections of Shareholders in the UK

On the basis of the above anatomy of the self-protective mechanisms in the UK, it can be concluded that British corporate governance is built on shareholders' governance authority.[92] Moreover, the rapid increase of the institutional investors in the UK during the recent decades also shows that the legal and regulatory reforms have positively responded to institutional investors' demands for powerful intervention in corporate management. Therefore, UK corporate governance can be trademarked as contractualism in the following three domains:

First, fundamentally, the company law is formally reluctant to limit the allocation of powers between the parties in companies. The managerial authority of the board is derived from the shareholders' contractual arrangement, namely the articles of association, instead of any external authorities, including the state.[93] The shareholders can also freely determine their powers and relationships between one another in the management of firms by contracting specific terms in corporate contracts and shareholder agreements. The class share system also provides the flexibility in arranging their rights attached to shares for both incumbent shareholders and potential outside investors in capital markets. Although the Companies Act 2006 recognizes the independent power of directors in management, the shareholders' consistent and unconditional power to remove directors has been a sword of Damocles over the heads of directors. The management has to seriously consider the shareholders' attitude before making decisions. Additionally, to further enhance the protection of public investors, the Listing Rules of the LSE encourages shareholders to participate actively in the governance by allowing them the power to approve significant transactions of listed companies. In such a way, it can be said that the company law and regulations in the UK have actually put the companies under the control of shareholders.

Second, the strong power of shareholders in corporate governance can better protect the shareholders. However, the contracting between shareholders must be time-consuming, or in large public companies the agreements between all shareholders are even impractical. Hence, the Corporate Governance Codes and Model Articles provide a pack of standard contracts for the members of UK companies. The application of such standard contracts by default has

[92] Christopher M. Bruner, *Corporate Governance in the Common-Law World: the Political Foundation of Shareholder Power* (Cambridge University Press 2013) 29.
[93] Ibid., 36.

effectively saved costs in contracting. The shareholders, in turn, can not only amend the Model Articles by special resolutions, but also opt out of the Corporate Governance Codes with acceptable explanations. The contractual nature of UK corporate governance is strongly confirmed again.

Finally, the conservatism in the judicial practices of the UK also plays a role in keeping the shareholder primacy contractual. The freedom that shareholders enjoy in contracting on the shareholders' agreement and class shares will be prioritized by the court, although occasionally such freedoms may influence the statutory rights of the companies or directors in practice. Indeed, comprehensively considering the relationship between the statutes, model documentations and case law in UK company law, it can be seen that the British judges are quite reluctant to materially judge the reasonability in corporate contracts, the related cases actually warns about a series of risk in contracting, according to which the practitioners may avoid risks by adapting specific contractual arrangements.

4.4 The Institutional Background of Non-state Companies in China

4.4.1 The Non-judicial Protection of Minority Shareholders in Chinese Companies

When one talks about the regime of corporate governance of Chinese companies, the first point one should bear in mind is that the basic and original functions of Chinese corporate law is to establish a legal framework for restructuring the SOEs of China.[94] The official rules for corporate governance were not promulgated until the Law of Companies was enacted in 1993. To date, the company law was revised in 2005 and 2013 respectively; both of the amendments made efforts to improve the protection of minority shareholders in Chinese companies. However, the basic logic of corporate governance in Chinese law is still based on the centralised ownership model, instead of a dispersed ownership structure.[95] In terms of non-state companies, it is also quite common that the entrepreneur shareholder is at the same time in the position of the president of the board of directors, CEO and controlling

[94] Donald C. Clarke, 'Corporate Governance in China: An Overview' (2003) 14 China Economic Review 494.
[95] For example, according to the research carried out by the Chinese scholar Tiantao Shi, the state-owned shares and corporate shares, both of which are not transferrable in stock market account for over 50–60% in the shareholding structure of Chinese listed companies. Tiantao Shi, *Corporation Law* (Law Press China 2006) 307 [施天涛. *公司法论*. 法律出版社, 2006, 第 307 页].

shareholder of the company. Thus, the statutory protection of minority shareholders in Chinese companies is also a noteworthy issue.

Though the ownership structure of Chinese non-state companies are more diversified than the SOEs, quite a large number of the founding shareholders still hold more than one third of the shareholdings in listed non-state companies.[96] The controlling shareholders can easily control the election of board members, by which the outsider shareholders or minority shareholders may be excluded from the decision-making of the firm. According to the corporate governance practices in recent years, owing to the lack of effective constraint, the founding shareholders also have strong motivation to make private profit by making affiliated transactions and committing financial fraud with public and minority shareholders.[97]

4.4.2 The Listing Rules for Chinese Non-state Companies

The domestic public stock market of China was established in 1990. Although the stock market provides an effective source of finance for Chinese enterprises, the public stock market is still dominated by SOEs but not those non-state companies who are in need of funds.[98] Against this macro-economic background, the regulatory system and approach of listed companies on the Chinese stock market are also established on a state-controlled instead of market-controlled basis. Because the initial function of the Chinese stock market was a reform approach for restructuring the SOEs and transforming the planned economy into a market economy, the approval and regulation of the Chinese stock market, to a large extent, was determined by the authorities. Before 1996, the quota of listed companies in a certain year was pre-planned by the central and local authorities; in other words, only those enterprises that were recommended by the government to the CSRC might be listed, otherwise the entrepreneurs had no freedom to apply independently to list on the stock market.[99] Since the promulgation of the Law of Securities of the PRC in 1998, the CSRC

[96] Xiaonan Lu, Weidong Zhang, The Study of the Development of Non-state-owned Corporations in Chinese Stock Exchanges (The Research Centre of Shanghai Stock Exchange 2004) 47 [鹿小楠, 张卫东. 中国民营上市公司发展研究. 上海证券交易所研究中心，2004，第 47 页].
[97] Ibid.
[98] Chen Ji and Steve Thomas, ‘Emerging Stock Markets in the People’s Republic of China’ (Spring, 2003) Financial History 29.
[99] ‘The Concepts and Distinctions of the IPO Approval System and IPO Registration System’ (Finance China, February 2014) [IPO 注册制和核准制概念与区别, 中国财经, 2014 年 2 月 12 日] <http://finance.china.com.cn/stock/special/zcz/20140212/2178702.shtml > accessed 13 August 2015.

enjoyed the exclusive power to substantively examine listing applications and regulate listed companies.[100] In order to simplify the approval procedure, the annual quotas of listing in different provisions currently are uniformly pre-allocated by the CSRC.[101] However, because the Chinese stock market is still dominated by SOEs, the listing requirements of Chinese private companies are overly strict and costly.

According to the Measures for the Administration of Initial Public Offering and Listing of Stocks (2006)[102] issued by the CSRC, the qualified issuer 'must have been profitable in the most recent three years with annual net profits of more than RMB 30 million' and 'must have made the net cash flow more than RMB 50 million accumulated within the most recent three years or has made the revenue no less than RMB 300 million accumulated within most recent three years' and the issuer also 'must have a total share capital of no less than RMB 30 million before the IPO'.[103] By the end of 2012, the small and medium enterprises[104] have accounted for more than 98% of the total number of enterprises in China.[105] However, for most Chinese SOEs the above high-level financial requirements have been a main barrier in their way of listing on the stock market. Moreover, the high-level disclosure institution, continuous stability of management and equivocal timetable of approval[106] also reduce the private companies' enthusiasm to expand finance on the Chinese public stock markets.

In sum, such a series of strict and high-level listing rules can hardly provide effective financial sources for the majority of Chinese private companies. By contrast, the relatively efficient approval procedures and low-level listing requirement in overseas stock markets have been quite attractive to Chinese private enterprises.[107] Although overseas listing can provide a wider range of finance for Chinese private companies in relatively more efficient

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[100] For details see s 10 and 11 of the Law of Securities (1998).
[101] *Supra* n 99.
[102] Hereinafter referred to as 'the Listing Rule (2006)'.
[103] The Measures for the Administration of Initial Public Offering and Listing of Stocks (2006), s 33 [首次公开发行股票并上市管理办法 (2006), 第 33 条].
[104] Hereinafter referred to as 'SMEs'.
[105] Jun Ma, 'The SMEs accounted for More Than 98% of All Enterprises in China' (SinaFinance, April 2012) [马骏：中小企业占中国企业数量的 98% 以上, 新浪财经，2012 年 4 月 26 日] < http://finance.sina.com.cn/hy/20120426/100211929864.shtml> accessed 12 August 2015.
[106] For details, *see* Chapters 1, 3 and 4 of the Measures for the Administration of Initial Public Offering and Listing of Stocks (2006) [首次公开发行股票并上市管理办法 (2006), 第 1,3,4 章].
[107] Yingmao Tang, 'Why Chinese Private Companies Choose Overseas Stock Markets: a regulatory analysis of Chinese Red-chip Listing' (2010) 28 Tribune of Political Science and Law 161 [唐应茂, '私人企业为何去海外上市—中国法律对红筹模式海外上市的监管', 政法论坛，2010 年第 4 期, 第 161 至 166 页].

listing procedures, in the long run, the particular capital control policies that are mainly against foreign PE-held corporations may lead to serious instability in corporate governance in Chinese overseas listed companies.

4.5 The Problems of Corporate Governance in PE-held Companies in China

4.5.1 The Conflict between Entrepreneurs and Private Equity Shareholders

The separation of the ownership and control is one of the most significant features of modern corporations. The director in corporations usually plays a role as the agent of shareholders, which can increase the agency costs in corporate governance. In order to control agency costs, the contractarians argue that the alignment of the residual claimant and residual control between the owners and managers of the firm is essentially significant.[108] By contrast, the ownership structure of private family corporations is highly concentrated, the founder of the firm is also the controlling shareholder and president of the board of directors; in other words, the separation of ownership and control in private family corporations is not sufficient, but the informal contractual arrangements such as the blood relationship among family members or the founder's personality and authority usually play a more important role in the management of family firms. As a consequence, the traditional principle of corporate governance may not work well to attenuate the agency problem.

In addition, the contractual theory of corporation argues that the nature of the corporation is a 'nexus of contracts' between the parties of the company,[109] which suggests that the parties of the company should have the freedom to form and amend articles of association. The related problem is whether the power of the parties is unlimited in determining the specific rules in corporate governance? According to the Law of Companies of China,[110] the general meeting of shareholders has the power to determine the specific rules of articles of association. Therefore, if the major shareholder holds enough shares in the capital structure of the company, the rules of corporate governance can be determined by the controlling or major shareholders. In this regard, however, the demarcation of shareholders' power may be changed, which will threaten the interests of minority shareholders. Gome Company Limited

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[108] Henry N. Butler, 'The Contractual Theory of the Corporation' (1989) 11 (4) George Mason University Law Review 99, 105.
[109] Ibid.
[110] The Law of Companies (2013 Revision), s 37.

as one of the most influential corporate governance cases in China shows how the unclear role of the board of directors and general meeting of shareholders can increase transaction costs in corporate governance. Since Gome Company Ltd was listed on the Hong Kong Stock Exchange in 2004, the shareholding of Guangyu Huang, the founder of the company, was significantly diluted. For enhancing the control power, Huang amended the articles of association by exercising his shareholder rights. The board of directors has exclusive power of nominating directors and approving incentive mechanism for the management team.[111]

In 2009, owing to the lack of finance, Gome Company Limited introduced Bain Capital, a US-based private equity firm, as the strategic institutional investor to support the business expansion. According to the agreement between Bain Capital and Gome Company Ltd, Bain Capital held a convertible bond valued at RMB 1.8 billion. If the convertible bonds are converted into common shares, Bain Capital would hold 9.8% of shares in the company. Moreover, Bain Capital also claimed to nominate three non-executive directors on the board,[112] which was not consistent with the percentage of shares that Bain Capital held in the shareholding structure of the company. At the anniversary shareholders general meeting of 2010, as the major shareholder Huang vetoed Bain Capital's nomination of three directors. However, the board of directors argued that the resolution of the shareholders general meeting should be invalid, because it failed to reflect the interests of other shareholders in the company.[113] Consequently, the board vetoed the resolution of the general meeting and nominated three non-executive directors representing Bain Capital to the board.

4.5.2 The Cultural Conflict between PE Shareholders and Entrepreneurs

4.5.2.1 Confucianism Ethics and the Commercial Practice in Modern China

In Chinese traditional society Confucianism,[114] which was derived and has developed in Chinese history for more than two thousand years, has played an important role in shaping

[111] Longfei Su, *The Battle of Control Power* (Pecking University Press 2012) 163 [苏龙飞，*股权战争*，北京大学出版社，2012，第 163 页].
[112] Ibid., 167.
[113] Ibid., 168.
[114] The original idea of Confucianism is based on the system of philosophy of Confucius (551–479 BC), who is regarded as the leading Chinese thinker and social philosopher in ancient China. Since 134 BC, in order to control society politically, Confucianism was adopted by the authorities as the dominating social thought until the collapse of the Chinese Empire in 1912.

the morality and ideology in both the state law system and social governance. In ancient China, social life was organized on the basis of agricultural society, where the development of the economy was self-organized by families, instead of the class of merchants. In traditional Chinese families, income and labour were mainly subject to the male adults' abilities to farm. The family rules also emphasized the other family members' obedience to the family leader.[115] Moreover, subject to the technology and transportation, most Chinese people in rural areas do not migrate out of their hometown throughout their lifetime, and the people in the village or the nearby areas are acquainted with one another. As a consequence, the social norms in such a familiar society rest more upon customs that are practised and accepted by people in the community, rather than the law created by the authority.[116] Accordingly, Confucian ethics were the philosophic reflection of the agricultural economy in ancient China, which can be shown by a series of values in Confucianism. Firstly, the most significant virtue in Confucianism is filial piety that absolutely requires offspring to respect and obey their parents. Secondly, the brotherhood requires the younger brother to respect his elder brothers; thirdly, *Li* (礼), as the core concept in Confucian philosophy, emphatically emphasises the hierarchy between different groups of people, such as subjects and ruler, old and young, husband and wife and so forth;[117] in other words, from the Confucian perspective, the idealistic social order is established on the basis of strict hierarchical system, rather than the equality of individuals.

Moreover, in the Confucian belief system, objects of worship are ordinary figures and characters in the real world, including Confucius, other Confucian scholars such as Mencius, the Chinese emperors, and ancestors of the clan and family.[118] In religious thought, the nature of Confucian ethics is a series of moral values,[119] rather than transcendental beliefs (e.g., the

115 Tung Tsu Chu, *Law and Society in Traditional China* (Zhonghua Book Company 1981) 5–6 [瞿同祖. 中国法律与中国社会. 中华书局，1981，第 5 至 6 页].
116 Hsiao T áung Fei, *From the Soil, the Foundations of Chinese Society* (Hsiang t'u Chung-kuo tr, University of California Press 1992) 42.
117 Chu (n 115) 272; Patrick Kim Cheng Low and Sik Liong Ang, 'Confucian Ethics, Governance and Corporate Social Responsibility' (2013) 8 International Journal of Business and Management 30; Max Weber, *The Religion of China: Confucianism and Taoism* (first published 1915, J.C.B Mohr (Paul Siebeck) Tubingen 1920, Rong Fen Wang tr, The Commercial Press, 1999) 206-207 [马克斯 韦伯. 儒教与道教. 王荣芬 译，商务印书馆，1999，第 206–207 页].
118 Weber (n 117) 193–196.
119 For example, the five pillar virtues (五常), namely (i) benevolence (仁), (ii) rightness (义), (iii) propriety (礼), (iv) wisdom (智) and (v) trust (信) compose the main structure of Confucian ethics. As a kind of belief, the believers in Confucianism believe that behaving under Confucian ethics in real life can be conducive to their

‘natural law’ thought in Western philosophy). In a practical sense, the nature of the Confucian governance mechanism is obedience to the senior and prestigious members in a community or organization. A certain behaviour or idea is commonly justified on the basis of the status and authority of a specific good or virtuous individual in a community, rather than some kind of transcendental value or religious thought.

Influenced by the Confucian culture and tradition, the merchants who behaved in accordance with Confucius’s moral teaching were labelled *Ru Shang* (Confucian merchants or virtuous merchants) and widely praised in ancient Chinese society. Firstly, a notable and respectable businessman should never desert benevolence when he doing business or dealing with others.[120] Secondly, the good businessman should frequently examine himself and voluntarily correct any error or inappropriate or immoral behaviours.[121] Moreover, Confucius requires that any profit should only be obtained in the right way and any profit made from unscrupulous behaviour or against morality should be criticized.[122] Compared with the legal culture in Western countries, the values and ethics in the Chinese commercial world are very different. In Confucian ethics, individual virtue and good personality are regarded as the core of norm system, that is to say, both the harmony among people and social order are based on people’s independent self-discipline, instead of an objective rule system of social or occupational norms, such as legislations and regulations.

4.5.2.2 The Conflict of Interests between the Heterogeneous Directors: A Case Study

In terms of the corporate governance in China, the personality and self-cultivation of the key entrepreneurs usually play a significant role in shaping the corporate culture and establishing trust between the management and shareholders of the company. A fair number of successful Chinese entrepreneurs believe that their outstanding morality or personal charm is the irreplaceable strength in achieving successful business. As mentioned above, the good virtue of an entrepreneur will be conducive to establishing a good reputation in the market. The

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health, domestic peace, good harvest and good luck in their real life, rather than luck or good life in their world to come. Ibid., 196.

[120] Alex CK Chan and Angus Young, ‘Chinese Corporate Governance Regime from a Historical-Cultural Perspective: Rethinking Confucian System of Governance’ (2012) SSRN Electronic Journal <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2156300 > accessed 24 July 2015.

[121] Ibid.

