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Venture Capital In China And India: Does Business Form Matter?

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VENTURE CAPITAL IN CHINA AND INDIA: DOES BUSINESS FORM MATTER?

*Lin Lin** & *Umakanth Varottil***

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ABSTRACT

This paper re-evaluates the importance of business organizational forms with regard to venture capital funds by exploring two major Asian markets, China and India. Evidence suggests that the limited partnership is the leading business form among Chinese venture capital funds. On the other hand, Indian venture capital funds are predominantly organized as private non-charitable trusts. These findings challenge the orthodox view that the limited partnership is the preferred business form for venture capital funds. Instead, Indian venture capital funds have used the trust vehicle effectively and regard it as a functional equivalent to limited partnerships. This paper argues that the choice of business form is not the sole determinant of a vibrant venture capital market due to the presence of multiple functional equivalents that can substantially satisfy the goals of investors and fund managers. This paper advocates for a more nuanced analysis that takes into account peculiar local factors when considering if a particular business form should be introduced to facilitate the development of a venture capital market.

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I. INTRODUCTION

As engines of growth in the start-up sector, venture capital funds perform a crucial intermediation role as they pool capital from various investors, both individual and institutional, and in turn make early stage investments into portfolio companies.¹ A specific ownership and management structure epitomizes the venture capital industry, with venture capital funds comprising active managers who bear unlimited liability and passive investors who enjoy limited liability.² Accordingly, organizational forms in any jurisdiction ought to supply default rules that facilitate the establishment of firms with these features in an optimal combination that not only enables venture capital fundraising and investments, but also protects the interests of the investors. This is usually achieved by aligning the interests of the managers and investors. While this much is incontrovertible, the question that arises—one that strikes at the heart of this paper—is whether any particular business form or organizational structure is the most desirable solution to incentivize venture capitalists and meet the needs of investors.

Conventional wisdom indicates that the limited partnership has become ubiquitous as the preferred business form for venture capital funds. It allows venture capitalists to act as general partners (GPs) and engage in the management of the fund, while investors act as the limited partners (LPs) with limited interventional capabilities in the control of the fund. Management rights and liability go hand-in-hand as GPs bear unlimited liability for the actions of the firm, while LPs obtain the benefit of limited liability, except when they intervene in the fund’s management.³

Scholars have lauded the limited partnership as an appropriate vehicle for venture capital funds, referring to it as “venerable”⁴ and as “the single most important organizational innovation of

¹ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070 (2003); Lin, *Venture Capital Exits and the Structure of Stock Markets: Lessons from China* 12(1) ASIAN J. COMP. L. 1 (2017).

² J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97, 101 (2000). See also, Larry E. Ribstein, *Limited Partnerships Revisited*, 67 U. CIN. L. REV. 953, 958 (1999); Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 865 (1988).

³ Lin, *Engineering a Venture Capital Market: Lessons from China*, 30(1) COLUM. J. ASIAN L. 160, 181 (2017).

⁴ Joseph A. McCahery & Erik P.M. Vermeulen, *Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form*, 5 EUR. BUS. ORGAN. LAW REV. 62, 65 (2004).

the modern venture capital system.”⁵ The limited partnership structure first became visible in the American venture capital arena in the 1960s,⁶ and turned into the dominant organizational form starting in the 1970s,⁷ due especially to the legal and tax incentives available to it.⁸ Some have called for a widespread application of the United States (US)-style limited partnership by other countries, especially in Europe.⁹ Further, legislatures in some jurisdictions have hastened the introduction of the limited partnership, while in others they have sought to modernize existing limited partnership structures to suit evolving business needs. For instance, jurisdictions such as China, Singapore, New Zealand, Taiwan, Japan and Switzerland have introduced the limited partnership over the last decade,¹⁰ while others such as the United Kingdom (UK), the British Virgin Islands (BVI) and Australia modified their limited partnership law to meet changing business requirements.¹¹ This has propelled the limited partnership to be the dominant business form globally.¹²

