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Legal Updates

Recent PRC Partnership Law Amendments: Domestic Changes Significant—Little Immediate Impact Seen on Foreign Private Equity Investment July 2007

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Taking an important step towards a more pro-investment corporate law, China amended its Partnership Enterprise Law 《中华人民共和国合伙企业法》 (“**Partnership Law**”) on August 27, 2006. The amended Partnership Law, which took effect on June 1, 2007, significantly alters existing partnership rules and principles established under the original Partnership Law enacted a decade earlier. While the Partnership Law governs domestic partnership enterprises, based on Article 108 of the Partnership Law, the PRC government has specifically contemplated foreign investment in PRC partnerships. In accordance with Article 108, the Ministry of Commerce (“**MOFCOM**”) drafted the Foreign Investment Partnership Regulations 《外商投资合伙企业管理办法 (送审稿)》 (“**FIPR**”) and circulated it to other governmental agencies for comments on January 25, 2007. The FIPR is currently still in its drafting stage, but we can expect to see the new regulation promulgated soon. As with any new PRC regulation, there are a number of questions raised by the draft. The FIPR and the Partnership Law may in the future provide foreign investors with an alternative structure through which they may raise funds for investment into PRC enterprises. Many uncertainties have been raised about certain provisions incompatible with the operation of foreign private equity funds. These initial concerns seem to indicate that, if the FIPR is promulgated as drafted, the immediate impact of the FIPR on foreign private equity investment will be negligible. This update provides a brief overview of the significant amendments to the Partnership Law and the provisions of the draft FIPR.

Significant Changes to the Old Partnership Law

The significant changes made by the amended Partnership Law include:

- Limited Liability Partnership – Under the old Partnership Law, only unlimited liability partnerships were permissible. Such structures, which are similar to general partnerships in the U.S., expose the partners of a partnership to joint and several liability for the liabilities of the partnership. The amended Partnership Law now permits investors to establish limited liability partnerships (“**LLP**”). An LLP is similar to a limited partnership in the U.S. It provides for a class of partners with limited liability, but also requires a general partner. The general partner is liable to the full extent of the debts of the partnership, while the limited liability partners’ liabilities to third parties and to the other partners are limited to the extent of their capital contributions to the partnership.
- Legal Person Partners – The old Partnership Law required partners to a partnership to be individuals. The amended Partnership Law allows both legal persons and individuals to invest in partnerships. However, it is unclear whether non-individual legal persons such as PRC or foreign corporations with limited liability may be a general partner of a PRC LLP.
- Bankruptcy – It was previously unclear whether a partnership could be forced into bankruptcy under the old Partnership Law. The amended Partnership Law, however, gives creditors of LLPs the option, when the partnership is unable to meet its obligations when due, either to apply to the people’s court for bankruptcy liquidation, or to claim directly against the general partners.

- Pass-through Taxation – Article 6 of the amended Partnership Law expressly exempts partnerships from paying income tax, taxing the income to partners on a pass-through basis.

Foreign Invested Partnerships

The amended Partnership Law only applies to domestic partnerships. According to Article 108 of the amended Partnership Law, administrative measures regulating foreign invested partnerships will be promulgated by the State Council. In furtherance of Article 108, MOFCOM drafted the Foreign Investment Partnership Regulations (“FIPR”) and circulated it to other governmental agencies for comments on January 25, 2007. It is anticipated that the FIPR will be promulgated soon.

The bottom line for foreign investors is that the FIPR raise more questions than answers about the viability and advisability of establishing a foreign-invested partnership (“FIP”) pursuant to the Partnership Law and the FIPR. For the most part, the existing requirements for foreign investment enterprises (“FIE”) will also apply to FIPs. However, the FIPR are silent on many issues and indeed, the draft FIPR include several material departures from the Partnership Law governing domestic investors in partnerships. Set forth below is a brief summary of the high-and-low-lights of the new regulations.

- According to Article 2 of the draft FIPR, MOFCOM will permit the establishment of FIPs, and Chinese individuals and other legal persons are expressly permitted to cooperate with foreign investors to establish FIPs.
- In a departure from Article 16 of the Partnership Law, unlike domestic investors, foreign investors are not permitted to make capital contributions by performing services for partnership.
- Unlike a domestic partnership in which the investors may contribute capital in accordance with a schedule agreed to and set forth in the partnership agreement, foreign investors in an FIP must contribute capital in a lump sum within 90 days of the approval of the FIP.
- Foreign general liability partners are required to file a list of their major assets with the PRC approval and registration authorities and must update such filing whenever there are material changes to such assets.
- The FIPR are silent on a number of important matters that will be of concern to foreign private equity investors, including:
 - Whether a foreign limited liability company may be a general partner of an FIP;
 - Whether an FIP is permitted to be an investment vehicle, with no project scope other than to invest in PRC domestic enterprises;
 - Whether an FIP will require additional approvals for each investment transaction as if the investment were being made by a foreign person, or whether the investments made by the FIP will be viewed in a manner similar to a Foreign Invested Venture Capital Enterprise (where a post-investment filing is all that is required).
 - Whether and how foreign exchange and cash and in-kind distributions will be handled in respect of foreign investors in FIPs. May foreign limited partners or general partners make contributions in U.S. dollars and receive distributions in U.S. dollars? May foreign limited partners receive distributions of securities of portfolio companies that are listed on a domestic stock exchange?

Implications of the Amended Partnership Law on Foreign VC and PE Investment

At the moment, the Partnership Law will have little to no impact on foreign investment by private equity investors in the PRC. First and foremost, the draft FIPR have yet to be promulgated, so there has been no official implementation of Article 108 of the Partnership Law contemplating foreign investment in a PRC partnership enterprise. In addition, as described above, the current FIPR and Partnership Law either are silent on key elements necessary for a foreign investor to make an informed decision about whether an FIP is a suitable investment vehicle, or the provisions that apply to foreign private equity investors are inconsistent with the way private equity funds typically operate. For example, it is unclear whether the general partner of a limited liability partnership may be a limited liability company. Virtually every general partner of a foreign limited partnership operating as a private equity fund is, in itself, a limited liability company of one form or another. In addition, the draft FIPR require foreign limited partners to fund 100% of their capital contributions within ninety days of approval of the establishment of the partnership. This requirement is completely inconsistent with the way private equity funds operate, and would make the FIP a distinctly undesirable vehicle for private equity fundraising. Finally, and perhaps most importantly, it is unclear whether an FIP is permitted to operate as an investment vehicle and whether it would require additional MOFCOM approvals for each portfolio investment.

Unless the draft FIPR are significantly amended and clarified to address the foregoing issues, the new Partnership Law and draft FIPR are at best a step in the right direction for foreign investors. For domestic investors, the new Partnership Law represents a significant development in the evolution of corporate law in that it seemingly provides for the type of flexible partnership structure with limited liability features that is well- developed in other jurisdictions such as the United States, Japan, and the Cayman Islands. It remains to be seen whether these benefits may be extended to foreign investors.