[122] Ibid.

traditional commercial culture in China also emphasizes the core status of entrepreneur's personality and reputation in promoting the performance of the enterprise. In the modern commercial world, however, the deep-rooted governance mechanism based on 'rule of man' and Confucian enterprise culture may motivate entrepreneurs to over-confidently impose their personal opinion on the resolutions of the board of directors or general meeting of shareholders. Particularly, when a private company goes public, the shareholding of the entrepreneur will be significantly diluted, which can stimulate the entrepreneur shareholders to act against corporate governance principles for enhancing their control over the company. Because in most cases the entrepreneurs are the controlling shareholders, in the circumstances where the institutional investors such as private equity and venture capital funds are introduced as the minority shareholders in the company, the arbitrary conduct of the entrepreneur may be against the interests of the private equity and other shareholders. This point can be well illustrated by analysing the case of NVC Lighting Limited (NVC), a PE-held Chinese listed company.

NVC was incorporated in 1998. After more than ten years' development, the company has been ranked among the leading companies in China's lighting industry. Before introducing institutional investors, Changjiang Wu, the founder of NVC, held 70% shares of the company and actually controlled the company. During 2006 to 2008, Goldman Sachs and SAIF Partner Fund (a Hong Kong-based venture capital fund) invested in NVC as financial investors. By 2008, SAIF Partner Fund and Goldman Sachs respectively held 30.73% and 9.39% of the shares of the company and Wu's shareholding was diluted to 29.33%.[123] In 2010 NVC was listed on the Hong Kong Stock Exchange and public shareholders continually diluted Wu's shares. Moreover, for the purpose of enhancing the company's competitiveness in the household lighting market, NVC introduced Schneider Electric Company Limited,[124] a global-leading energy management service provider in July 2011. Schneider held 9.04% of the shares in NVC.[125] Consequently, Wu's shareholding was diluted further to 17.15%.[126] By contrast, the SAIF Partner Fund, Goldman Sachs and Schneider, who can be regarded as the concerted party, in total held around 33% of the shares and the rest were held by public shareholders. Although Wu did his best to increase his shareholding in the ownership

[123] The Prospectus of NVC Lighting Holding Limited, 68.
[124] Hereinafter referred to as 'Schneider'.
[125] Su (n 111) 46.
[126] Ibid., 47.

structure of NVC,[127] the representatives of NVC on the board of directors of the company only held two seats. By contrast, the concerted party possessed four seats (i.e., two for the SAIF Partner Funds, one for Goldman Sachs and one for Schneider).[128] Since the private equity fund and other institutional shareholders had invested in NVC, it is obvious that the controlling power had been dramatically diluted in the process of both private financing and public listing. Wu, the board director of the company was actually at the risk of being removed by the PE investors and other shareholders.

In response to such a disadvantageous status in the corporate governance of the company, Wu had a strong motivation to act against the board of directors to enhance his influence in the company. In the autumn of 2011, he proposed that the headquarters of the company be moved from Huizhou to Chongqing (his hometown). Although the board of directors disagreed about doing so, as a compromise, they agreed to setting up a subsidiary, NVC (Chongqing) Industrial Company, in Chongqing which would only function as a sale premises rather than the headquarters of NVC. In order to control the company directly, however, Wu arbitrarily authorised the subsidiary with other main functions, including marketing, purchasing and logistics departments without the board of director's approval.[129] Moreover, Wu arbitrarily signed an agreement with the Chongqing government, by which the use of land for building the Chongqing NVC Plaza was authorised to another company personally held by Wu. Because his misconduct went seriously against the basic corporate governance principle, in May 2012 the board of directors demanded that Wu resign as the CEO and president of the board.[130]

From the perspective of Western corporate governance theory, the CEO of the corporation should respect the resolutions of the board of directors; in other words, the CEO has no right

[127] According to related reports in the public media, Changjiang Wu bought long the public shares of NVC in 2011, and became the first majority shareholder with over 19% of shares in the company. Ibid., 49–50; 'A Storming Attack against Director Changjiang Wu: the Emergent 48 Hours for NVC Lighting' (Finance China, May 2012) ['董事长吴长江风暴：雷士照明紧急的 "48 小时"'. 财经中国. 2012 年 6 月 25 日] <http://finance.china.com.cn/industry/20120625/824076.shtml> accessed 28 July 2015.

[128] Su (n 111) 50; Chenguang Ma, 'The War of Control Power of NVC Lighting and the Development of Chinese Private Companies' (Co-Effort Law Firm LLP, 2012) [马晨光，'从"雷士照明控制权之争"思民营企业发展之路'. 协力律师事务所，2012] < http://www.co-effort.com/zh_CN/infomation_show.asp?id=455 > accessed 28 July 2015.

[129] 'NVC Lighting: The Chongqing "Headquarters" as Illegal Headquarters for Regulatory Arbitrage' (*China Economy*, August 2014) ['雷士照明：所谓'重庆总部'实为绕开上市公司监管的非法总部'. 中国经济网. 2014 年 8 月] <http://finance.ce.cn/rolling/201408/28/t20140828_3444022.shtml> accessed 28 July 2015； Su (n111) 50.

[130] Su (n 111) 50.

to arbitrarily make any decision without the permission of the board of directors. Emotionally, however, based on the traditional Chinese culture, the employees and staff of a company may regard the entrepreneur as the ‘spiritual leader’ of the enterprise. The personality and ability of the entrepreneur are sometimes held in higher regard than the managerial institution in corporate governance.[131] On 13 July 2012, the staff of all the subsidiaries across the country started to strike. In the meantime the suppliers and sellers ceased any co-operation with the board of directors of NVC, and asserted that they would not co-operate with NVC unless the board agreed to inviting Wu back to the management layer of the company, citing as reasons that among the members of the management only Wu was the expert in the lighting industry, and his personal ability and reputation were an irreplaceable resource for NVC.[132] The board of directors finally agreed to allow Wu back to the company in late August 2012.[133]

The case of NVC shows that although eventually the entrepreneur regained the controlling power over the company, the cost of such a long process of negotiation and the fight between the institutional investors and entrepreneur would be very high.[134] The nature of the problem in this case is that in the circumstances where the entrepreneur of the company is also the director and CEO of the company, once the entrepreneur shareholder’s ownership is diluted by the public shareholders and institutional investors such as private equity and venture capital funds, the entrepreneur is able to arbitrarily intervene in the operation of the company by exercising his or her managerial power and utilizing his social resources which finally considerably increases the transaction costs in corporate governance.

[131] Teemu Ruskola, ‘What Is a Corporation? Liberal, Confucian, and Socialist Theories of Enterprise Organization (and State, Family, and Personhood)’ (2014) 37 Seattle University Law Review 637.
[132] ‘Changjiang Wu’s Counterattack: The Staff, Suppliers and Sellers vs the Board of Directors of the NVC’ (Jiaju Sina, 13 July 2012) [‘吴长江逆袭：雷士员工供销商对峙董事会’ . 新浪家居，2012 年 7 月 13 日] < http://jiaju.sina.com.cn/news/2012-07-13/091530158529.shtml> accessed 29 July 2015; ‘The Sellers against the Investors: the Disordered Board of Directors of NVC’ (Jiaju Sina, 13 July 2012) [经销商逼宫投资方撤离 雷士董事会内乱疑云’ ’ 新浪家居，2012 年 7 月 13 日] < http://jiaju.sina.com.cn/news/2012-07-13/144114158615.shtml> accessed 29 July 2015.
[133] Su (n 111) 62.
[134] Compared with 2011, the revenue of 2012 fell 7% (3.55 billion RMB); the gross profit of 2012 also dramatically went down by 22% (RMB 0.76 billion). The Annual Report of NVC Lighting Holding Limited (2012), 5 <http://www.hkexnews.hk/listedco/listconews/SEHK/2013/0426/LTN20130426446.pdf> accessed 29 July 2015.

4.5.3 Variable Interest Entities and Overseas Listing: The Lack of Fiduciary Duties

4.5.3.1 The Policy Barrier to Overseas Listing of PE-held Companies in China

a. The Industrial Policy Restriction of Overseas Listing of PE-held Companies

As early as 1995, the Chinese Ministry of Commerce of China[135] enacted the Catalogue for the Guidance of Foreign Investment Industries,[136] which aims to restrict foreign investors' investment activities in mainland China. Basically, the industries for foreign investors to invest in China are classified into three categories, namely (i) encouraged industries, (ii) restricted industries and (iii) prohibited industries. Although this regulation has been revised six times[137] during 1996 to 2016 and the authority tends to make the Chinese market more accessible for foreign investors, even now foreign investors are still prohibited from investing in cultural and media areas, including information technologies (IT) industries;[138] in other words, foreign private equity and venture capital investors are not permitted to hold shares in domestic IT companies. As a consequence, Chinese IT companies have no choice but to apply alternative organizational structures for overseas listing, which mitigates the risk of MOFCOM turning down their application.[139]

b. The Capital Restriction of Overseas Listing of PE-held Companies

As mentioned in Chapter 2 and 3 of the present research, since the 1990s international private equity and venture capital firms have been consistently playing a significant role in the Chinese private equity and venture capital market. Ever since the first Chinese non-state-owned company was successfully listed on the NASDAQ in US in 1999,[140] more and more Chinese entrepreneurs recognized that compared with the strict administrative approval requirements of listing on the Chinese stock markets,[141] overseas listing was a more efficient

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[135] Hereinafter referred to as 'MOFCOM'.
[136] Hereinafter referred to as the 'Catalogue'.
[137] Since the promulgation of the Catalogue, it has been revised in 1997, 2002, 2004, 2007, 2011 and 2015.
[138] The Catalogue (2015 Revision), s 11 of the Sub-catalogue of Prohibited Industries for Foreign Investment. [外商投资产业指导目录（2015 年修订），‘禁止外商投资产业目录’第 11 条].
[139] Wu Wang, 'The Legal Analysis of VIE Structure' (Global Law Bulletin, August 2013) [王武，VIE 结构相关法律问题分析，环球法律评论，2013 年 8 月].
[140] Qiao Xing Universal Resources, Inc. (NASDAQ：XING) was the first Chinese private company listed on foreign stock exchange market.
[141] The primary limitation to private companies listing on domestic stock exchanges is due to the limited resource of sponsors for private companies; in other words, as regards the listing on the public stock market, the

way to raise funds. Coincidentally, with the great boom of the internet economy in the global market in the late 1990s, an increasing number of Chinese entrepreneurs engaged in IT industry. Particularly, since the three most influential web portal companies, namely Sina, SOHU and Net Ease subsequently listed on the US stock market in 2000, the new emerging Chinese IT industry has quickly recognized that introducing international private equity investors and then listing on overseas stock markets such as the US or Hong Kong stock exchanges is a more efficient way of not only expanding financing, but also establishing their international commercial reputation.

In practice, the most popular way to list PE-held companies overseas before 2006 was the so-called red-chip listing.[142] In this model of overseas listing, the domestic actual controller and international private equity funds jointly register a shell company in offshore financial centres such as the British Virgin Islands (BVI) or Cayman Islands. The offshore company then registers another shell company in Hong Kong[143] and the Hong Kong offshore company wholly acquires the domestic company. Finally, the BVI or Cayman offshore company will be listed on a stock market abroad.[144] The period 2000 to 2006 was a golden age for the Chinese private economy; some of the most famous Chinese private enterprises such as Mengniu and Gome were successfully listed on foreign stock exchanges. One of the noteworthy factors of this wave of overseas listing is that quite a large number of the most successful overseas financing projects were backed by international private equity and venture capital funds or investment banks.[145]

Chinese authorities obviously tend to give priority to state-owned corporations, rather than private companies. Shoushuang Li, Longfei Su and Rui Zhu, *Red-Chip Listing Game* (China University of Political Science and Law Press 2012) 4 [李寿双，苏龙飞，朱锐，*红筹博弈—10 号文时代的民企境外上市*，中国政法大学出版社，2012 年，第 4 页]; Xianwu Zeng, Lihui Bai, 'Variable Interest Entity Structure in China' (King & Wood Mallesons Law Offices, February 9 2012) <http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/ > accessed 6 June 2015.

[142] The basic structure is illustrated in Figure 4.1.

[143] The function of the Hong Kong shell company is the tax shelter. According to s 10(2) of the Arrangement between Mainland China and Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income (2006) [内地和香港特别行政区关于对所得避免双重征税和防止偷漏税的安排, 2006] (hereinafter referred to as the 'Arrangement (2006)'), where a Hong Kong-registered company holds no less than 25% of a domestic company registered in Mainland China, the rate of tax on dividends can be reduced to 5%. By contrast, pursuant to s 3(3) and 4(2) of the Law of Enterprise Income Tax of Republic of China (2007 Revision), for non-resident enterprises that make a profit inside China, the non-resident enterprise shall pay tax at the rate of 20%.

[144] Beijing Docvit Law Firm, *Foreign Private Equity in China* (CITIC Press, 2011) 193 [北京道可特律师事务所. 外资 PE 在中国的运作与发展. 中信出版社，2011，第 193 页].

[145] For example, Sina, the earliest Chinese website company backed by Walden International (US$6.5 million) was listed on the NASDAQ in 2000; MengNiu, the second-largest dairy producer in China backed by Morgan Stanley and Actis (US$61 million) and listed on the HKSE in 2004; Baidu, the largest Internet search service

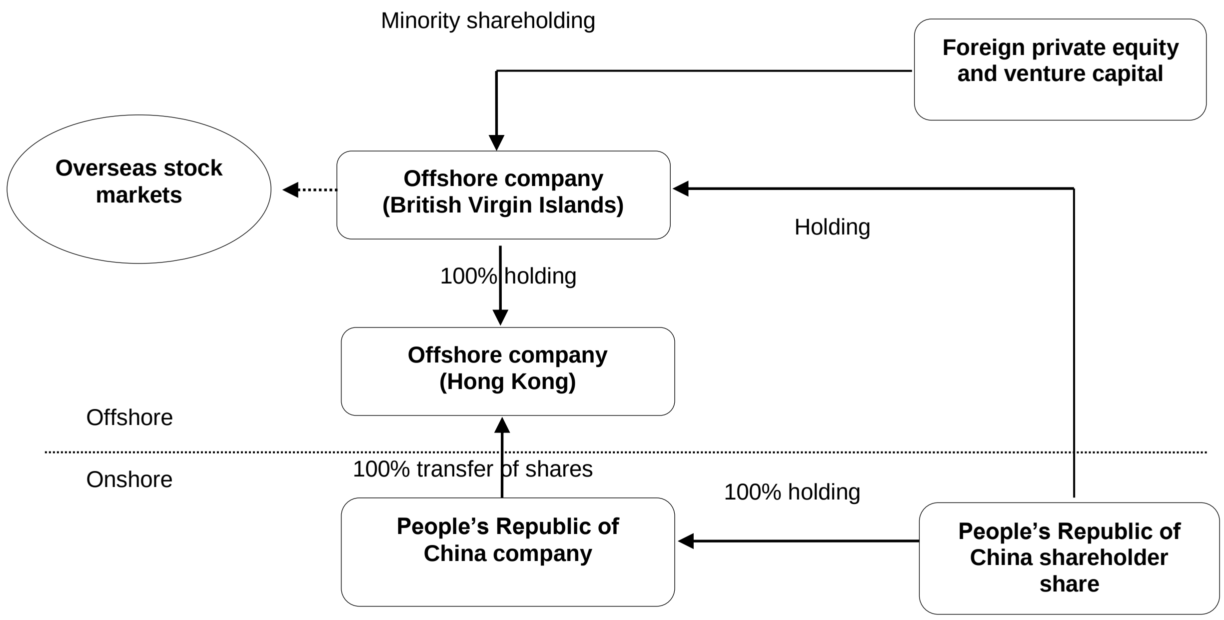

Figure 4.1: The red-chip structure

The Chinese regulator, however, considered that the uncontrolled overseas listing of Chinese private companies may cause serious capital flight and the Chinese public investors also levelled criticism that the CSRC's policy failed to attract excellent private companies to the domestic stock market.[146] Against this background, the regulators enacted the very strict listing rules, namely the Provisions on the Merger or Acquisition of Domestic Enterprises by Foreign Investors[147] in September 2006,[148] which substantively blocks the path for the overseas listing of Chinese private companies. Specifically, according to s 42 of the M&A Rules (2006), any domestic corporations or natural person should not register any offshore special purpose company (SPC), unless it is approved by MOFCOM. If the application is approved by MOFCOM, then any listing transactions of the SPC are required to be approved by the CSRC.[149] Moreover, where the offshore SPC acquires the domestic company's shares, such listing application must also be approved by MOFCOM, otherwise the acquisition will

company in China backed by Draper Fisher Juvetson (US$12 million) and listed on the NASDAQ in 2005; New Oriental Education Group, the largest education training company in China backed by Tiger Universal Fund (US$30 million) and listed on the NYSE in 2006. Shoushuang Li, et al, (n143)17; Su (n111) 144–149; Li Du, 'What Can We Learn from the Overseas Listing of New Oriental?'(*China Youth Daily*, 19 May 2006) [堵力，'新东方纽约上市给中国教育带来了什么？'，中国青年报，2006 年 5 月 19 日] <http://news.xinhuanet.com/edu/2006-10/19/content_5221332.htm> accessed 5 June 2015.

146 Li, et al, (n141) 20.

147 关于外国投资者并购境内企业的规定 (2006).

148 Hereinafter referred to as the 'M&A Rules (2006)'.

149 M&A Rules (2006), s 40.

be invalid.[150] Although the law formally provides a procedure for an overseas application for Chinese domestic companies, in fact, since the promulgation of the M&A Rules (2006), until now the CSRC and MOFCOM have not given their approval for a private company to be listed successfully overseas.[151] As a result, the current regulation of the capital control of Chinese private companies also motivates both the international private equity and venture capital investors and Chinese entrepreneurs to introduce alternative legal structures that can prevent the risk of the prohibition by Chinese financial regulators.