The other business vehicle for venture capital and other similar investment funds is the trust, which has not received as much attention from the business and legal circles, despite its suitability for the purpose.¹³ When a trust is used as an investment vehicle,¹⁴ the trustee manages assets on behalf of the investors who are the beneficiaries of the trust. This arrangement substantially mimics the limited partnership structure, whereby the beneficiaries are the passive investors and the trustee (or its agents) the active manager.¹⁵ While the trust originated under the Anglo-American tradition, the concept has now been transposed to several civil law jurisdictions as well.¹⁶ Yet, the trust has not received much traction as a business form for venture capital, especially when compared with the proliferation of limited partnerships across various jurisdictions.¹⁷

⁵ Martin Kenney & Richard Florida, *Venture Capital in Silicon Valley: Fueling New Firm Formation*, in UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION 110 (2000), cited in David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, COLUM. BUS. L. REV. 363, 365 (2002).

⁶ Rosenberg, *supra* note 5, at 365.

⁷ Josh Lerner, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED—AND WHAT TO DO ABOUT IT 10 (2009).

⁸ William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990); Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. ECON. 463, 469 (1996); Curtis J. Milhaupt, *Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 885 (1997); Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in MICHAEL J. WHINCOP (ED.), BRIDGING THE ENTREPRENEURIAL GAP 54, 69 (2001).

⁹ McCahery & Vermeulen, *supra* note 4 at 65.

¹⁰ Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 181.

¹¹ *Id.* See also, Lin, *Venture Capital in Singapore: The Way Forward*, 5 J.B.L. 363, 377 (2019).

¹² Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 180-81.

¹³ Robert H. Sitkoff, *Trust as “Uncorporation”*: A Research Agenda, 2005 U. ILL. L. REV. 31, 31 (2005); John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145, 2145 (2016).

¹⁴ Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 436-37 (1998); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 564 (2003).

¹⁵ Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 633 (2004).

¹⁶ Steven L. Schwarcz, *Commercial Trusts as Business Organizations: An Invitation to Comparatists*, 13 DUKE J. COMP. INT’L L. 321, 323 (2003).

¹⁷ In certain jurisdictions, the limited liability partnership and limited liability company have been used as business forms for venture capital funds. John H. Matheson, *Choice of Organizational Form for the Start-Up Business*, 1 MINN. J. BUS. LAW & ENTREP. 7, 11-13, 14-15 (2002); Callison, *supra* note 2, at 98. However, this paper is confined to an analysis of the limited partnership and the trust.

Against this background, several questions emerge. Is there a specific business form that is optimal for funds and essential to constructing a successful venture capital market? If so, is the limited partnership the most optimal business form? Can other business forms, such as the trust, act as functional alternatives to the limited partnership and help engender a vibrant venture capital market? This paper seeks to address these questions through a comparative study of the business forms that are dominant in the Chinese and Indian venture capital markets. An analysis of these two jurisdictions is interesting for a number of reasons. First, these are two key markets for venture capital, not just in Asia but around the globe.¹⁸ Second, venture capital has thrived in both markets despite the fact that venture capital funds in each jurisdiction adopt altogether different business forms, *viz.*, the limited partnership in China and the trust in India.

Recognizing the importance of limited partnerships to venture capital fund raising, the Chinese legislature introduced the limited partnership under the revised Partnership Enterprise Law (PEL), which was effective from 1 June 2007.¹⁹ The adoption of the limited partnership was part of the government's strategy to develop the venture capital market.²⁰ Consistent with the benefits of limited partnerships in the US, the Chinese limited partnership regime also has two types of partners: GPs, who are jointly and severally liable for the debts and liabilities of the firm, and LPs, who are only liable to the extent of their capital contributions.²¹ LPs are not permitted to "carry out partnership affairs", while GPs have the right to conduct the day-to-day management of the firm.²² The PEL also provides a "safe-harbor" list of the activities in which LPs may engage without being viewed as participating in the management of the firm. This is in order to assist LPs in demarcating the legitimate scope of their participation in the firm's activities.²³ The limited partnership has since become the most popular business vehicle among newly raised funds in China (see Table 1).²⁴ Before the introduction of the limited partnership, companies and trusts were the two major forms of venture capital fund formation in China, whose importance has since drastically declined.²⁵