4.5.3.2 Variable Interest Entities as an Alternative Legal Structure for Overseas Listing of PE-held Companies

The above regulations on foreign investment in China have shown that currently foreign investors are strictly restricted by the regulators. In order to successfully complete overseas IPO, and circumvent the uncertain and time-consuming administrative procedures, the VIE structure is widely used by both foreign PE funds and Chinese private companies. The nature of the VIE is an adjustment of the red-chip structure, as indicated in Figure 4.2. The difference between the red-chip structure and the VIE is that in the VIE structure the foreign private equity and venture capital holds shares through a wholly foreign-owned enterprise[152] registered in China, rather than directly controlling the domestic company. Through a series of contractual arrangements among the domestic company, the WFOE and domestic shareholders, the WFOE is able to control the domestic company as if it holds shares in the domestic company.

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[150] M&A Rules (2006), s 44.
[151] Li, et al, (n 143) 58; Beijing Docvit Law Firm, (n 147) 193; Xinhui Liu, 'Private Equity Investment and the Legal Issues of Listing Rules' in Lawyer College of Renmin University of China (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China 2014) 97 [刘新辉，私募股权投资及上市之法律问题 载 人民大学律师学院组编，风险投资与私募股权律师实务，法律出版社，2014，第 97 页].
[152] Hereinafter referred to as the 'WFOE'.

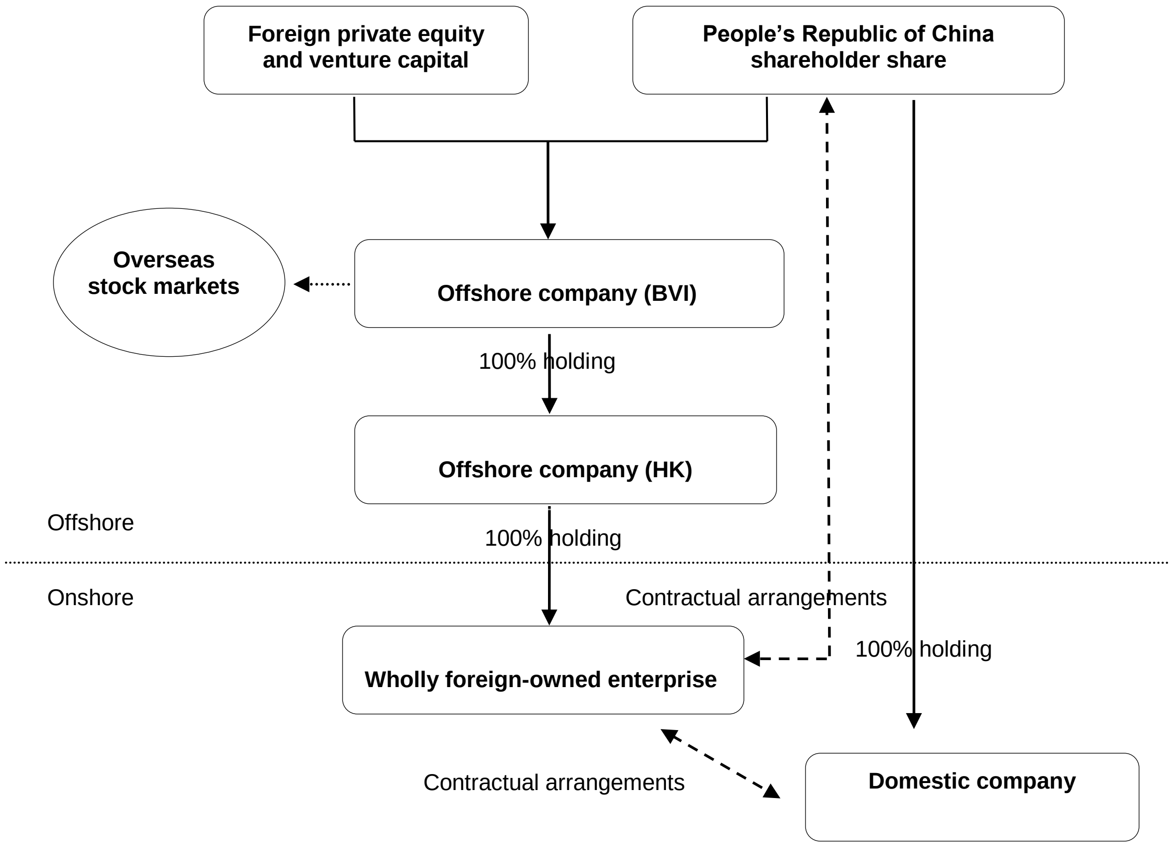

Figure 4.2: The variable interest entity structure

As with the red-chip structure, before establishing a series of contractual arrangements between the parties, the PRC shareholders and foreign private equity and venture capital funds jointly incorporate shell companies in BVI or Cayman Islands and Hong Kong and then also establish a WFOE in mainland China as a main contractual party in a VIE structure.[153] The contractual arrangements of the VIE structure include the following provisions, by which the foreign private equity and venture capital funds are able to invest indirectly in domestic companies: first, the loan agreement between the WFOE and PRC shareholders, in which the capital of the WFOE contributed by foreign private equity and venture capital funds and PRC shareholders will be extended to the PRC shareholders and then the PRC shareholders contribute the loan to the domestic company. Second, the WFOE and domestic company enter into the consulting and services agreement, through which the WFOE provides certain services such as industrial consulting or technical support for the domestic company. In return, the domestic company is obliged to transfer all the profit to the WFOE as the 'service

[153] The PRC shareholders usually only contribute very little capital, therefore the Chinese authority's approval of capital flow can be successfully avoided.

fee'. In this way, the foreign private equity and venture capital funds are able to fully obtain the profit of the domestic company who is licensed to engage in the industries that are not opened to foreign investors. In terms of the corporate governance of the domestic company, the voting rights proxy agreement between the WFOE, domestic company and PRC shareholders commonly provides that the PRC shareholders fully authorize their voting rights to the WFOE, by which the WFOE will be able actually to control the domestic company. For the convenience of exiting, the PRC shareholders commonly agree to grant an option to the WFOE which permits the WFOE or a third party to purchase the shares of the domestic company at a pre-agreed price. Finally, by signing the equity pledge agreement, the PRC shareholders' equity interests in the domestic company will be pledged to the WFOE as a guarantee for the performance of the domestic company's obligation.[154]

4.5.3.3 The Problems of Corporate Governance in VIE Structure: Case Studies

a. The Nature of the Corporate Governance Problems in VIE Structure

During recent decades, foreign private equity investors have become familiar with the VIE structure. Although the VIE structure facilitates private equity and venture capital investors to overcome the restriction and prohibition on certain industries, due to the contractual nature of the VIE structure, the stability and certainty of the WFOE's controlling power is much weaker than the direct shareholding relationship. In such circumstances, if the PRC shareholder breaks VIE agreements, the offshore companies will lose control of the domestic businesses; in other words, from the perspective of corporate governance, the PRC controlling shareholders are able to unilaterally control the domestic company and threaten the equity interests of the PE investors. Even if the private equity investors can enforce the domestic company or PRC shareholders to fulfil the contractual obligations under Chinese

[154] The evidence and details of the above diagram and analysis of VIE structures can be found from the following resources: Jian Qiu, 'Private Equity Investment Transactions and Legal Services' in Lawyer College of Renmin University of China (eds), Legal Practices of Venture Capital and Private Equity (Law Press China, 2014) 175-176 [邱健，私募股权投资交易及法律服务 载 人民大学律师学院组编，风险投资与私募股权律师实务，法 律出版社，2014，第 175 至 176 页]; Xianwu Zeng, Lihui Bai, 'Variable Interest Entity Structure in China' (King & Wood Mallesons Law Offices, February 9 2012) <http://www.chinalawinsight.com/2012/02/ articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/ > accessed 7 June 2015; Su (n 111) 28–29; David Roberts and Thomas Hall, 'VIE Structures in China: What You Need to Know' (O'Melveny & Myers LLP, October 2011) < http://iis-db.stanford.edu/evnts/6963/TICL_-_VIE_Structures_in_China.pdf > accessed 7 June 2015.

contract law, the costs of the dispute resolution process is time-consuming and expensive.[155] Moreover, owing to the lack of shareholding relationship between the private equity investor and domestic company, the contractual nature of the VIE structure also makes it hard to apply fiduciary duty principles to the PRC shareholders who are actually the director of the domestic company. By reviewing the following two cases, one can clearly see how the VIE structure may significantly increase private equity investors' risk in corporate governance under the Chinese legal system.

b. Case Studies of Corporate Governance in Variable Interest Entity Structure

Walden International invested in Sina, one of the leading Chinese Internet corporations, and successfully listed on the NASDAQ in 2000. Owing to the policy restriction on the Internet industry, the VIE structure was used in the listing process of Sina, by which two of the founders of Sina simultaneously wholly held a domestic company for the purpose of holding the Internet content provider[156] licence. The profit of the domestic company was transferred to offshore entities that are listed on the overseas stock exchange market. However, owing to the inconsistencies in business strategies between Zhidong Wang, the key founder of Sina and the board of directors, Wang was removed by a resolution of the board. As a defence, Wang attempted to break the contract between the domestic company and the WFOE, which might have resulted in the VIE structure collapsing and causing the failure of overseas listing.[157] Although through negotiation within the board of directors, eventually the adverse consequences in the Sina case were prevented, the serious legal problems within the VIE structure had drawn more attention and concern.

Similarly, the Alipay incident is another high-profile case showing the potential conflicts between the founder of the portfolio company and private equity investors in a VIE structure. Since 1999, Alibaba Group, the most influential Chinese e-commerce company, has attracted investment from a series of international venture capital and institutional investors. Given

[155] Xianwu Zeng, Lihui Bai, 'Variable Interest Entity Structure in China' (King & Wood Mallesons Law Offices, February 9 2012) < http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/ > accessed 26 June 2015.
[156] Hereinafter referred to as 'ICP'. The ICP refers to the commercial entities that provide Internet services to the public. In China any company is not permitted to enter the Internet services industry unless it is licensed by the authority.
[157] Su (n 111) 142–157.

future overseas listing, the VIE structure was set up between Alibaba Group (Cayman) and Alibaba E-commerce (Zhejiang) Corporation. As the domestic company, Alibaba E-commerce (Zhejiang) Corporation controlled by Jack Ma, the key founder of Alibaba,[158] is licensed to engage in third-party payment service and Alipay, one of the most lucrative subsidiaries of Alibaba Group, was controlled by both foreign institutional investors and domestic shareholders of Alibaba through the VIE agreements.[159] In 2005, to establish the commercial reputation in the online commerce market, Alibaba agreed to co-operate with Yahoo! who holds 40% of shares in Alibaba Group. As a consequence, the founder Jack Ma and other individual Chinese shareholders' shares were diluted to 31% and Yahoo! became the first majority shareholder in Alibaba Group.[160] In order to keep control of the company, the parties to the transaction agreed that Jack Ma and other individual Chinese shareholders could hold half of the seats on the board, while Yahoo! and other private equity investors could only have the other half. As a defence, however, Yahoo! required that Yahoo! should be entitled to appoint one more director from October 2010, which means that the founder would lose control both in the capital and governance structures.[161] Although Alibaba Group acquired financing and reputational resources from Yahoo! to develop its own business, the tense relationship between the founder and institutional investors has become a serious threat to the stability of Alibaba Group's corporate governance.[162]

Coincidently, the People's Bank of China[163] issued the Administrative Measures for the Payment Services Provided by Non-financial Institutions (June 2010)[164] which stipulates that any applicant applying for a payment services licence should be a company legally formed inside China. In the name of complying with the aforementioned regulation, Jack Ma unilaterally unwound the VIE agreement and transferred the whole ownership of Alipay to the Alibaba E-commerce (Zhejiang) Corporation without the board's permission. In this way, although Jack Ma had enhanced control over the core business of Alibaba Group,[165] the interests of foreign private equity and other institutional shareholders were seriously damaged.

[158] Jack Ma holds 80% and Shihuang Xie another founder of Alibaba holds 20% of the shares of Alibaba.
[159] Su (n 111) 21.
[160] Ibid., 16.
[161] Ibid., 16–19.
[162] Ibid., 16–19.
[163] Hereinafter referred to as the 'PBOC'.
[164] The Administrative Measures for the Payment Services Provided by Non-financial Institutions (2010), s 8 [中国人民银行. 非金融企业支付服务管理办法, 第八条].
[165] Wang (n139).

4.5.4 The Nature of Corporate Governance Problems in Chinese PE Investments

The case studies of corporate governance of Chinese listed companies show that due to the strict requirement of listing on the Chinese stock market, quite a large number of private equity investors get their return by listing the portfolio companies on the overseas stock exchanges. Consequently, in the process of private financing and listing, the control power of the entrepreneur will be continually diluted by both the private equity and venture capital investors and public shareholders. As a means of defence, the entrepreneur as the key person (e.g., the CEO or president of the board of directors) in the management layer of the company is able to influence the management of the company substantially, the interests of minority shareholders might be threatened by the entrepreneur's arbitrary behaviour in corporate governance.

From a theoretical perspective, the legal problems in the corporate governance of private equity-held companies also show that the nexus of contract theory of corporate governance may, to some extent, also be doubted. According to the contractual theory of the firm, the nature of the firm is a series of autonomous contracts between stakeholders. Therefore, company law should be established on a discretionary basis. However, the analysis of the above cases in China shows that the basic rules of corporate governance (such as the articles of association) should also have their own limits; in other words, the parties of the company should not have unlimited powers to change the power of the board of directors, otherwise in the circumstances where the interests of private equity investors and entrepreneur shareholders are not balanced in the general meeting of shareholders, the over-powerful board of directors may be controlled by the private equity and venture capital directors and their concerted parties to oppress the entrepreneur's legal rights, in which case the transaction costs will be increased. Moreover, the lack of fiduciary duties in the VIE structure also shows that compared with the joint stock company, owing to the unstable relationship between the listed entity and domestic company, which is controlled by the entrepreneur shareholders, the contractual nature of the firm should also be doubted.

To sum up, in order to improve the corporate governance in Chinese PE-held companies, it is recommended that reform in future should emphasize developing a series of contractual mechanisms between the private equity shareholders and entrepreneurs which can not only provide the entrepreneur with effective control power over the company, but also grant private equity and venture capital shareholders special rights to guarantee their interests in portfolio companies. In terms of company law reform, this chapter argues that although the board of directors is regarded as the centre of the corporate governance in Western countries, owing to their different cultural and social backgrounds, the limits of the board of directors should be reconsidered in Chinese company law.

4.6 A Proposal for Corporate Governance Reform of Chinese PE-held Companies

The case studies above illustrate the imbalance in common issue in private equity- and venture capital-held companies in China between the CEO-controllers' desire for control and private equity and venture capital investors' demands of legal protection for their minority shareholding interests. The first chapter of this dissertation shows that the business organization laws in common law jurisdictions are mainly based on a contractual mechanism which grants a large scope of freedom between the parties within the firm. Specifically, the shareholder-centred model in UK company law further illustrates that the powerful general meeting of shareholders can effectively reduce agency costs in corporate governance, which implies that ideally in the jurisdictions with a weak judicial (fiduciary) protection system for investors, such as China, the shareholder-centred model corporate governance system is likely to be more transplantable and useful for investor protection. In fact, however, owing to the 'initial conditions'[166] in the Chinese economy, the particular background and interest pattern in Chinese companies will strongly characterise the Chinese corporate law. The analysis below will discuss the contributions and limits of UK model company law in improving the protection of private equity shareholders in Chinese companies. The lessons from the corporate law reforms in post-Socialist countries in Eastern Europe will also be briefly referred.

[166] According to Lucian A. Bebchuk and Mark J. Roe, 'research, the path dependence in corporate ownership and governance root in two factors (initial conditions), the one is that the parties who are interested from the initial corporate ownership will have motivation and ability to impede any change in existing corporate shareholding structure; another is that the initial ownership structure can affect the interest group to select particular corporate governance rules which may enhance the protection for the interested parties in initial corporate ownership. Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127.

4.6.1 The Basic Principles of Legal Reform of the Corporate Law in China

4.6.1.1 Lessons and Experiences from the Privatizations in post-Socialist Countries

Before discussing the possibility of legal transplantation of UK model company law to enhance investor protection in China's PE-held firms, one important point that needs to be considered is what the precondition is for such transplantation in transforming the economy. In similar economic and social situations, post-Socialist states such as Russia and Poland may provide some implications and lessons. As the path dependence theory suggests, the starting point for the establishment and reform of corporate law in post-Socialist countries is based on a highly concentrated stated-owned economy. Therefore, the existing initial ownership and governance structures in such an economic and political condition determined that the initial corporate law in such jurisdictions must be rooted in the long-term battle between private investors and politically interested parties. In Russia, for example, as with the history of Chinese economic reform,[167] the initial function of joint stock company law was totally based on corporatization and privatization of SOEs.[168] In the process of the Russian privatization, owing to the serious inflation and lack of monitoring and disclosure mechanism, most Russian corporations had been controlled by the insiders and incumbent managers of the SOEs.[169] In consideration of the weak judicial system in Russia, the reformers introduced a kind of so-called self-enforcing company law, which was drafted by two American scholars.[170]

From the perspective of such self-enforcing companies, the basic model was actually more like the UK's shareholder-centred governance structure. For instance, the operation was mainly in the hands of inside parties such as shareholders, directors and managers, instead of outsiders such as intermediaries, which substantially gave the shareholders decision-making power in corporate governance; specifically the supermajority voting right on significant

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[167] Clarke, (n 94).
[168] Gregory Wolk, 'Corporate Governance Reform in Russia: the Effectiveness of the 1996 Russian Company Law' (1999) 8 Pacific Rim Law & Policy Association 119.
[169] Ibid., 223; Jun Wang, Privatization, 'Company Law and Corporate Governance: A Review of Russian Privatization and Joint Stock Company Law' (2003) (4) Journal of Comparative Law 85, 87 [王钧，'私有化、公司法和公司治理：评俄罗斯的私有化及其股份公司法'，比较法研究，2003 年第 4 期，第 87 页].
[170] For example, it was proposed that shareholders be granted with wide a range of rights and powers under self-enforcing corporate law, including the mandatory cumulative voting for directors, takeout rights after a change of control, determining power of remedies for minority shareholders and so forth. For details, *see* Bernard Black and Reinier Kraakman, 'A Self-Enforcing Model of Corporate Law' (1996) 109 Harvard Law Review 1911.

transactions and cumulative voting.[171] Although the Joint Stock Company Law of the Russian Federation came into force in 1996, it was, to a large extent, in the self-enforcing or shareholder self-protection model, the effectiveness was surprisingly disappointing. The value of companies was extravagantly tunnelled by existing inside controllers by pervasive self-dealings and the predicted protection of minority shareholders was proven to have failed.[172] Although it cannot be denied that the lack of effective remedy for regulating self-dealings is crucial in corporate governance, the point should be especially emphasised that the nature of the collapse of shareholder-centred corporate law in Russia is attributed to lack of separation of ownership and control;[173] in other words, the more power the shareholders had, the more serious the oppression of minorities would be, because the very small portion of ownership of outside shareholders could hardly bring pressure to bear or influence decision-making. Consequently, the 'common-law style' self-enforcing model of the company law proved that the law was only an instrument for the 'ruling class'.[174] Ironically, in the new Russia it may be the inside managers of privatised firms.

In contrast, Poland, as another large post-Socialist country which has been widely recognized as a much more successful transforming economy, shows a quite different landscape in corporate law reform, although the initial condition in the Polish economy was also the privatization of publicly owned enterprises. Generally speaking, since the coup took place in 1989 the process of capital privatization proceeded mainly in the following steps. First, the government transferred the ownership in SOEs to the Polish Ministry of Treasury, which resulted in the founding supervisory body being replaced with the ownership supervisory body.[175] In the second stage the Ministry of Treasury freely sold the shares to external investors by floating them on the stock exchange, private placement and public tender. Finally, the Polish SOEs were mostly owned by private and foreign investors, instead of

[171] Ibid.
[172] Bernard Black, Reinier Kraakman and Anna Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong?' (2000) 52 Stanford Law Review 1731.
[173] Ibid; Yangzhi Zhang, 'Cultural Analysis of Corporate Governance Structure in Russia' (2004)(4) East European, Russian & Central Asian Studies 28 [张养志，'俄罗斯公司治理结构的文化分析'，俄罗斯中亚东欧研究，2004 年第 4 期，第 28 至 34 页].
[174] Raymond A. Belliotti, 'Marxist Jurisprudence: Historical Necessity and Radical Contingency' (1991) 4 Canadian Journal of Law & Jurisprudence 145, 160.
[175] Piotr Lis, Joanna Mazurkiewicz and Sławomir Zwierzchlewski, 'Privatization Model in Poland: Commercial or Social?' (2013) 4 International Journal of Business and Social Science 42, 43.

insiders.[176] Therefore, in the moderate process of privatization, the external capital market was gradually established. Correspondingly, the systematic financial regulation would become indispensable. In fact, the first securities law had come into force in Poland as early as 1991 and the Polish Securities Commission, playing a role as independent financial regulator in the capital market, was also established.[177] The stringent external regulatory system in Poland ensured the healthy performance of financial intermediaries in the capital market and enhanced the information disclosure for both the public investors and regulators.[178] In sum, the successful prevention of inside control in privatized companies and tough investor protection can play a significant role in securing private property rights against political interference, especially in those countries that do not have a strong and sophisticated judicial system.

Based on the synchronous reform in financial regulation, the legal transplant of a shareholder-centred company law performed much more positively in Poland than in Russia. According to the Polish commercial code, Polish company law has vested a wide range of powers in shareholders, such as cumulative voting; preference shares; statutory power to elect the supervisory board and management board; approval power of significant transactions; and two-third majority voting on any proposed amendment of articles of association.[179] As a result of both the stringent external protection and wide freedom of contractual rights for shareholders, the performance of Polish firms and the stock market developed much better than not only Russia but also other Eastern European post-Socialist jurisdictions.[180]

With reference to the comparison between the transplantation of shareholder-centred company laws in the two transforming economies, it can be manifestly concluded that the 'initial conditions' in both the ownership structures and external capital markets will remarkably influence the path dependence in legal transplantation. Primarily, the shareholder-centred corporate governance model should be based on the ownership structure without a

[176] Ibid., 43, 45; Qidong He and Tingzhu Zhu, 'A Review of the Process of Privatization in Poland' (Shanghai University of Finance and Economics, 2003) [何起东，诸廷助，'波兰私有化进程及评价'，上海财经大学，2003 年]< http://www.hujingbei.net/n165c44.aspx> accessed 28 October 2015.

[177] Edward Glaeser, Simon Johnson and Andrei Shleifer, 'Coase versus the Coasians' (2001) 116 The Quarterly Journal of Economics 853, 874–875.

[178] La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny, 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 3, 22–23.

[179] Glaeser, et al, (n 177) 870–873.

[180] Ibid., 885–892.

single large shareholder, otherwise the shareholder-centred corporate law may only become the controllers' instrument to oppress minorities and to exploit the company's interests. Furthermore, the avoidance of a single majority shareholder makes it possible to attract outside investors and, as a result, the securities regulation would be indispensable for the authority, otherwise the attraction of external capital providers would be seriously reduced.

From the perspective of contractual theory, the above issues can be analysed as follows: although the Coasian contractual firm describes the firm as substitution of a nexus of contracts between employers and employees,[181] but actually the core meaning of contractual explanation in corporate governance would be the contractual relationship between the managerial personnel within the corporations.[182] From a corporate law point of view, the contractual nature of an enterprise can be regarded as a combination of contracts in areas of (i) non-human capital and (ii) human capital.[183] The practical meaning of 'human capital' is that due to the absolute monopoly of human capital of each individual, the value maximization of individuals' efforts can only be incentivised, but never exploited;[184] in other words, the precondition for applying contractual company laws is an existing free market for managers. By contrast, in a public enterprise or in a broader sense, the pressure and incentive from the market for managers never exist in an enterprise without separation of ownership and control,[185] so that any incentive contract or self-enforcing mechanism can hardly perform well.

4.6.1.2 The Feasible Direction for Corporate Governance Reform in China

With reference to the path-dependence theory of corporate governance and the above analysis of the corporate law reforms in post-Socialist countries, the primary question needs to be

[181] Ronald H. Coase, 'The Nature of the Firm: Influence' (1988) 4 Journal of Law, Economics, and Organization 33.
[182] Xinbo Wang, 'The Rethinking of the Nature of the Firm: The Implications in Modern Joint Stock Companies' (1992) (9) Economic Research Journal [汪新波，'对企业性质的重新思考—现代股份公司的启示'，经济研究，1992 年第 9 期].
[183] 'Human capital' refers to such aspects as professional skills, intellect, experience of individuals which are commonly intangible and irreplaceable. Qiren Zhou, 'The Firms in Markets: The Contracts of Human Capital and No-human Capital' (1996) (6) Economic Research Journal 71 [周其仁，'市场里的企业: 一个人力资本与非人力资本的特别合约'，经济研究，1996 年第 6 期，第 71 至 80 页].
[184] Ibid., 75.
[185] Qiren Zhou, 'The Nature of Public-owned Firms' (2000) (11) Economic Research Journal 3 [周其仁，'公有制企业的性质'，经济研究，2000 年第 11 期，第 3 至 12 页].

answered is what the specific path-dependence is of Chinese corporate law reform and whether shareholder-centred corporate law is feasible and useful in solving agency problems and enhancing protection of private equity investors in Chinese private equity and venture capital industry. Similar to the initial conditions in the economy of Eastern European, in the first instance, Chinese company law was also designed for the corporatization and commercialization of Chinese SOEs. Thus, any pure academic or imaginary proposal for legal transplantation would not be feasible. The following section of this dissertation basically argues that in the current Chinese economic and political environment, the transplantation of UK-style corporate law is partially possible, and some of the core institutions in the UK's company law have been gradually introduced into the Chinese commercial law system. However, the inherent interest pattern in the Chinese politics and economy will still play a negative role in impeding the liberalistic reform in Chinese corporate law.

On the one hand, as discussed in the first chapter of this dissertation, the rapid development of the Chinese private economy, including the private equity and venture capital industry, has been calling for a new type of corporate governance norm with more contractual freedom and less administrative intervention. From the political perspective, since the Third Plenary Session of the 18th Central Committee of Communist Party of China convened in November 2013, the highest level of Chinese authority has decided to significantly speed up the social reforms in improving the market price mechanism and encouraging the non-public sectors in the Chinese economy.[186] Moreover, with the development of industrial restructuring in the Chinese economy, the takeover activities will boom in the foreseeable future and then the real private equity funds or buyouts funds will play a more important role in the Chinese economy. As a response and in preparation for such a prediction, one should have the confidence that the takeover legal system which focuses on the equality in investor protection in mergers and acquisitions will be improved by Chinese legislators.[187] In sum, the general economic environment of liberalistic reform of Chinese company law is optimistic.

[186] The Decision on Major Issues Concerning Comprehensively Deepening Reforms (2013) [中共中央关于全面深化改革若干重大问题的决定（2013 年 11 月 10 日审议通过）].

[187] A similar trend can also be found in the development of British takeover rules: due to the lag of economy after WW II in the Western world, both the entrepreneur and British citizens increasingly put pressure on the UK government. As a positive response, the self-regulatory body concerning the takeovers in UK, namely the Panel on Takeovers and Mergers, was established in 1968. Moreover, in order to accelerate industrial expansion, the Labour's government adopted a relatively modest and liberal antitrust policy since the second half of 1960s.

On the other hand, owing to the statutory-dominating status of the party state system, however, the unshakable status of the publicly owned economy in China may make it impossible to wholly transplant the shareholder-centred system into the Chinese legal system in the short term;[188] in other words, the path of corporate law reform in China will still be significantly influenced by the publicly owned firms. The problem here is that with reference to the experience of the UK, the ownership structure played a fundamental role in the transformation of corporate governance model. Therefore, the dominant position of SOEs will have strong motivation and ability to hinder, or at least slow down, the transformation of Chinese corporate law from the insider model to dispersed shareholder-centred model.

In terms of the corporate governance of PE-held companies in China, the primary conflict is the protection of PE investors as minority shareholders and balancing the pluralistic interest pattern in the company. Hence, the shareholder-centred company law that provides a series of advantages in minority shareholder protection should still be much more useful for reducing agency costs in the corporate governance of Chinese PE-held firms.[189]

4.6.2 The Limits of Shareholders' Voting Rights in Amending Corporate Contracts

4.6.2.1 The Uncertainty of Contractual Freedom in Corporate Contracts

Since the first amendment of the Company Law of China in 2005 to the most recent substantive revision in 2013, it is quite clear that the evolutionary path of Chinese company law is liberalistic, which is mainly based on a common law corporate governance system. In terms of the corporate governance structure, the shareholders' power and rights are also continually enhanced by the legislation. For example, according to the Company Law (1993),

Christopher M. Bruner, 'Power and Purpose in the 'Anglo-American' Corporation' (2010) 50 Virginia Journal of International Law 579, 625–632.

[188] An Liu, 'The Political-Economic Dimension of Corporate Governance: an Analysis based on Chinese Company Law' (2014) 13 Securities Law Review 62, 81 [刘安，'公司治理的政治经济学维度—基于中国公司法的分析'，证券法苑，2014 年第 13 卷，第 81 页]; According to the Section of 'Basic Economic System' of The Decision on Major Issues Concerning Comprehensively Deepening Reforms (2013), it is clearly stated that 'China's economic system is one with public ownership serving as its main body but allowing for the development of all types of ownership', which means that although the price mechanism is emphasised by the present authority, the prioritised position of public-owned economy will not be waived.

[189] Ciyun Zhu and Kai Lin, 'A Review of Chinese Corporate Governance based on the Global Convergence Theory' (2013) 5 Chinese Journal of Law 24, 27 [朱慈蕴，林凯，'公司制度趋同理论检视下的中国公司治理评析'，法学研究，2013 年第 5 期，第 27 页].

the directors cannot be dismissed by shareholders without any causes.[190] The Company Law (2005 Revision) removed such restrictions and permitted the general meeting of shareholders to freely determine the removal of directors guided by the articles of association of each company.[191] At present, the newly revised Company Law of China (2013 Revision) also insists on empowering the shareholders' power in corporate governance.[192] It can be concluded that the general meeting of shareholders has played the supreme power centre in Chinese corporate governance.[193] According to the contractual theory, the voting principle can be freely distributed between the parties in the company. However, the decision-making power in creating or altering basic governance rules of companies should be approved by shareholders, because the residual claimants have strong motivation to seriously vote in consideration of the interests of the firm aligning with their own stake.[194] Although the current company law grants the power of amending the articles of association to the shareholders, the scope of contractual freedom in Chinese company law is still quite uncertain,[195] which leads to the problem that the majority voting may oppress the minority shareholders by controlling shareholders. This is why the Gome case is important in a practical sense.

[190] Company Law (1993), s 47(2), s 115(2).

[191] Company Law (2005 Revision), s 38, s 100.

[192] According to s 36 and 99 of the Company Law (2013 Revision), the general meeting of shareholders have the following powers: '(i) to decide on the business policies and investment plans of the company; (ii) to elect and replace directors and supervisors that are not appointed from representatives of staff and workers, and to decide on matters concerning the remuneration of directors and supervisors; (iii) to consider and approve reports of the board of directors; (iv) to consider and approve reports of the board of supervisors or supervisors; (v) to consider and approve the company's proposed annual financial budgets and final accounts; (vi) to consider and approve the company's profit distribution plans and plans for making up losses; (vii) to pass resolutions on the increase or reduction of the company's registered capital; (viii) to pass resolutions on the issuance of corporate bonds; (ix) to pass resolutions on matters such as the merger, division, dissolution, liquidation or change of the corporate form of the company; (x) to amend the articles of association of the company; and (xi) other functions and powers specified in the articles of association of the company.

[193] Liu Junhai, 'Experience of Internationalization of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work?' (2014) European Business Law Review 107, 114–115.

[194] Peixin Luo, 'The Legal-Economic Implications in Company Law Studies: Focusing on the Voting Rules' (2006) 5 Chinese Journal of Law 44, 52 [罗培新，'公司法学研究的法律经济学含义'，法学研究，2006 年第 5 期，第 52 页].

[195] Huining Dong, 'Introduction' of *The Freedom and Legal Restriction of Company Charter* (Law Press, 2007) [董慧凝，*公司章程及其法律限制*，法律出版社，2007，导言].

4.6.2.2 The Limitation of the Self-protection Mechanisms for Minority Shareholders

In the Gome case, in order to enhance and keep the control of the company, Guangyu Huang as the controller of the company, overwhelmingly determined the amendment of the articles of association. As a result, the board of directors exercised their strong powers of appointing directors, issuing corporate bonds and incentive mechanisms without the general meeting's approval.[196] According to s 38 of Company Law (2005 Revision),[197] the general meeting of shareholders has the power 'to elect and to replace directors and supervisors that are not appointed from representatives of staff and workers'. The opting-out of such a rule, however, means that minority shareholders may lose their voice in appointing and supervising their representatives in the boardroom.

Admitting that stricter approval procedures to amend articles such as the entrenchment provisions stipulated in the Companies Act 2006 of the UK may prevent value-decreasing amendments proposed by controllers. Any approval of value-increasing amendments may also be very difficult and even inefficient.[198] From a more social perspective, it was argued that in order to make the corporate law flexible, the contractual nature of the corporation should be insisted on, which means that the opting-out of corporate law by amending articles of association should be the basic principle in general law.[199] Considering the balance of the flexibility of commercial activities and the weak status of public investors in public companies, the law of public companies and financial regulations should not only encourage the contractual autonomy of business organizations and the government should create a kind of 'standard rules', including listing rules, securities law and model articles of association as default corporate contracts that can save contracting costs in corporate governance.[200] However, for protecting minority shareholders, the restriction on controlling shareholders in amending articles of association and judicial interventions in amending articles of association are quite necessary.

[196] Su (n 111) 163.
[197] The same stipulation as s 36 of the Company Law (2013 Revision).
[198] Lucian A. Bebchuk, 'Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments' (1989) 102 Harvard Law Review 1820, 1856.
[199] Henry Hansmann, 'Corporation and Contract' (2006) 8 American Law and Economics Review 1, 7–8, 13–14.
[200] Ibid., 11.

In order to reduce majority shareholders' opportunistic behaviours in altering governance structure, the norms in company law should be categorised in different groups, depending on various functions of norms, the modifiability of each category of rules would be different. Basically, the norms in corporate law can be categorised in the following types: first, the structural rules and distributional rules. The former mainly distribute the powers between different organs within the company and the latter group of rules stipulate the distribution of corporate assets between the owners.[201] Second, the fiduciary rules in respect of the obligations of directors and controlling shareholders which mainly play a role as the gap-filler and default rules applied by the judicial approach.[202] Because the structural and distributional rules are fully exercised by the parties in the company, which means that the parties of the corporate contract are able to reasonably consider and utilize the information for maximizing their interests, it is unnecessary to restrict the contractual freedom in contracting and altering such terms in the articles of association. On the contrary, owing to the separation of ownership and control, and controllers' advantageous status, the fiduciary rules should be compulsory. The court will play a role as delegated contractor for owners, especially for the minorities of the corporation.[203] In such a categorised structure of corporate rules, the corporate law cannot only keep the flexibility and contractual freedom, but also prevent the majority's oppression on minority shareholders.