While the limited partnership has risen in popularity in China, venture capital funds in India are predominantly organized as private non-charitable trusts.²⁶ These trusts are governed by an age-old legislation in the form of the Indian Trusts Act, 1882, which sets out the default terms

¹⁸ Preqin, *Preqin Insights: Alternative Assets in India* (Nov. 2017), available at <http://docs.preqin.com/reports/Preqin-Insight-Alternative-Assets-in-India-November-2017.pdf>, at 20; See also Lin, *Venture Capital in Singapore*, *supra* note 11, at 365.

¹⁹ Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 182.

²⁰ *Id.*

²¹ Partnership Enterprise Law at art. 2.

²² *Id.* arts. 2, 67, and 68.

²³ *Id.* arts. 68.

²⁴ *Id.*

²⁵ Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 184. (Table 4 of the paper shows the change of dominate business forms for funds in China over the years.)

²⁶ Saikrishna Bharathan & Ganesh Rao, *Alternative Investment Funds in India: Unlocking Sophisticated Investment*, NLS BUS. L. REV. 1, 6 & 52 (2017); Ashwath Rau, Pallabi Ghosal & Vivaik Sharma, *Chambers Global Practice Guide on Investment Funds (India)*; Abhinav Sharma & Apurva Kanvinde, *Private Equity in India: Market and Regulatory Overview*, THOMSON REUTERS PRACTICAL LAW, (Nov 1, 2016), [https://content.next.westlaw.com/Document/Ieb4a24e91cb511e38578f7ccc38dcbee/View/FullText.html?contextData=\(sc.Default\)&transitionType=Default&firstPage=true&bhcp=1](https://content.next.westlaw.com/Document/Ieb4a24e91cb511e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1);

governing such private trusts.²⁷ Counterintuitively, and in the age of the major expansion of the limited partnership form, trusts have been used effectively in the Indian context as functional equivalents to the limited partnership. The investors, as beneficiaries to the trust, play a similar role as LPs and the investment manager, as the trustee or its agent, discharges a role similar to that of the GP in a limited partnership. The principal explanation for India's unique approach can be attributed to the fact that there is no legislative framework that enables the establishment of limited partnerships in India.

While this is understandable, the situation deserves further explanation. Why has the legislature in India failed to jump on the bandwagon and introduce the limited partnership form to facilitate the growth of venture capital? Curiously, while there have been some recommendations for the introduction of the limited partnership form, these proposals have not received much momentum.²⁸ These proposals have not been significant on the legislative agenda due to the lack of impetus from the industry and practitioners, who have simply enjoyed tremendous comfort with the trust structure over the years.²⁹ In fact, there is a perceptible resistance against a change in the business form, indicating the influence of path dependence.³⁰ Unlike in China, where the limited partnership represents a recent innovation, the trust form has been tried and tested in India. The forces of path dependence help explain the different trajectories adopted by China and India, with China's venture capital market rapidly embracing the limited partnership and India continuing to shun it.

Using the examples of China and India, this paper argues that the presence of specific business forms, while important at the outset, is not determinative of the growth of the venture capital market if there are functional equivalents that can substantially achieve the goals of investors and managers. Where multiple organizational forms are available under law, parties are likely to choose the most optimal one.³¹ The choice of venture capital firms in China in preferring the limited partnership structure to trusts is emblematic of this phenomenon. However, where only one business form is available, parties are likely to nevertheless adopt it despite minor inefficiencies, as long it provides the same principal benefits as the dominant (absent) form.³² Not only does the use of trusts in India characterize this position, but the feebleness of the reform efforts and resistance to change suggests that market players are willing to continue using the form that is embedded in the legal system, even if it is inefficient compared to proposed alternatives. In this situation, the legislative and transactional costs of transitioning

²⁷ It is necessary to distinguish private trusts from public charitable trusts, which are governed by a somewhat different legal regime. Public charitable trusts are beyond the scope of this paper.