4.6.2.3 Set up a Judicial Standard of Contractual Freedom in Chinese Company Law

In the existing Chinese company law, with the rapid rise of institutional shareholders and in consideration of the priority of minority shareholder protection, the derivative actions for shareholders are encouraged more than before.[204] As early as the amendment of the Company Law in 2005, a shareholder derivative lawsuit system was introduced in China: in the circumstance where directors or supervisors violate their duties, any eligible shareholders are entitled to institute proceedings on behalf of the company against the directors or supervisors for their wrongdoings.[205] The fiduciary duty system in Chinese commercial law is not yet

[201] Melvin A. Eisenberg, 'The Structure of Corporation Law' (1989) Columbia Law Review 1461, 1463–1469.
[202] Ibid., 1469–1470.
[203] Ibid., 1463–1469. In practice, for instance, according to s 232 of the Companies Act 2006 of the UK, any forms of contractual provisions purporting to exempt a director's liabilities are void.
[204] For details are available in Junhai (n 193) 117–124.
[205] Company Law (2005 Revision), s 152.

widely implemented, notwithstanding, the possibility of judicial remedy for minority shareholders in amending corporate charters s has been provided by the law.

In practical terms, more and more legal disputes in respect of the articles of association in Chinese companies have also arisen from China's judicial practices. However, the Chinese courts have not reached consensus on judging the validity of amending articles of association. For instance, some local courts considered that in the circumstances where specific shareholder(s) do not accept an amending proposal of the articles that may significantly influence the rights of the shareholder(s), such shareholder(s) should not be legally bonded by the amendment.[206] The reason for the above decision is that the dissenting shareholder(s) are not the contractual parties to the amendment of the articles.[207] Put differently, in some cases judges have argued that the contractual autonomy in amending the articles should be respected by the court, unless the voting procedure is defective,[208] as the majority voting procedure was statutory in Chinese company laws.[209] It is obvious that none of the above two viewpoints can perfectly solve the problems in practice. On the one hand, if the standard of judgment only stands on the basis that the statutory procedure of voting is complied with, the abuse of voting rights in amending corporate contracts by controlling shareholders can hardly be restricted. On the other hand, if the dissenting shareholders can be exempted from general meeting decisions, the majority voting principle will be threatened.[210]

In this regard, a series of practical principles developed in UK common law that would be useful for Chinese legal practices. As a fundamental principle, the common law requires that an amendment of articles should only be decided in the interests of the company as a whole, otherwise any alteration of the articles of association based on specific shareholders' personal stake would be regarded as invalid. This judging standard was initially set up in the case of

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[206] Jianbin Wu, 'How Can the Consensus Principle Overwhelm the Majority Voting? An Analysis of the Localization of the Contractual Theory of the Corporation' (2011) (2) Law Science 55, 61 [吴建斌，'合意原则何以对抗多数决—公司合同理论本土化迷思解析'，法学，2011 年第 2 期，第 61 页].
[207] Ibid.
[208] Yulin Qian, 'The Corporate Charter as the Source of Adjudication: Legislative Discourse and Judicial Practices' (2011) (1) Studies in Law and Business 95, 98 [钱玉林，'作为裁判法源的公司章程：立法表达与司法实践'，法商研究，2011 年第 1 期，第 98 页].
[209] Company Law (2005 Revision), s 44(2); Company Law (2013 Revision), s 43(2).
[210] Ciyun Zhu, 'The Capital Majority Voting Principle and the Fiduciary Duties of Controlling Shareholders' (2004) (4) Chinese Journal of Law 104 [朱慈蕴，'资本多数决原则与控制股东的诚信义务'，法学研究，2004 年第 4 期，第 104 至 116 页].

Allen v Gold Reefs of West Africa Ltd (1900),[211] in which Lindley MR held that voting power in amending the articles of association at the general meeting should be subject to the principle that the exercise of such votes must be 'bona fide for the benefit of the company as a whole'.[212] However, the further important issue is how to assess the standard of 'bona fide' and 'the benefit of the company as a whole'; particularly, if a controller is able to determine the amendment of the articles of association, by means of which the proceeds of both the company and the controller are increased, in what circumstances should such an amendment be valid? In the case of *Shuttleworth v Cox Bros Ltd* (1926),[213] the Court of Appeal held that the *bona fide* standard should not be determined by the judge, rather it should be tested by (i) whether a rational reason is available that any one reasonable person would consider such amendment was made in the interests of company as a whole or (ii) whether such an amendment is so unreasonable that no any reasonable man would consider that it was decided in the interest of the company instead of a given shareholder.[214] In such an examining approach, the validity of amending the articles of a company is much clearer.

In addition, the remedies for unfair prejudice in UK case law may also be referential for facilitating the protection of minority shareholders in Chinese companies. The unfair prejudice remedy differs from the derivative action, the former one is a legal instrument especially for the interests of minorities instead of the corporation. According to s 994 of the Companies Act 2006, in the circumstances where the given minority has been or is at the risk of being unfairly oppressed by controlling shareholders, such judicial remedies can be provided by the court. The core issue in this regard is the criteria of judging the unfairness in each petition. In the leading case *O' Neil v Phillips* (1999),[215] the two fundamental standards of judging the unfairness was initially formed. Lord Hoffman held that first, the contract such as the articles of association is usually created at the moment when the company is incorporated, thus the norms and limits in relation to the company's affairs should be regulated by the provisions of corporate contracts. As a general principle, the British court is reluctant to provide unfair prejudice remedies if the defendant have not breach the articles.

[211] *Allen v Gold Reefs of West Africa Ltd* [1900–03] All ER Rep 746.
[212] Ibid.
[213] *Shuttleworth v Cox Bros Ltd* [1926] All ER Rep 498.
[214] Ibid.
[215] *O' Neil v Phillips* [1999] 2 BCLC 1.

Second, if some issues which are obvious against the ‘equitable considerations’, the court is likely to remedy the minority shareholders. In most cases, the so-called ‘equitable considerations’ in relation to unfair prejudice is applicable to those small quasi-partnership firms (e.g. the start-ups), rather than those large public corporations, as in such enterprises the mutual trust and understanding among all the members are the foundation of association, even though some of them will never be recorded in any contract.[216] In such firms, the shareholder who is in a controlling position should be prevented by the court from the behaviours aiming at pushing the minorities aside from corporate management or from enjoying the profit.[217] Since the presence of a controlling shareholder is a feature of PE-held start-ups in both the UK and China, it is possible to envisage that this remedy could work in both systems in the context of quasi-partnership firms.

Although at the outset of this research suggests that the effectiveness of judicial protection for investors in China may be limited, in this regard, this research insists that, to some degree the judiciary should play a role in judging the justification of altering the articles of associations in PE-held companies, as the requirement of ‘for the benefit of the company as a whole’ is actually a practical standard instead of a fixed and express ‘rule’ stipulated in written laws. Similar to the advantages of fiduciary duties in promoting the efficiency, the amendment of corporate contract are not so frequent that worth very detailed legislation. In contrast, it will be more cost-efficient to judge a given amendment of articles of association by controlling shareholders on a case-by-case basis.

In practice, currently the liberalistic reform of Chinese company law remarkably enhanced the judicial right of shareholders to restrain controlling shareholders’ oppression. In consideration of costs and solidarity of the parties in companies, however, the judicial intervention in shareholders’ contractual behaviours should be conservative and prudent. In private companies, especially family-owned companies, the relationship between not only the management, owners and even employees are very closely tied. Any over-encouraged judicial intervention between the minority and controlling shareholders will weaken or even destroy the trust, friendship and co-operation between the parties in the

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[216] Paul L. Davis and Sarah Worthington, *Gower’s Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 666.
[217] Ibid.

companies.[218] Therefore, from the perspective of the operational efficiency within the enterprise, the judicial intervention or assessment of the alteration of articles should not be launched, unless the internal remedies such as active communication with the boards of directors and supervisors have been exhausted.

In a practical sense, the reform can be carried out in two aspects in future. The one is that in order to save the costs in judicial intervention, in the circumstance where a given shareholder institutes a proceeding against a defective amendment of articles, the defendant – commonly the controlling shareholder – must effectively prove that such an amendment is proposed in the interest of the company rather than the controlling shareholders' benefit. If the controlling shareholder fails to do so, such an amendment of articles of association can be adjudicated as invalid and the responsible controlling shareholder may be ordered to compensate any loss to the company and those victim shareholders. The other one aspect is that the Supreme Court of China may be capable to release more detailed guidance of judicial practices in relation to the cases of fiduciary duties in company law,[219] by which the judging standard of so-called 'for the benefit of the company as a whole' can be interpreted on a case-by-case basis. For the quality and stability of judicial practices in China, however, such sort of detailed and practical standard can only be gradually developed in practice. What's more, the pilot reform project of 'case guidance system' in Chinese judicial system is also led and encouraged by the Supreme Court of China since 2010.[220] Although it is still at an early and experimental stage, in comparison with those sensitive areas such as constitutional review and administrative law, the development of judicial practices in civil and commercial law system can be expected. Therefore, it is recommended that the Chinese courts at present should be encouraged to accept the disputes in relation to the justification of amending provisions in corporate contracts, only in this way, the standard for PE shareholders and the entrepreneurs'

[218] Feifei Wu, 'The Theoretical Debate and Judicial Explanation of the 'Otherwise Stated in the Articles of Association' Provisions: A Perspective of Contractual Theory and Principle of Shareholder Equality' (2014) (1) Journal of Gansu Political Science and Law Institute 92, 97 [吴飞飞，'公司章程另有规定'条款的理论争点与司法解说—以公司合同理论与股东平等原则为认知路径'，甘肃政法学院学报，2014 年第 11 期，第 97 页].
[219] For example, the Supreme Court has issued four official guidances for the judicial practices of Chinese company law during the time 2006-2014.
[220] The Guidance Rules for Establishing the Case Guidance System (2010) [关于案例指导工作的规定(2010)] was issued by the People's Supreme Court of the PRC in November 2010. In this official document, the Supreme Court is clearly obliged to screen and to publish most significant leading cases annually as guidances for the lower courts.

contractual activities can be gradually developed, of course, the maturity of such practical standards may take time.

4.6.3 Class Share: Why Not?

4.6.3.1 Class Share as Efficient Contracts for PE Investors and Entrepreneurs

Owing to the deep-rooted tradition of rule of man in Chinese society, when outside investors such as private equity and venture capital funds enter into a family firm, the conflicts between the capital and control would be easily triggered. As analysed above, the nature of such a problem is the extremely heterogeneous demands and expectations of the corporate governance of PE-held companies between the founder-controller and private equity shareholders. Therefore, in Chinese private equity industry a more flexible capital structure that can establish a balance mechanism between the PE and VC investors and founder-controller has been strongly desired. More specifically, it can be seen from both the failure of corporate governance in the case of NVC and the violation of the contractual spirit in the VIE structure that a stable and friendly collaboration between the entrepreneurs and PE and VC investors can hardly be reached; only the provisions in the articles of associations may be resorted to, but also a kind of capital instrument meeting pluralistic demands of different shareholders in the company.

Since the early 2000s, in order to align the interests of the PE investors and entrepreneurial shareholders, a kind of special shareholders' agreement that is aimed at incentivising the entrepreneurial shareholder to work assiduously for the interests of the company, the so-called value adjustment mechanism[221] provision was made for Chinese venture capital players.[222] In a typical VAM contract, if the entrepreneur can reach a specified goal of corporate performance, such as a predicted compound annual growth rate[223] or return on equity[224] or successfully list the company on public markets by a pre-agreed date, the PE fund

[221] Hereinafter referred to as 'VAM'.
[222] Dongsheng Zhao, *A Guidebook on Legal Practices of Private Equity Funds: Fundraising, Financing, Restructuring and Listing* (Shanghai Academy of Social Science Press, 2011) 188-189 [赵东升，*私募股权基金法律实务大全—募集 融资 ·企业改造 ·上市*，上海社会科学院出版社，2011，第 188 至 189 页].
[223] Hereinafter referred to as 'CAGR'.
[224] Hereinafter referred to as 'ROE'.

should transfer a sum of shares to the entrepreneur without any charge as a reward.[225] Otherwise, if the entrepreneur of the investee company fails to reach the pre-agreed goal of performance, the entrepreneur shareholder, commonly the controller of the company, must transfer a given amount of shares without any charge to the private equity and venture capital shareholders.[226]

It is obvious that the legal nature of VAM contract is a supplementary agreement between particular shareholders, which aims to optimally arrange the benefits pattern among the shareholders with various demands. However, because of the immaturity of the entrepreneurs in Chinese private firms, many of the founders of enterprises over-ambitiously enter into VAM contracts with experienced venture capitalists without prudent consideration of their profitability and sufficient investigation of markets. As a consequence, the failure of VAM practices in PE/VC-held companies successively occurred in China.

On the one hand, some cases occurred in the recent decade such as Yolo Electronic Company Limited[227] have clearly reflected that over reliance on the incentive mechanism in VAM contracts will put investee companies at the risk of business failure or over-costly transactions.[228] Xiao Chen, the CEO-controller of Yolo, entered into a VAM contract with Morgan Stanley and China Diamond Holdings L.P.[229] in 2005. As a consideration, the two private equity funds contributed USD 50 million to the company. According to the VAM contract, if the annual net profit of Yolo exceeded RMB 0.75 billion in the 2007 fiscal year, the private equity shareholders agreed to transfer 3% of the shares to the founder as a reward free of charge. By contrast, however, if the annual net profit of Yolo amounted to less than RMB 0.6 billion in 2007, Xiao Chen must transfer a total 6% of the whole shareholding to

[225] Zetong Chen and Yu Zhao, ‘The Categorical Analysis and Judicial Implications of VAM Contracts in China’s Private Equity’ in South China International Economic and Trade Arbitration Commission (eds), *Equity Investment and Corporate Governance in China* (University of International Business and Economics Press, 2014) 119–131 [陈泽桐，赵宇，‘我国 PE 对赌协议的类型化分析及其诉讼案例启示’载华南国际经济贸易仲裁委员会，中国股权投资与公司治理——2013 年华南企业法律论坛论文集，对外经济贸易大学出版社，2014，第 119 至 131 页].
[226] Na Wang, ‘The Illegitimacy and Legitimacy of Value Adjustment Mechanism Agreements’ (LLM thesis, East China University of Political Science and Law 2013) 2 [王娜，对赌协议的非法与合法，华东政法大学法学硕士学位论文，2013，第 2 页].
[227] Hereinafter referred to as ‘Yolo’.
[228] Similar typical cases also include the costly listing case of Renhe Commercial Holdings (2008) and liquidation case of the Taizinai Group [太子奶集团] (2010), all of which were caused by the failures in VAM agreements. See more details in Su (n111)104-112, 238-255.
[229] Hereinafter referred to as the ‘CDH’.

the private equity shareholders without any charge.[230] Owing to the unpredictable competition pressure, such an over-ambitious goal was actually impossible in such a short term. Finally, Xiao Chen the CEO-controller of Yolo had no choice but to sell the company to another leading household electronic appliances retailer in 2006, only for the purpose of avoiding the adverse consequence of the VAM contract.[231]

On the other hand, although the Supreme People's Court's judicial adjudication of the validity of VAM contracts[232] preliminarily legalized the validity of VAM provisions in the Chinese private equity and venture capital industry,[233] as one of the most complex and innovative practices in the Chinese financial industry, the limits of the contractual freedom of VAM agreements in China is still highly uncertain.[234] Moreover, owing to the speculative tendency in VAM contracts, the regulator's attitude towards VAM is still conservative. Therefore, at present the compliance risk in applying VAM agreements in the Chinese PE industry is also high and uncertain.[235]

No matter the CEO-controller's abuse of power in corporate governance, such as in the case of Changjing Wu in NVC, or the breakup of the spirit of the contract in VIE structure, such as in the cases of Sina and Alibaba, or even the failure in practice of VAM, as in the case of Yolo, the key issue reflected by all the cases above is that in the Chinese private equity

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[230] Ibid., 81–82
[231] Ibid., 83–88.
[232] Haifu Investment Co., Ltd v Gansu Shiheng Nonferrous Resources Recycle Company Limited (2012) [中华人民共和国最高人民法院民事判决书（2012）民提字第 11 号].
[233] For a detailed analysis of this case *see* Terence Foo and Jiang Niao, 'Chinese Courts Rule on Value Adjustment Mechanism: Impact on Private Equity Investments' (Clifford Chance LLP, 30 January 2013) <http://www.cliffordchance.com/briefings/2013/01/chinese_courts_ruleonvalueadjustmentmechanis.html> accessed 12 November 2015; Xiaohu Ma, Thomas Chou, Paul McKenzie and Jun Deng, 'China's Supreme Court Ruling in *Haifu v. Shiheng* Changes the Landscape for Value Adjustment Mechanisms in Onshore Private Equity Transactions' (Morrison & Foerster LLP, 21 January 2013) < http://media.mofo.com/files/Uploads/Images/130121-China-Supreme-Court-Ruling-Haifu-v-Shiheng.pdf> accessed 12 November 2015.
[234] For example, because in China the adjudications of courts are not legally binding, the Supreme Court's attitude in the *Haifu* case may not be widely cited or followed. In fact, at present some local courts have dealt differently with cases involving VAM contracts. Dongxia Xia and Ting Yang, 'The Typical Judicial Cases After the Haifu Case' (King & Wood Mallesons LLP, 24 April, 2015) [夏东霞，杨婷，'海富投资案后对赌协议代表案例'，金杜律师事务所，2015 年 4 月 24 日] <http://www.chinalawinsight.com/2015/04/articles/dispute-resolution/%E6%B5%B7%E5%AF%8C%E6%8A%95%E8%B5%84%E6%A1%88%E5%90%8E%E5%AF%B9%E8%B5%8C%E5%8D%8F%E8%AE%AE%E4%BB%A3%E8%A1%A8%E6%A1%88%E4%BE%8B/> accessed 12 November 2015.
[235] For example, although there is no clear rule, up to now, the CSRC has insisted that any companies signing VAM contracts with private equity and venture capital funds will not be approved for IPO, until the VAM contracts are terminated. Zhao (n 222)190–191.

industry, the immaturity of Chinese entrepreneurs and commercial culture currently are unable to establish a sustainable foundation for feely applying shareholders' agreements.