²⁸ Securities and Exchange Board of India, *Report of K.B. Chandrasekhar Committee on Venture Capital* (Jan. 8, 2000), available at <https://www.sebi.gov.in/reports/reports/jan-2000/report-of-k-b-chandrasekhar-committee-on-venture-capital-21001.html>, (hereinafter the *Chandrasekhar Committee Report*); Securities and Exchange Board of India, *Report Submitted by Alternative Investment Policy Advisory Committee* (Jan. 20, 2016), available at <https://www.sebi.gov.in/reports/reports/jan-2016/report-submitted-by-alternative-investment-policy-advisory-committee-31510.html> (hereinafter *AIPAC Report – I*).

²⁹ This view emerged strongly in our conversations with legal practitioners in India involved in the venture capital fund formation space.

³⁰ Sitkoff, *Trust as "Uncorporation"*, *supra* note 13, at 45-46; Callison, *supra* note 2, at 107.

³¹ Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 303, 316-17 (2006).

³² Lin, *Engineering a Venture Capital Market*, *supra* note 3, at 209.

to a perceived optimal business form, such as the limited partnership, will likely be higher than maintaining the status quo.

At the same time, the choice of business form depends on a number of historical and institutional factors. The trajectory in China is evident from the fact that both the trust as well as limited partnership were relatively new, thereby allowing for switching between the business forms. On the other hand, given the entrenched nature of trusts in India, one might assume that even if limited partnerships were to be legislatively permitted, the take-up rate is unlikely to be significant.³³ In that sense, this paper challenges the orthodoxy that uncritically seeks to crown the limited partnership as the kingpin among business forms. It cautions against such a uniform approach and advocates for a more nuanced analysis that takes into account peculiar local factors in each jurisdiction.

This paper proceeds as follows. Part II will analyze the evolution of the business forms for venture capital in China and India and examine the broad legal framework governing the industry. The three parts which follow thereafter seek to establish the functional similarities between the limited partnership in China and the trust in India. While the two business forms share a number of features, they each suffer from certain inefficiencies, as this paper seeks to demonstrate. In doing so, it is necessary to clarify that the paper adopts a theoretical, functional and comparative approach to the analysis of business forms rather than a legalistic or doctrinal approach.

Part III focuses on the issues pertaining to whether the business forms in China and India confer entity status on the venture capital fund. This is relevant from the perspective of ring-fencing the funds and also addressing the claims that the creditors of the fund as well as creditors of the investor may have. Part IV considers the delegated management structure in each business form and, in particular, whether and to what extent the investors enjoy the protection of limited liability. Part V embarks upon an agency problems analysis and examines the statutory and fiduciary duties of managers to act in the interests of the investors, and the extent to which the investors can enforce those duties. Finally, Part VI concludes with some key lessons and the way forward.

II. EVOLUTION OF VENTURE CAPITAL BUSINESS FORMS IN CHINA AND INDIA

Organizational law bears certain fundamental characteristics, which include the exercise of control over management, the assumption of risk from the venture and sharing of returns.³⁴ While this is enough for most business forms, venture capital funds have additional features

³³ This is evident from Singapore's experience where limited partnerships have failed to thrive despite legislative change over a decade ago that facilitated the introduction of such a business form. See Lin, *Private Equity*, in FINANCIAL SERVICES LAW AND REGULATION 563 (Hans Tjio, Dora Neo & Lan Luh eds., 2018) at Table 1; Lin, *Venture Capital in Singapore*, *supra* note 11, at 372. The limited partnership as a business form in Singapore between 2009 and 2016 showed that the rate of adoption of limited partnerships has been consistently low. For example, in 2016, only 142 limited partnerships were registered in Singapore, as compared to 2431 newly registered LLPs, 27121 new business (general partnerships and sole proprietorships) and 35228 companies.

³⁴ Callison, *supra* note 2, at 100.

essential to their activity that must be accommodated. The first is the flexibility that actors within the business form enjoy in establishing their contractual relationships, and in setting up the business and exiting from it.³⁵ Contractual freedom is of utmost importance.³⁶ Second, given the sensitivities involved in the business of early stage portfolio companies and the associated secrecy surrounding venture capital funds and their investors, venture capital funds flock to business forms that require no disclosures to government agencies or to the public. Third, the availability of tax pass-through is a *sine qua non* for venture capital firms, whereby the earnings of the fund are taxed in the hands of the investors as if they directly earned it, and not at the fund level.³⁷

In light of these broad parameters, it would be essential to explore the evolution of the limited partnership law in China and the trust in India as fund vehicles for venture capital. This background will aid in a deeper analysis of the respective business forms.

A. *China: Rise of the Limited Partnership*

Prior to the introduction of the limited partnership in 2007, the major business forms used by venture capitalists in China to raise funds were the limited liability company (LLC), the joint stock company (JSC), the general partnership and trust.³⁸ However, these entities suffered from disadvantages that discouraged investment. LLCs and JSCs faced double taxation treatment, substantial formation costs and considerable financial disclosure requirements.³⁹ General partnerships imposed unlimited liability on all partners and a similarly harsh tax burden on partners until the year 2000.⁴⁰

The trust-type fund began to emerge in China in 2007, following the enactment of the first Trust Law in 2001.⁴¹ In a typical trust-type fund, a trust company acts as the trustee of a fund and is responsible for fund raising and investments. The capital is pooled from investors by

³⁵ Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom of Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 790 (2008); Rosenberg, *supra* note 5, at 376.

³⁶ *Id.* See also, Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15, at 638.

³⁷ Conaway, *supra* note 35, at 790. At the same time, the interrelationship between business form and taxation is somewhat less specific. This is because the legislature can accord the same tax treatment for various business forms through a statutory sleight of hand, which bears no relation to the precise nature of the organization. Hansmann & Mattei, *supra* note 14, at 478; Langbein, *supra* note 14, at 181. Taxation has also been considered an "exogenous effect" to business. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, *supra* note 14, at 580.

³⁸ Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 183. There are also contractual-type funds in China but they are rarely used by venture capital funds.

³⁹ *Id.*

⁴⁰ *Id.* Before 2000, the PRC partnership enterprise was subject to taxation both at the enterprise level and upon distribution. Since 2000, the partnership enterprise has become tax transparent.

⁴¹ This type of fund is regulated by the PRC Trust Law and the *Operational Guidelines for the Private Equity Investment Trust Business of Trust Companies 2008* (PRC) (The China Banking Regulatory Commission, Yinjianfa 2008 No. 45). Before that, trust companies were not allowed to invest in the private equity sector directly. Under the *Trial Implementation Measures for the Customer Asset Management Business of Securities Companies 2003* ('*Measures for Asset Management*') and *Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds 2007* ('*Measures for Trust Plans of Assembled Funds*'), securities companies, trust companies or individuals in China can establish "the non-limitative aggregate asset management plan" or "the trust plan of assembled funds" to engage in private equity investments. Under such trust plans, securities companies or trust companies enter into investment management contracts with individual investors. The investors' assets are transferred to the securities companies and pooled together for the purposes of investment. The securities companies or trust companies act as trustees of these assets.

means of a trust plan. The trust company would either employ a professional investment company (normally a private equity firm or an investment bank) as the investment consultant of the fund, or conduct investments on its own. It is also common for the trust company to set up an investment committee to select portfolio companies and make investments. Investors participate in the management of the trust plan through beneficiary meetings and share profits according to the trust plan. Although there is no taxation of trust profits and, instead, income tax or enterprise tax is levied at the beneficiary level,⁴² trusts have not been a popular business form for fund raising in China (see Table 1), due to the complex structure, insufficient protection available to investors,⁴³ as well as the lack of a registration regime.⁴⁴