In sum, compared with the special agreements between private equity shareholders and founder-controllers, as a more flexible corporate finance instrument, the class share will be more advantageous in the following respects: (i) based on a statutory framework in corporate law, the uncertainty in using class shares will be much less than shareholder agreements such as VAM provisions; (ii) the details of class shares will be clarified in the articles of association, whereas the shareholder agreements generally will not be disclosed to public investors or other third parties, including the creditors of the company.[236] Moreover, again, concerning the immaturity of the entrepreneurs of private companies in China, a more normative contractual structure rather than pure contractual activities without instruction, would be more suitable and securable.

4.6.3.2 The On-going Reform of Class Share System: 'State Control' as the Key Word

After around one decade during which the privatization reform of SOEs in China, with the promulgation of the Decision on Major Issues Concerning Comprehensively Deepening Reforms by the China Communist Party in November 2013, a new wave of commercialization of the Chinese economy has been launched, in which the marketization of China's SOEs is positioned as the primary goals. In this aspect, the class share system as a very specific legal regime is expected to play a significant role in facilitating mixed ownership reform of Chinese SOEs. For instance, it is suggested that the state-owned shares should be converted into preferred shares without voting rights, by which the monopolistic control power of the administrative bodies will be significantly restrained. At the same time, the economic rights in preferred shares will also reduce the risk and maximize the value of state-owned assets, which should be the core function of SOEs in Chinese economy.[237] Furthermore, in a wider sense, the application of dual-class shares in Chinese SOEs is also

[236] Ciyun Zhu and Zhaohui Shen, 'The Class Share and the Evolution of Chinese Company Law' (2013) (9) Social Sciences in China 147, 152 [朱慈蕴，沈朝晖，'类别股与中国公司法的演进'，中国社会科学，2013 年第 9 期，第 152 页].
[237] Junhai Liu, 'Preferred Shares May Cure the Illness of SOEs and VIE Structure' (2012) (3) Directors and Boards 43 [刘俊海，'优先股将根治国企/ VIE 难题'，董事会， 2012 年第 3 期，第 43 至 44 页].

beneficial. With reference to failed management buyouts[238] of Chinese SOEs during the mid-1990s to 2003, the root reason for the failure was the over-concentrated ownership in the hands of the management layer,[239] the 'one vote per share' principle is unable to provide minority shareholders with sufficient power to protect their interests. As a response, in order to arrange the pluralistic ownership structure in the SOEs flexibly, it is recommended that state organs should hold special shares with super-votes and the private shareholders hold preferred or common shares in those SOEs that have a close relationship with public welfare or state security.[240] In such a kind of mixed ownership structure, the economic interests of institutional investors can be guaranteed by the preferred shares and in those special industries, meanwhile, the dual-class share will facilitate the state control.

Against such policy background, the time is ripe to transplant the class share regime into Chinese company law which will significantly improve the efficiency of PE-held companies. Almost at the same time as the promulgation of the new proposal for the comprehensive reform of the Chinese market economy, the State Council released the first general regulation regarding class shares, namely the Guiding Opinions of the State Council on Carrying out the Pilot Program of Preferred Shares (2013)[241] in which the fundamental legal framework of preferred shares was preliminarily established.[242] As a pilot project in the legal reform relating to the Chinese private equity and venture capital industry, the basic functions of preferred shares such as preference in distributing dividends and liquidation are provided in this regulation,[243] and some restrictions such as the prohibition of issuing participating preferred stocks[244] are highlighted as well. Successively, a more detailed regulation of preferred shares was also issued by the CSRC in March 2014,[245] according to which both private and public companies registered in China are eligible to issue preferred stocks. In terms of protecting the interests of preferred stockholders, the Measures for the Pilot

[238] Hereinafter referred to as 'MBOs'.
[239] Guo Feng and Meng Yang, 'The Second Wave of SOEs Reform and the Application of Dual-Class Share Structure' (2014) 32 Science of Law 150 [冯果、杨梦，'国企二次改革与双层股权结构的运用'，法律科学，2014 年第 6 期，第 150 至 157 页].
[240] Ibid.
[241] Hereinafter referred to as 'Guidance on Preferred Shares (2013)'.
[242] 国务院关于开展优先股试点的指导意见 (国发 2013, 46 号).
[243] Ibid., s 2 and 3.
[244] At present, the holders of preferred shares are not allowed to participate in profit distribution with the holders of common shares after the dividends of preferred shares have been gained. ibid., s 10(4).
[245] CSRC. The Measures for the Pilot Administration of Preferred Stock (March 2014) [中国证券监督管理委员会. 优先股试点管理办法（证监会第 97 号令）， 2014 年 3 月 21 日公布].

Administration of Preferred Stock (March 2014)[246] entitles the preferred stockholders to the voting right in deciding a series of issues such as (i) the alteration of the provisions relating to preferred shares in the articles of association; (ii) a proposed capital reduction in the sum of more than 10% of the registered capital of the corporation; (iii) the mergers, separations, liquidations or alteration of form of the corporation; (iv) issuing preferred stocks and (v) other circumstances stated in the articles of association.[247] Moreover, in the circumstances where the company refuses to disburse dividends to preferred stockholders in accordance with the terms in the articles of association or other agreements for three fiscal years cumulatively or two fiscal years consecutively, the preferred stockholders' voting right in the general meeting of shareholders shall be recovered as the same as other holders of common shares.[248]

4.6.3.3 The Pros and Cons of Class Shares in the Chinese Private Equity Industry

Both the cases discussed in this chapter and the legal institutions widely used in the private equity market in the UK, such as the shareholder's agreement and class share, show that the heterogeneity of shareholders in PE-held companies has been pervasive. The current on-going pilot reform of preferred shares makes it possible to apply class shares in PE-held companies, by which the economic interests of PE investors and control power of the CEO-founders can be well balanced. Again considering the NVC case, although the contractual spirit has been increasingly highlighted and emphasized in both the media and academia in recent years, the change of deep-rooted Chinese culture of the 'rule of man' within a short period may be impractical. Providing the private equity and venture capital shareholders with preferred shares and the founder-controlling shareholders with common stock respectively can, to a large extent, counterbalance the interests in the company. Moreover, the prioritization of private equity and venture capital shareholders in the capital structure of the company will also encourage the management to consider and improve the level of corporate governance more prudently for the purpose of generating enough profit for dividend distribution.[249]

[246] Hereinafter referred to as the 'Measures for Preferred Stock (2014)'.
[247] Ibid., s 10.
[248] Ibid., s 11.
[249] Haifeng Hua and Dongfeng Zhang, 'A Thinking of the Preferred Stock Regime' (2012) (7) China Securities 59, 62 [华海峰、张冬峰，'对优先股制度的思考'，中国证券，2012 年第 7 期，第 62 页].

As regards the problem of control in VIE structures, the class share, especially the dual-class voting right, is also beneficial. In China, owing to the political concerns in some special industries, especially the media and education, foreign capital is still strictly prohibited. The breach of contract and the corporate governance failure in VIE structure actually reflect the intension to control power between the founder-controllers and foreign private equity shareholders on an overseas listing level. Consequently, VIE agreements are used as a hatchet with which the controllers may threaten the private equity and venture capital shareholders. Serving as a balance mechanism for heterogeneous shareholders in PE-held companies, the dual-class share may effectively mitigate the risk in the overseas-listed companies involving VIE structure such as AliPay and Sina.[250] Specifically, if the founder-controllers can hold a special class of shares attached with super votes through which the controllers can firmly control the companies and be shielded from hostile takeovers or dilution in successive financing, the governance failure caused by the scramble of control in VIE structures can be mitigated. Although it is also true that the controllers' super votes may also impede the external investors from investing in the company, the very limited sources of financing in China's private economy will still drive Chinese entrepreneurs to welcome private equity and venture capital shareholders, rather than reject them from the start.

Although the Company Law of China (2013 Revision) does not provide clear guidance on issuing dual-class shares,[251] the related experimental applications have been launched in some overseas listed Chinese companies.[252] By using the dual-class shares in public-listed

[250] Actually, in the media and among IT barons, the dual-class share regime has been widely welcomed; for example, the Murdoch family owns around 12% of the shareholding in News Corporation, but controls about 40% voting rights by means of a special class of shares; similarly, Google and LinkedIn are also firmly controlled by the founder shareholders in the application of class shares with super votes. 'Dual-class Share Structures: The Cost of Control, the Trouble with Non-Voting Shares' *The Economist* (21 July 2011) < http://www.economist.com/node/18988938> accessed 15 November 2015.

[251] According to s 126 of the Company Law (2013 Revision), [s]hares shall be issued in accordance with the principles of equitability and fairness. Each share of the same type shall carry the same rights and benefits. Shares of the same type in the same issue shall be issued on the same conditions and at the same price. The same price shall be payable for each of the shares subscribed for by any work unit or individual. It is not unreasonable to understand this section that the Chinese law basically does not refuse the use of dual-structure of shares, however, the further specific rules in relation to class shares are still lacking.

[252] For example, the two Chinese e-commerce tycoons namely JD.com (JD), Inc and Alibaba Group (BABA) listed on the NASDAQ in May 2014 and the NYSE in September 2014 respectively. The founders of the two companies as minority shareholders control the listed companies through holding special classes of shares with super votes. In the Alibaba case, the founder, Jack Ma, and other 27 key members of the Alibaba firmly control the exclusive power of nominating the simple majority of directors. In the case of JD.com, the founder, Richard Qiangdong Liu, owns all Class B shares attached with 20 votes each share, by which the founder represents 83.7 % votes but only holds 20% equity interests in the whole shareholding structure of the company. See The Prospectus of Alibaba Group Holding Limited (May 6, 2014)

companies, the founder of the companies can strongly resist the dilution from both the follow-up financing provided by PE institutions and public investors after going public, which may be an advantage for the stability of company development and keeping the innovation ability of the core management team.[253] However, there is no perfect legal system in the world; the dual-class share is also a double-edged sword. Firstly, the dual-class votes may shield the management from the pressure of the control market,[254] which will reduce its positive effect in motivating managers to continually improve the level of governance. Secondly, the over-centralized ownership structure causes the 'tunnelling behaviour' of the founder-controllers in PE-held companies which may be exacerbated by applying the dual-class voting system. In this regard, the advantage is that it protects entrepreneurial management from the demands of ordinary shareholders. The disadvantage of a dual-class share structure is that it protects entrepreneurial management from the demands of shareholders.'[255]

As the countermeasures against the conundrum of dual-class shares, both the regulators and legislators of China should not only clarify the legitimacy of the dual-class share regime, but also impose necessary restrictions on the controlling shareholders and provide effective remedies for victim shareholders oppression occurs. On the one hand, in respect of self-governance, it can be stipulated in the articles of association that in the circumstances where the portion of shareholding of the founder-controllers or management layer is below a threshold rate, the super votes attached to the class share automatically convert to one vote per share, the same as other common stocks. In this way, the deviation of the interests of the management layer and the company as a whole under the regime of dual-class share may be mitigated. On the other hand, the financial regulatory institutions such as the CSRC should be

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<https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm#toc709111_16> accessed 16 November 2015; The Prospectus of JD.com, Inc (January 30, 2014) <https://www.sec.gov/Archives/edgar/data/1549802/000104746914000443/a2218025zf-1.htm#ev17701_shares_eligible_for_future_sales> accessed 16 November 2015.

[253] Wendao Lu and Wenxin Wang, 'The Dual-Class Share Structure and its Deviation from the One-Share-One-Vote Rule: an analysis inspired by the Alibaba Partnership system' (2013) 9 Securities Law Review 179, 197 [卢文道、王文心，'双层股权结构及其对一股一权规则的背离—阿里上市方案中'合伙人制度'引起的思考'，证券法苑，2013 年第九卷，第 197 页].

[254] Actually, the dual-class share was not officially accepted by the NYSE until 1984, during which the demands of financial instruments facilitating anti-takeover strategies were extraordinarily high and eventually the dual class share was accepted by both the NYSE and NASDAQ. *See* Xiaomin Jiang, 'The Dual-Class Share Structure in the US: Development and Debates' (2015) (9) Securities Market Herald 70, 70-73 [蒋小敏，'美国双层股权结构：发展与争论'，证券市场导报，2015 年 9 月号，第 70 至 73 页].

[255] Charles Elson et al., 'Dual-class Stock: Governance at the Edge' (2012) (Third Quarter) Directors and Boards 37.

authorised to exercise statutory power in investigating the legislative foundation of applying dual-class structures in particular companies listed on stock exchanges. As a related requirement, all the listed companies applying a dual-class share structure should disclose the relevant information in a timely manner, in respect of the accountability, track records of the controllers and the balance mechanism of interests of heterogeneous shareholders on a corporate governance level, otherwise the regulator may intervene in the use of dual-class shares in a given company.[256] Last but not least, similar to the restriction on contractual freedom in drafting articles of association, medium and minority shareholders should be permitted to claim against the controllers to the courts where it is proven that a given behaviour of the holders of super-votes is not in the interest of the company as a whole.

[256] Ruoying Chen, 'The Practice and Supporting Regimes of Dual-Class Share Structure in Corporate Law: The Related Regulatory Countermeasures in China' (2014) (3) Securities Market Herald 4, 7 [陈若英，'论双层股权结构的公司实践及制度配套—兼论我国的监管应对'，证券市场导报，2014 年 3 月号，第 7 页].

Conclusion

1 The Role of the State in Private Equity Governance and Development of the Laws of Business Organizations in China

This thesis explores the legal solution to the agency problems in the lifecycle of the private equity investment in China from a cross-jurisdictional perspective. As mentioned at the beginning of this research, the agency problems generated from the separation of ownership and control widely exist in different business organizations. Based on neo-liberalistic ideology in Anglo-American academia during recent forty years, both the legal scholars and economists have widely agreed to regard and analyse the business organizations as outcomes of contractual freedom between the members or establishers and then the attention of the legal and economic analysts is being attracted from external regulation to internal governance strategies. China as one of the largest transitional economies in the world has positively pursued marketization reformation in its economy throughout the last nearly forty years. Nevertheless, the state control over the Chinese economy still exerts essential impact on the legal system of business organizations which is always at a core position of private equity industry.

1.1 The State and Limited Partnerships in China's Private Equity Market

As it has been repeated in this thesis that the limited partnership has been applied as the dominant legal structure to undertake private equity investments in both China and UK, the combination of owners (LPs)' limited liability protection and managers (GPs)' unlimited liability deterrence to a large extent can reduce the high risk in PE investment. Moreover, the transition mechanism of the limited/unlimited liabilities of LPs in the circumstance where the LPs participate in the management of the partnership enterprise effectively mitigates the risk of unprofessional decision-making and the carried interests as incentive mechanism properly align the interests of GPs and LPs. In a nutshell, the limited partnership structure can effectively reduce the agency costs between fund manager and investors of PE funds.

In consideration of the state control over the PE industry, the legal system of limited partnerships in China however, experienced and experienced a path quite different from the partnership law in UK. Since the most leading domestic PE firms (GPs) are those fund management companies incorporated by the large SOEs, the economic and shareholding relationships between these GPs and princeling families or interested groups of the Chinese government are quite complicated. As an aftermath, although the latest reform of China's law of partnership enterprises admitted the legal status of limited partnerships, it can be imaged that the realization of key managerial staff's liability in PELPs management (e.g. the establishment of individual bankruptcy system) is still impeded. In terms of the independence of PE firms' management, the political factors also to some extent hinder the improvement of the governance of PELPs. Indeed, the partnership law of China excludes the transferring rule of LPs' limited liability to unlimited liability in the circumstance where the LP(s) actively participate in the management of the fund. Actually, this research implicates that the lack of 'piercing LPs' veil' in Chinese partnership law is caused by the *ex parte* protection of the LPs having economic relationship with the SOEs. Overall, due to not only domestic investors' immaturity of drafting limited partnership agreements but also above political barriers to establishing a UK-style limited partnership regime, the protection for the LPs in China is relatively weak and LPs' unprofessional intervention in fund management has increased transaction costs in Chinese PE industry.

1.2 The State-owned Capital and the Governance Structure of Private Equity Investment Trusts

It is discussed in the second chapter of this thesis that a unified legal protection for China's private investment funds was not available until the latest five years. As an alternative way, the commercial trust was also applied for organizing PE and VC investments, by which domestic PE investors can be better protected by the CBRC. Owing to the historical legacy of China's trust industry, the high flexibility of commercial trusts has been undermined by the state-controlled ownership structure of China's trust corporations. In specificity, as the professional experience and reputation of China's trust companies in PE market are both quite weak, the 'zero loss promise' for the investors of PEITs has been adopted widely by most trust corporations as an effective marketing strategy. Consequently, the 'zero loss promise' seriously hinder the fostering of market participants' ability to judge market risk and a large amount of state-owned capital is being improperly paid to the PE investors as a kind of 'guaranty'. Moreover, although the CBRC's regulations require the custodian banks to independently supervise the performance of the trustee, the affiliated relationship of custodian banks and trust corporations has substantively disrupted the independence and objectivity of the custodian's supervision of the trustees of PEITs.

In regard of the governance structure of China's PEITs, political influence is also considerable. Just as mentioned at the first chapter of this dissertation, the fiduciary duty system in China is quite weak, because the adjudication is firmly controlled by the CCP and administrative power, rather than professional judges. Therefore, the CBRC entitles beneficiaries with the voting right in decision-making process of PEITs, by which the disputes between trust corporations and beneficiaries are expected to be solved within the governance structure of PEITs. As a result, beneficiaries' control power behind the trust corporations in PEIT-involved companies cannot successfully comply with the disclosure requirement of China's securities regulations. Although in practice investors have developed several alternative approaches to remove the barrier to IPO of PEIT-held companies, the transactions costs are also remarkably increased. From the analysis the agency problems in China's PEITs, it can be seen that the initial relationship of the state (especially the shareholding relationship) and PE firms in a country may profoundly change the economic function of a certain type of commercial organization.