The very first Chinese Limited Partnership (*Wenzhou Donghai Chuangye Touzi Hehuo Qiye*)⁴⁵ was set up on June 27, 2007, soon after the enactment of the revised PEL on June 1, 2007.⁴⁶ By the following year, more than half of the newly raised venture capital funds were organized as limited partnerships.⁴⁷ Table 1 (below) shows that the limited partnership was the most popular business form among the newly raised venture capital funds in recent years, reflecting an overwhelmingly positive response from the business community towards the limited partnership as a business vehicle.

The popularity of the limited partnership in China can be attributed to several factors. *First*, the adoption of the limited partnership increases the range of business options available for venture capitalists. As discussed above, the LLC, JSC and trust had their own limitations and were unable to comprehensively meet the business needs of the venture capitalists and investors.

Second, much like the partnerships in most parts of the world, the Chinese partnership is governed by the partnership agreement. Partners are able to enter into bespoke covenants that align the interests of the investors and the venture capitalists, particularly in terms of compensation and fund management. Moreover, as compared to companies, partnerships enjoy lower formality costs and a greater degree of confidentiality in their financial information,

⁴² Lin, *Engineering a Venture Capital Market*, *supra* note 3 at 183; Deloitte, *New Belgium-China Income Tax Treaty Applicable as of 1 January 2014*, 2 (Jan. 27, 2014), <http://bit.ly/1iQU98h>.

⁴³ Under the Guideline of the Trust Company Collective Funds Trust Scheme Management 2009 (CBRC 2009, No.1), the investment committee decides on important investment issues. It is typically formed primarily of investment consultants, one of whom will also serve as the committee's chair, and it is supplemented by members from the trustee company. The beneficiary meeting has no powers to interfere with project selection and investment decision making. However, in practice, investment consultants play a role similar to that of GPs in a limited partnership-type fund. The heavy involvement of investment consultants in the investment making process creates a problem of inadequate protection for the beneficiaries or investors. Since the investment consultants are not the agents of the investors but are instead appointed by the trust company, they do not owe duties nor are they otherwise accountable to them. Furthermore, unlike the GPs, they do not bear unlimited liability for their investment decisions.

⁴⁴ Article 27 of the Trustee Company Management Guideline 2007 (CBRC 2007 NO. 2) provides that the "trustee company has the duty towards the trustor and beneficiaries to keep all other trust matters and documentation confidential, except when it is otherwise agreed upon." As a result, the trustee company, in ensuring that the identities of the beneficiary investors are kept confidential, does not need to register the trust. From a legal viewpoint, the lack of registration means that trust assets and properties cannot be fully ascertained. This has adverse effects on the law's ability to safeguard the rights of transacting parties, particularly with regard to the transfer and determination of assets. More importantly, the fact that the identity of the beneficiaries cannot be determined becomes an obstacle when the portfolio company that the trust has invested in wants to conduct an IPO.

⁴⁵ Shanghai Securities News, *The First Venture Capital Limited Partnership was Established* (29 June 2007).

⁴⁶ *Diyi Caijing Ribao* (第一财经日报) [FIRST SECURITIES DAILY] (May 8, 2008), <http://bit.ly/2tINAsy>.