1.3 The State Control of China's Company Law Reform and the Corporate Governance Issues in PE-held Companies

After analysing the relationship between the state control and governance of PE funds, the agency problems generated from the process of corporate governance of PE-held companies in China is also discussed in details in this research. In account of the initial condition of China's company law, since the promulgation of China's first Company Law in 1993, the impact of SOEs reforms are noteworthy and which directed the developing path of Chinese corporate governance. In the first place, it can be imagined that the highly concentrated ownership structure of SOEs can hardly tolerate a company law which encourages diversified corporate governance structure. Therefore, even up to now the class share regime is still not clarified by the company law of China. In terms of the corporate governance of PE-held companies, however, the class share system is essential in balancing the interests between the entrepreneurial controllers of the investee company and the PE shareholders. As reflected from the case study regarding the conflict between the entrepreneurial controller and representative directors of PE funds, a large number of Chinese entrepreneurs have a very strong thought that the founder should always determine the management of the company. Consequently, the PE investor's interests are at the risk of the controllers' oppression. Because of the very deep-rooted influence of Confucian culture in China, it may be quite difficult to foster the spirit of contract and equality in Chinese entrepreneurship in short time, therefore the dual-class share system is highly expected to be adopted by the company law of China in expectable future.

The state's influence on China's PE market also exists at the moment when PE-held companies are listed. Although the public stock markets were established as early as 1990, because of the high standard requirement of listing, currently the majority of Chinese listed companies are SOEs, rather than non-state-owned companies. The dramatic unbalanced interests pattern of listed SOEs and non-state companies in China' s stock market makes the transactions costs of listing application and approval is unaffordable for the SMEs, which eventually drives more and more PE/VC-sponsored firms choose to list on abroad stock exchanges. The VIE problem of foreign PE-held companies discussed in this research shows that the over-strict regulation of capital market may encourage the regulatory arbitrage at the expense of minority shareholders' interests in corporate governance. Specifically, in the VIE structure, the PE shareholders as the minorities may be continually threatened by controlling shareholders, as a result of the lack of class share system under China's company law. Once the majority shareholder tends to keep the control over the company after the investee company has been listed on the stock exchanges, he/she may breach down the VIE contracts at the expense of the PE investors' economic benefits. Overall, both the SOE-preferred stock markets in China and the special prohibition of foreign direct investment in particular industries have increased the risk in corporate governance of PE-held companies. It is not unreasonable that the particular industries such as online media and publishing may not be accessible to international PE investors in a short future, the VIE structure and the related risk between the majority and minority shareholders will continuously exist, therefore, the application of preferred share as a balancing mechanism between the controllers and PE investors may avoid collapse of corporate governance.

2 The Prospect of Legal Reforms of China's Private Equity

Based on the analysis of the agency problems in the process of governance of China's limited partnerships, trusts and PE-held corporations, there is no doubt that the state's influence on the future reforms for China's private equity legal system will also be essential. In other words, different degrees to which the authorities control the governance process, different paths of regime transition of the three commercial organizations in China's PE industry, which may shape a distinct landscape of the PE legal system from western countries.

As discussed above, the primary goal of PELPs reform under Chinese legal system is making the personal liability system of partners work well. Although the latest wave of mixed ownership reform of the SOEs has been launched, limited to the unbalanced pattern in China's PE/VC market, the princeling-controlled GPs and LPs may still have the power and political priority in impeding the reform of the law of partnership enterprises. In respect of contractual autonomy of LPs and GPs, this thesis considers that the structured incentive mechanism can be gradually accepted and applied in the process of China's PE market development. As for the external regulation of China's PELPs, the regulatory reform of PELPs towards a transparency-focused system has been launched in recent years. The new investment fund law and regulation of private investment funds not only firstly clarifies the CSRC's official regulation over PELPs but also requires all PELPs in to file with the AMAC who plays the self-regulatory role in China as the BVCA in the UK. The AMAC as the unifying self-regulator of investment funds in China is entitled the power to develop detailed self-disciplinary rules and impose reputational sanctions on the GPs who violate the self-regulatory rules.

In terms of PE investment trusts, the prospect of China's PEITs also depends on the mixed ownership reform of the state-controlled trust corporations, by which the 'zero loss promise' may be broken by diversified interest pattern at corporate governance level of the trustees. Specifically, the present pilot ownership reform of several selected trust corporations has shown that the unprofessional and lagging management of CIS (including PEITs) has pushed the CBRC to encourage non-state enterprises or institutions to invest in the trust corporations and dilute state control, by which the high quality investment decision-making experience may be introduced. In such a way, the competitiveness of PEITs in PE market can be enhanced and more importantly, the 'zero loss promise' will be rejected by non-state shareholders of trust corporations. As a consequence, in consideration of the investment security, the investigation and approval of qualified investors of PEITs will be stricter than before, which can reduce the irrationality of investors' decision-making. The last point, in contrast to beneficiaries' direct intervention in fund management, judicial adjudications settling the disputes between trustees and beneficiaries are able to provide more efficient remedies for the investors of PEITs, of course, such a development may take time.

In order to improve the corporate governance of investee companies, the current pilot reform of preferred shares led by the CSRC has been functioning as a balancer of majority shareholders' control power and PE/VC shareholders' economic interests in the investee company. The current guidelines for applying preferred shares have established a platform to enhance contractual rights of PE investors and entrepreneurial shareholders for the purpose of reducing the transactions costs in corporate governance. It is evident that the reform of Chinese corporate governance is increasingly contractual throughout the recent revamps of the company law, the PE shareholders are being vested more power to bargain with the entrepreneurs and reach the balance at the starting point of contracting. In such a way, the corporate governance conflicts in the VIE structure can be defused. In respect of external protection, the judiciary office may develop a series of practical rules for drafting and amending articles of association, according to which the majority shareholders' power will be restricted and the court is able to provide remedies for the PE shareholders when PE/VC minorities are oppressed by the majority shareholders. Nonetheless, again, the high quality judicial practice in China may be a complex and time-consuming process of reform.

3 The Transaction Cost Theory of Legal Transplantation: A Preliminary Framework

This thesis aims at exploring feasible approaches for reducing the agency costs in Chinese private equity organizations. At the same time, the comparative studies of the investor protection mechanisms in three types of business organizations (limited partnership, corporation and trust) may provide another viewpoint of considering the legal transplantation between different jurisdictions, which may be especially relevant to institutional transplantations in transitional economies. In a methodological aspect, this theoretical hypothesis is mainly built up on transaction cost economics which may facilitate to understand why a modification of a given form of business organizations may considerably impact its efficiency in an 'importer country' and what the precondition is for successful legal transplantation of business organization laws.

3.1 The Analytical Foundation

Each main chapter of this work begins with a comprehensive analysis of the origins or functions of the given business organizations (e.g. limited partnership, trust and corporation), by which the viewpoint is emphasized that any given form of business organization is derived from a series of specific social demands in a particular historical background. For example, as illustrated in chapter 2, the social demand of a special organization form which could efficiently combine the wealth with low-level risk and professional managerial skills with high-level incentive and unlimited liability deterrence is the root origin of limited partnership in history. Similarly, the origin function of English trust in history was actually a legal creation for maintaining the value of household land, charitable funds or ecclesiastical assets, rather than commercial investment. As a result, the high-level liability mechanism and incentive mechanism were not as so necessary as that in limited partnership or *commenda*. This is the reason why the fundamental legal structure of English trusts is simpler than that of limited partnership. As for the corporation, the rise of institutional shareholder in modern corporate governance reflects a fact that the multi-level class of shareholding and governance structure can strike a balance among heterogeneous shareholders inside a corporation and this feature has remarkably expanded the corporation's scope of application in most industries with medium risk. Thus, any legal transplantation of a given form of business organization should respect its inherent economic functions. This functional analysis is adopted as the fundamental philosophy of the following doctrinal construction.

3.2 The Internal Costs and External Costs in Protecting Investors

The analysis of the investor protection mechanisms in British commercial law illustrates that the degree to which the protection mechanisms depend on external legal institutions (such as regulatory intervention, judicial review and self-regulation) generally has positive correlation with the degree to which the ownership and control of the owners of given business organizations. For instance, statistically the main body of the protective mechanism in traditional law of trusts in England was formed on judicial practices during a long history, whereas the contractual autonomy of limited partnerships and corporations play a much more important role in decreasing agency costs in organizational governance.

Based on above idea, the hypothesis of this theory can be summarized as: in an ideal capitalist market, the costs of protecting investors of business organizations can be classified into two categories, the one is called 'internal cost' which refers to the costs generate from (1) the owner's labor in decision-making process in governance[1] and (2) the owner's monetary contributions to the assets of the firm.[2] The other type of costs is called 'external cost' which refers to the costs generate from (1) external intervention by financial regulators[3] and (2) *ex post* judicial remedies.[4] Hence, quantitatively, the key definitions of 'internal cost (IC)' and 'external cost (EC)' are expressed respectively as:

$$IC= L+A \qquad (A)$$

and

$$EC= R+J \qquad (B)$$

The detailed analysis of the economic implications and its relationship in legal transplantation will be discussed later. Prior to a theorization of above ideas, an experiential and comparative review of the IC and EC in each main type of organization will be necessary and helpful.

3.3 The Distribution of Internal Costs and External Costs in Various Organizations

For the convenience of illustrating and analyzing, the main types of business organizations are categorized into three groups by differentiating the degrees to which the ownership and control of investors' contributions in firms is separated, namely the partnership-like organizations, corporation-like organizations and trust-like organizations. The distributions of IC and EC in the following popularly applied organizational forms are specifically discussed.

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[1] Briefly, represented as 'L'.
[2] Represented as 'A'.
[3] Represented as 'R'.
[4] Represented as 'J'.

3.3.1 The Partnership-like Organizations

3.3.1.1 General Partnerships

The general partnership does not have any separation of ownership and control and mostly it is used for organizing small-scale business. Thus in most cases, there is no need to cost regulatory resources for protecting the partners, instead, all the partners have to actively participate in decision-making process for guaranteeing their own interests in the partnership enterprise. In such a governance structure, the effectiveness of protection for each partner depends on the full range of contractual freedom and unlimited liability of each partner. In general partnerships, the residual claim and residual control over the firm assets are fully aligned.

3.3.1.2 Limited Liability Partnerships

As a special type of general partnership, the limited liability partnership (LLP) delimits the limited liability of no-fault partners and unlimited liability of partners in fault. Compared with the general partnership, the limited liability of partners in LLPs makes it possible that in most cases, although all the partners are unlimitedly liable for debts of the partnership enterprise if the debts are not triggered by the ignorance and wrongdoings of one or some certain partner (s). The law of business organization as a kind of 'standardized contract' here imposes unlimited liability of each partner and clarifies the conditions triggering unlimited liability, which actually saves the negotiation costs of the owners and to some extent creates a potential dual class 'residual claim' of all the partners. In terms of the residual control, all the partners can equally participate in management, as the same in general partnerships. LLPs are used in professional services such as law firms and accounting firms or real estate agencies. The high level requirements of each particular profession are commonly created by occupational or industrial associations, for instance, bar associations and certified accountant associations. Again, the strict personal liability on each partner in LLPs can consistently constrain each partner's opportunistic behaviors. Therefore, as a balance, the external protection costs in LLPs are relatively low by comparison with a standard partnership.

3.3.1.3 Limited Partnerships

In limited partnerships, the partners own different portions of capital in the firm, however, the general partner as the managing partner is usually vested extra residual claim, namely the 'carried interest'.[5] Limited partners as the majority of owners enjoy limited liability protection unless they actively participate in management. It is obvious that in comparison with general partnerships and limited liability partnerships, most owners (limited partners) in limited partnerships save the cost of decision-making in daily operation and management of the firm, simultaneously limited partners have to share a large portion of residual claim to the general partner as an effective incentive. If we say that the primary mechanism of reducing agency costs in general partnerships and LLPs is the unlimited liability, the incentive mechanism maybe plays a more significant role in limited partnerships. The combination of unlimited liability deterrence and high level incentive makes the limited partnership quite suitable for high risk investment such as private equity, venture capital and hedge funds. In terms of external protection, a well-sound self-regulatory system is necessary for spreading the reputation records of each managing partners, the high pressure of the market of managers in particular industry like PE funds plays an important role in reducing agency costs of limited partnerships. Obviously, the self-regulation and official regulatory system will cost higher social resources, as limited partnerships are commonly used in very risky fields.

3.3.2 Corporation-like Organizations

In this category of business organizations, the most significant feature is the medium-level separation of ownership and control. In most jurisdictions, the laws of companies differentiate unlisted and listed corporations, the former commonly has small number of shareholders and does not need a public market of capital, whereas the later form of corporation has a huge body of shareholders who can freely transfer their shares of the corporations in a public stock market. The distinctive ownership structures and connection with public interest determine different distribution of internal and external protection mechanism in the two sorts of corporations.

[5] It is commonly 20% of gross profit of the limited partnership which is particularly popular in private equity and venture capital funds.

3.3.2.1 Unlisted Corporations

In a statistical sense, the members of the board are unnecessary to be shareholders of a corporation, although in unlisted companies, the directors commonly hold significant proportions of shares. This is the reason why we usually say that the legal nature of closed and unlisted corporations, especially the family-owned companies is a kind of 'quasi-partnership firm'. From the analysis of PE-held companies, it is not difficult to see that the internal protection for the shareholders of close companies depends on the contractual provisions in the articles of associations or other contractual mechanisms like shareholders' agreements. In terms of the residual control, in most scenarios the director board is in charge of daily management of the firm and most shareholders do not spend too much time on daily decision-makings. The application of various financial instruments including but not limited to preferred shares, convertible bonds and covenants can strike a balance of residual claims between shareholders, however, such complicated contractual techniques will dramatically increase negotiation costs inside the firm. Therefore, in comparison with partnerships, the lack of ongoing control over the capital inevitably increases the risk of agency problems. Moreover, the complexity of the contractual provisions among heterogeneous shareholders needs stronger external protection, especially the judicial remedies as an important interpreter of the vagueness in 'corporate contracts'.

3.3.2.2 Listed Corporations

Although the basic principles and statutory structures of corporate governance are almost the same in unlisted and listed corporations, the external protection for shareholders of listed companies is much more important than that of unquoted firms. Firstly, the stock markets are established as a nationwide and official capital markets, it is obvious that maintaining an efficient and consistent regulatory system must cost a huge amount of monetary and human resources. Secondly, the entire process of public financing in stock market will involve lots of intermediaries, namely investment banks, stock brokers, law firms, accounting firms and rating agencies. Thirdly, for enhancing the protection for huge number of minority shareholders in public stock market, the collective lawsuits will cost higher expense of investigation and adjudication. The EC of shareholders of listed companies, therefore also includes the social capital paid to extra regulatory system of financial service providers. As for the IC of listed corporations, the dispersed shareholding may give rise to 'free rider' and 'rational apathy' and therefore, most shareholders of listed companies spend very low level of costs in corporate governance.

3.3.3 Trust-like Organizations

The last category of business organizations, namely the trust, has high level separation of ownership and control. Generally, the internal governance structure of trusts is much simpler than that of partnership-like and corporation-like enterprises. The original model of this type of organizations is the English trust which was initially used as charitable funds in modern era. It is acknowledged that the charitable trust is not the object of this theory, however, as one limit of the functions, the distribution of IC and EC in charitable trusts is relevant to the discussion. Business trusts also use the very similar governance and ownership structure of charitable trusts, but its governance structure may be modified slightly. In this section, the similarity is more than the differences of the two types of trusts, thus they will be discussed together.

As shown in Chapter 3, the most significant feature of trust (both business and charitable trusts) is the full separation of ownership and control. The trustee commonly does not hold any residual claim of trust assets. Although in the sense of the common law the trustee is the 'legal owner' of trust assets, in an economic sense, however, the trustee should be regarded only as the manager instead of the 'owner' of trust assets. The beneficiary does not have any power in the governance process of trust funds but fully enjoys the interests of trust assets. In other words, the residual claim is fully separated from residual control of trust assets. The slight difference between business trusts and charitable trusts is that firstly, in business trusts, the beneficiary (at the same time the investor as well) is obliged to pay management fees to the trustee, whereas the trustees of charitable trusts traditionally do not take fees from beneficiaries. Additionally, the contractual techniques in trusts are also simpler than partnerships and corporations, as most rules for restraining the trustee's behaviors are developed from judicial practice rather than contractual negotiation. Hence, investors or trust beneficiaries spend the lowest internal costs in protecting their interests.

The high-level mismatch between the residual claim and residual control remarkably increase the agency costs in trusts, therefore, the external protection is usually the only way of protecting and offering remedies for beneficiaries (investors). Therefore, it can be imagined that the burdensome activities in judicial and regulatory practices will cost mass social resources. That is to say, the EC of protecting investors of trust-like organizations is much higher than any other business organizations.

3.4 The Economic Implications of Internal Cost and External Cost in Business Organizations

3.4.1 The Theorization of the Distribution of the IC and EC in Business Organizations

Pursuant to the analysis of the distribution of the two types of transactions costs in above three models of organizations, the correlation of IC and EC can be briefly expressed as two functions in Image I:

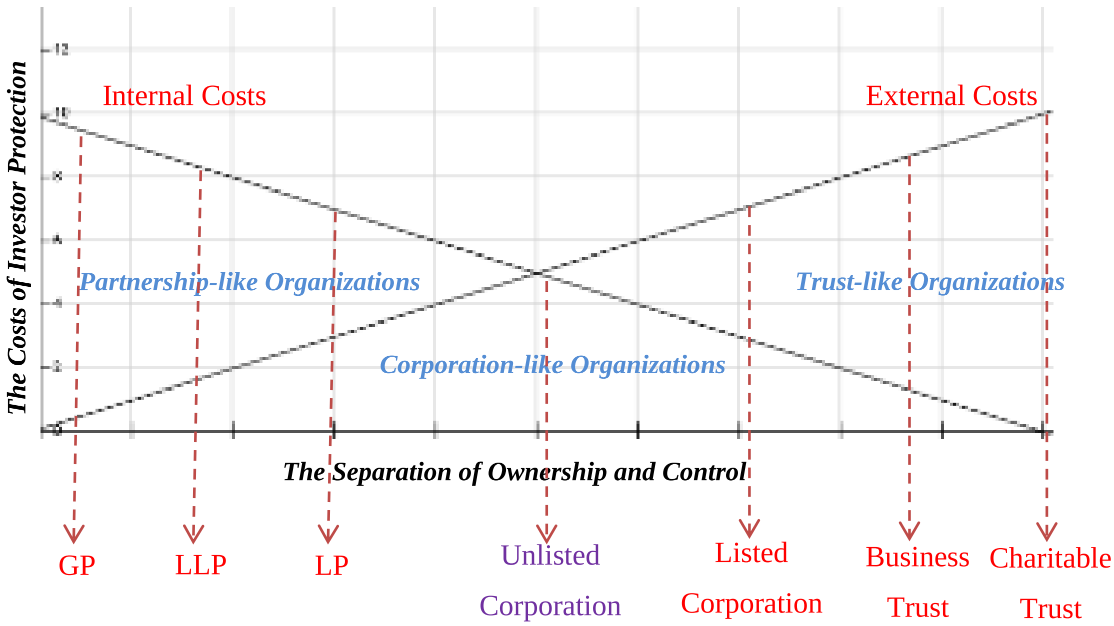


Image I: Internal & External Costs in Protecting Investors of Business Organizations

Owing to the fixity of statutory form of organizations, the 'carrying capacity' of transaction costs of each organizational form has its own limit. In other words, there should be:

$$0 \leqslant IC\ (p, c, t) \leqslant \alpha\ (p, c, t) \qquad (C)$$

This inequation expresses the limits of internal costs for each of the three main types of organization as lying between zero and the limit (α) imposed by the legal regime controlling the structure and governance of the relevant organization.

Similarly, as in idealistic model, the occupation of social resources in each sub-system (such as economic, legal, political and cultural systems) are limited and relatively fixed, by which the division of social labor will be sufficient and balanced. In such theoretical assumption,[6] the gross costs of investor protection of the regulatory and judicial sectors and self-regulatory system are not unlimited as well, namely:

$$0 \leqslant EC\ (p, c, t) \leqslant \beta\ (p, c, t) \qquad \text{(D)}$$

This inequation sets the limits for external costs for each of the three main types of organization as lying between zero and the limit (β) imposed by the constraints (e.g. economic, political) on investor protection and enforcement in any given jurisdiction.

Image I theorizes the distribution of IC and EC in different business organizations and the above detailed analysis of specific types of business organizations to a large extent illustrates this theorization. The further issue is what the economic implications are for institutional transplantation. In order to answer this question, the following section investigates the economic connotations of the IC and EC in the three models of business organizations respectively and then tries to illustrate why the balance of IC and EC in legal transplantation of business organization laws is important.

3.4.2 The Economic Implications of the Internal Costs of Protecting Investors

According to the mathematical model of the internal cost (IC) inside business organizations (equation (A)), the labor (L) that investors contribute to decision-making or contractual negotiation among the parties and the monetary assets (A) which are contributed as incentives for their agents (managers) in the firm constitute the gross amount of IC. It is also

[6] This is only an ideal economic assumption, the distribution of the external costs in reality is actually much more complicated, which will be discussed later.

acknowledged that the capacity of carrying transaction costs in each given organizational form is fixed and limited (inequation (C)). Therefore, comprehensively considering above factors, in any organizational forms, the function of IC is an indifference curve:

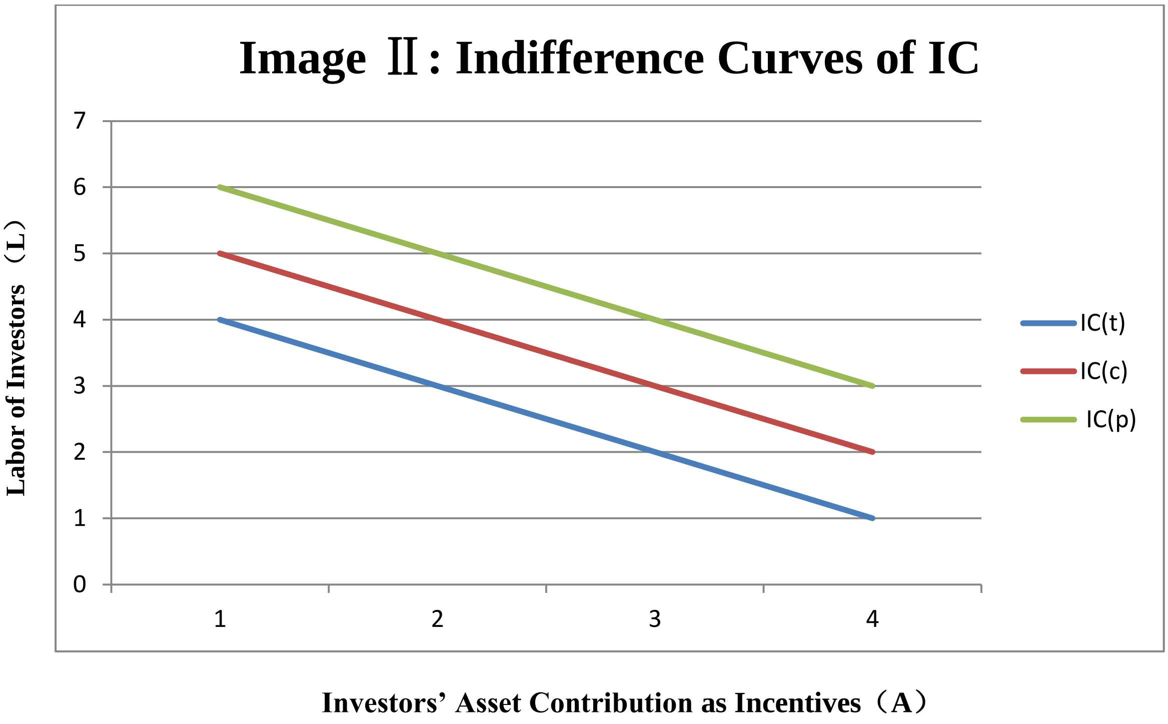


Image Ⅱ shows that in a general sense, the quantitative relation of the IC of partnerships, corporations and trusts can be simply expressed as below:

$$IC\ (t) < IC\ (c) < IC\ (p) \qquad (E)$$

Subject to the high-level closure of organizations, the risk generated from the intensive conflicts between owners and agents is not likely to overflow outside the separate system of business organizations, however, again, the carrying capacity of transaction costs in each organizational form has its limit.

3.4.3 The Economic Implications of the External Costs of Protecting Investors

According to the equation (B) and inequation (D), the quantitative relation of the expenses of regulatory and judicial resources should also satisfy indifference curve, the mathematical express should be as the same as Image Ⅱ, namely:

$$EC\ (t) > EC\ (c) > EC\ (p) \qquad (F)$$

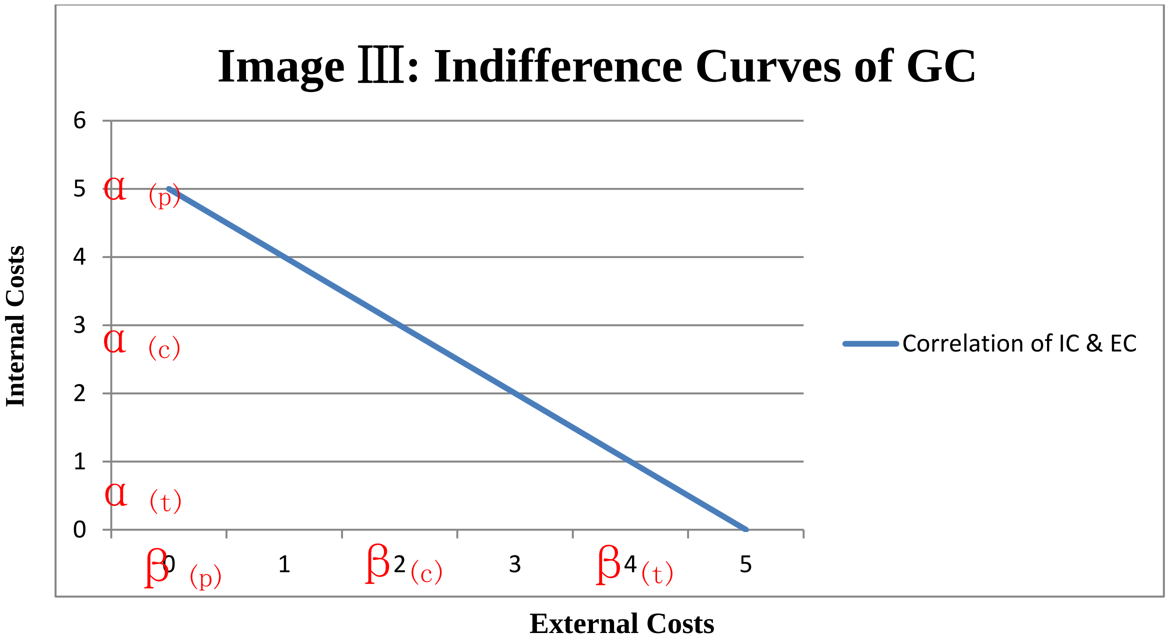
In reality, however, the relation between R and J does not always satisfy the conditions of indifference curves, as the social systems outside the business organizations are opened, or we can use another term 'coupling'. If the regulatory and judicial systems fail to independently operate, for example, being controlled by politicians or interested groups, the EC will be imposed on other sub-systems of society.

3.4.4 The Conservation of Gross Transaction Costs in Protecting Investors

The emergence of different business organizations in economic history reflects the change of social demands and advance of division of social labor which essentially and continually promotes efficiency of market. Generally speaking, the emergence and development of partnership with unlimited personal liability is a response to the demands of enhancing the personal credit for attracting business. As Image Ⅰ shows, the distributions of transaction costs in limited partnership and unlisted companies are somewhat similar which actually reflects the social demands of limited liability protection for overseas or colonial ventures during the late medieval ages. As for listed companies and trusts, the nature of them can be regarded as a kind of legal institution for large number of passive investors who are risk averters and contribute small portion of capital, in which the layer of professional managers (trustees) formed.

In a free market where economic activities are organized in spontaneous order, the above three types of business organizations can be regarded as specific legal instruments which efficiently facilitates heterogeneous financial activities of different stratifications. Lawyers and venture capitalists commonly are wealthy and well-educated people who have strong ability to control and resist risk, the partnership-like business organizations may suit their demands in commercial activities. People from middle class may have sufficient capital to run their own business, but most of them are not experts in certain industries and can only afford medium level of risk. Hence, the statutory limited liability protection which are stipulated in corporate law and stronger external protection are needed. The rest of people are in middle and lower classes of the society who have relatively weak ability to resist risk and insufficient knowledge of investment or finance, then the trust fund and active judicial protection help them efficiently manage their wealth and create value.

Accordingly, the curves in Image Ⅰ suggest that the gross costs (GC=IC + EC) of protecting different investors in each type of business organization should be equal, or called as 'conservation of transaction costs in protecting investors', which can also be expressed by an indifference curve (Image Ⅲ).



This is an ideal and optimal situation of the legal and regulatory regime of business organizations which properly allocates social resources in a whole society and the law provides equal opportunities of wealth appreciation and accumulation for the people in all stratifications. Importantly, this theory tends to regard the models in Image Ⅰ and Ⅲ as the ideal results of legal transplantation across different jurisdictions, as in such situation, the import of the legal and regulatory system of business organizations can benefit the destination country as a whole.

Moreover, by using Image Ⅲ, according to the inequations (C) and (D), we can also generally calculate the threshold values of IC (p, c, t) and EC (p, c, t) respectively, namely:

$$IC\ (t) \in (0,\ \alpha\ (t)),\ IC\ (c) \in (\alpha\ (t),\ \alpha\ (c)),\ IC\ (p) \in (\alpha\ (c),\ \alpha\ (p)) \qquad (G)$$

and

$$EC\ (p) \in (0,\ \beta\ (p)),\ IC\ (c) \in (\beta\ (p),\ \beta\ (c)),\ IC\ (t) \in (\beta\ (c),\ \beta\ (t)) \qquad (H)$$

3.5 The Overflow Effects of Transaction Costs in Legal Transplantation

This section will discuss 1) how the IC and EC are distributed in a transitional economy (such as China) and 2) what negative social impacts may be exerted on the importer jurisdiction, if the necessary legal regimes do not exist. Specifically, when the core legal regimes such as liability mechanism in partnership law or judicial intervention for trusts do not work well or even do not exist, the costs of protecting investors will overflow into other systems. This point may properly explain the problems in legal transplantation of the laws of business organizations in China and may provide some inspirations for further research.

3.5.1 The Overflow of Transaction Costs between Different Business Organizations

The economic implications of the inequation (G) and (H) provide a possibility when the IC or EC value of ‘organization A’, for example, is increased higher or decreased lower than its value domain, the economic functions of it may be changed to ‘organization B’. This phenomenon can be defined as ‘Transaction Overflow between Organizations’. The transaction costs overflow effect may negatively impact the destination country and distort the market which can be well illustrated by several cases of China’s PE legal system.

As summarized in the third chapter of this thesis, the barrier to IPOs of PEIT-involved companies is rooted in a series of social factors in Chinese society. Firstly, the zero-loss promise as a distorted ‘guarantee’ subverts the protective function of the courts. Secondly, the affiliated relationship between trust corporations and custodian banks weakened the protection for trust beneficiaries. Therefore, such subversion of external protection (or, in transaction cost terms, a lowering of the expense of external protection) motivates the beneficiaries to 1) actively participate in decision-making of trust funds and to 2) re-invest their capital into a limited partnership for the purpose of IPO, in which beneficiaries have to grant 20% around carries to the general partner. As repeated many times in this theory, the economic efficiency of trusts to a large extent is realized by the trustee's independent and professional management. In the case of Chinese PEITs, however, the active managerial power and limited liability of beneficiaries have changed the institutional features of trusts to that of 'quasi corporations'. The nature of this case is actually the overflow of transaction costs from external system outside the organization to the internal system inside the organization, and consequently weakened the advantage of trust funds.

Similarly, in the cases of corporate governance failure, which were discussed in Chapter 4, the lack of judicial standards controlling amendment of the articles of associations in companies granted an overly wide range of contractual freedom to shareholders. In other word, the internal cost was dramatically increased. Consequently, the disputes between venture capitalists as minority shareholders and controlling shareholders decreased the efficiency of corporate governance. Moreover, the lack of dual-class share system of Chinese company law gives rise to wide application of complex and high risk contractual instruments including VIE and VAM which considerably increased the tension between the shareholders inside the corporate organizations. The nature of such cases can also be seen as the change of institutional features of business organization caused by the overflow of transaction costs from the external system to the internal system. The overly wide range of contractual freedom in companies in fact changes the corporation to be more like a partnership: if the gross costs of contractual mechanism inside the firm breaks its limits of IC (p, c, t), then the governance mechanism of such business organization will collapse, such as the failures of VIE structure in China.

3.5.2 The Overflow of Transaction Costs between Different Social Systems

Even more, if the costs of external protection overflows too much into the organizations, the tension between the agent and principals are not fully absorbed by ending the operation of business, but then may further overflow into other social systems including the political system (e.g. irrational and collective demonstration marches or strikes), mass media system (e.g. misleading of public opinion) and criminal prosecution system (e.g. violent incidents). This extra negative impact caused by legal transplantation may be called 'Transaction Costs Overflow between Social Systems' which dramatically increases the tension and risk of other social areas and reduces the efficiency of the society as a whole.

3.6 Potential Implications for Legal Transplantations of Business Organizations

This theorization of the distribution of transaction costs in protecting investors of business organizations can be termed as 'the transaction cost theory of legal transplantation'. It is obvious that this innovation, based on the analysis of private equity investment presented in this thesis, is only a preliminary experiment of theoretical construction, the accurate legal-economic (even mathematical) discussion is necessary and worthy. Based on the comparative case studies in this thesis, this theory may provide the following useful implications for the legal transplantation in practice:

Firstly, no matter where the destination country is, the institutional transplantation of business organizations must respect the inherent economic structure of the given business organization in a capitalist economy, otherwise the transaction costs in organizational governance will be increased and consequently the efficiency inside the business organization will be negatively impacted.

Secondly, the balance of internal and external protection mechanisms for investors of business organizations is important, legislators and policy-makers in the importer country should make every effort to guarantee that the regulatory and judicial system are capable to provide sufficient protection for the investors of each type of business organization, otherwise the failure of governance between the investors will increase the burden of other social systems and impact the efficiency of the society as a whole.

Thirdly, it is inevitable that any transplantation of legal regimes may modify some legal features of business organizations for matching the social reality and culture of the particular destination jurisdiction. In this regard, suitable qualified investor regimes are significant, as the reasonable control of market entry can to a large extent enhance the carrying capacity of transaction costs inside the organizations and mitigate the risk of governance failure.

Last but not least, the diversification of business organizational structure will facilitate division of social labor, which is the foundation of an efficient and well-ordered economy in the modern era. Moreover, the equality of opportunity in wealth management is one of the universal values for modern human civilization. The insistence of diversified (instead of homogenous) organizational forms for commercial activities will be beneficial to common prosperity in the society.

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