⁴⁷ *China Venture Capital Yearbook 2009*, at 252.

which is advantageous to investors who do not wish to disclose their investment in the funds. Further, the combination of limited liability for investors and unlimited personal liability for managers meets the needs of the key players in a venture capital market, especially those of the investors, who prefer to entrust their capital to experienced venture capitalists and would not want to bear unlimited liability for the debts of the partnership.⁴⁸

Third, partnerships enjoy tax transparency at the entity level in China. There are also a number of preferential tax policies for LPs and GPs at the local level.⁴⁹ For example, in Tianjin, a considerably low 20% individual income tax rate is applicable to GPs and LPs who are natural persons, and a 100% subsidy is granted for any tax above this 20% threshold.⁵⁰

As of now, the limited partnership has become the dominant business form in China's venture capital market. A typical Chinese fund is a fixed-life fund organized as a limited partnership, raised and managed by a venture capital firm. A Chinese venture capital limited partnership is governed by both the limited partnership agreement concluded between the GP and LPs, as well as the PEL, which is the major legislation governing partnerships in China. The venture capital firm typically serves as the GP and carries out the day-to-day operations of the fund's business, such as raising new funds, selecting portfolio companies, and managing and monitoring the fund's investments. Investors serve as LPs and provide capital to the fund (Figure 1).⁵¹ Most of Chinese firms follow the internationally recognized two-and-twenty compensation structure to GPs, wherein GPs receive annual management fee (2% of the committed capital) and carried interest (20% of the annual profits of the fund).⁵² Furthermore, to align the interests of GP and LPs, most of the Chinese firms would also require the GPs to make a capital contribution to the fund.⁵³

⁴⁸ *Id.*

⁴⁹ Lin, *Engineering a Venture Capital Market*, *supra* note 3, 207-208.

⁵⁰ *Id.* at 179.

⁵¹ For the structure of PRC limited partnership in the context of China's private equity and venture capital market, see further Lin, *The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners*, 13(1) *J. CORP. L. STUD.* 185 (2013).

⁵² However, there are some variations in Chinese practice. See Lin, *Engineering a Venture Capital Market*, *supra* note 3, at 196 - 197.

⁵³ Telephone interview, Mr. Xu, fund manager of a Shanghai private equity fund), August 29, 2019; telephone interview, Ms. Shao, legal counsel of Gaorong Capital, August 29, 2019.

Figure 1. A Typical Chinese Venture Capital Limited Partnership

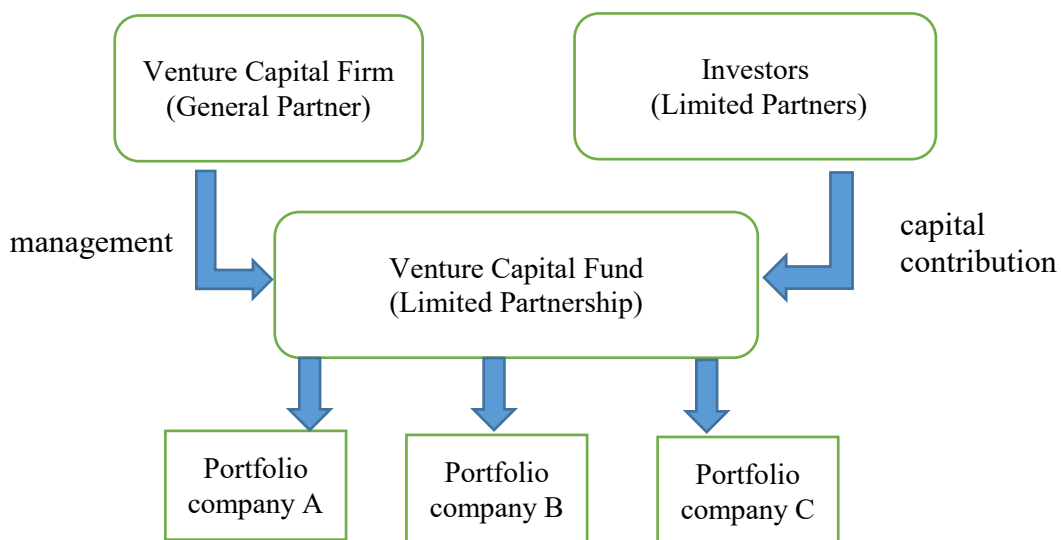


Table 1. Proportion of Different Types of Business Forms Used for Newly Raised VC Funds in China⁵⁴

Year	Limited Partnership	Company	Trust	Others	Total
2017	82.3%	6.1%	11.6%		100%
2013	68.96%	24.14%	0.00%	6.90%	100%
2012	57.50%	35.00%	5.00%	2.50%	100%
2011	69.64%	28.57%	0.00%	1.79%	100%
2010	46.56%	45.80%	1.53%	6.11%	100%
2009	25.20%	67.48%	3.25%	4.07%	100%
2008	51.19%	39.29%	4.76%	4.76%	100%

In all, while there were a number of business form available for venture capital funds, the introduction of the limited partnership altered the scenario in China where the other forms, including the trust, effectively faded away within a rather short span of time.

B. India: The Stickiness of the Trust

⁵⁴ Sources: CHINA CONSTRUCTION PRESS, CHINA VENTURE CAPITAL YEARBOOK 2008-2013 (Democracy and Construction Press). The sample sizes for the years 2008 to 2013 are 84, 123, 131, 112, 40 and 29 respectively. The 2017 figure was collected from Zero2ipo, 2017 China Equity Investment –Fund Raising Strategies Research Report <中国股权投资市场募资策略专题研究报告>, available at <https://m.pedaily.cn/news/431823>.

Venture capital emerged as an investment form in India in the 1980s.⁵⁵ It received considerable impetus from the government.⁵⁶ The industry began to flourish in the 1990s as the overall economic policy of the Indian government at the time focused on liberalization. The industry initially organized itself through an industry body in the form of the Indian Venture Capital Association.⁵⁷ It was only in 1996 that the industry was specifically regulated when India's securities regulator, the Securities and Exchange Board of India (SEBI), promulgated a set of regulations governing the sector.⁵⁸ Although registration was not mandatory under SEBI's regulations, the onerous nature of the legal regime imposed constraints on the sector. Hence, following a consultation process, the 1996 Regulations were replaced with a more comprehensive set of regulations in the form of the SEBI (Alternative Investment Funds) Regulations, 2012 (hereinafter the "AIF Regulations") which apply to several types of funds. Apart from venture capital, the AIF Regulations also apply to private equity, hedge funds and several others. Unlike the 1996 Regulations, the AIF Regulations require mandatory registration of alternative investment funds (AIFs) with SEBI.⁵⁹

The AIF Regulations impose several conditions and restrictions on the ability of AIFs to carry out their investment activities.⁶⁰ In doing so, the AIF Regulations trifurcate AIFs into different categories.⁶¹ Category I AIFs invest in start-up or early-stage ventures or in areas the government considers economically desirable. Venture capital funds fall within this category. Category II AIFs are the residual category of funds that do not undertake leverage or borrowing. Private equity, real estate, debt and distressed assets funds populate this category. Finally, Category III funds employ diverse or complex trading strategies and may engage in leverage. These include hedge funds. The nature and extent of SEBI's regulation of AIFs is consistent with the extent of risk to investors and the market. Accordingly, Category I AIFs are subject to relatively less regulation while Category III AIFs are heavily regulated.

When it comes to business forms, the AIF Regulations permit an AIF to be structured either as a trust, company or limited liability partnership (LLP). Of these three business forms, almost all AIFs are structured as trusts. The numbers are staggering, showing that the trust overshadows the other alternatives as the business form of choice. Of a total of 598 AIFs registered with SEBI as of July 12, 2019, 582 are trusts, 13 are LLPs and only 3 are companies.⁶² In other words, 97.3% of registered AIFs operate in the form of trusts. Although

⁵⁵ Manuel Gonzalo & Hugo Kantis, *Venture Capital in India: A Critical View from an Evolutionary and Systemic Perspective*, available at <http://liee.ntua.gr/wp-content/uploads/2018/02/532-Venture-capital-in-India-.pdf>, 2.

⁵⁶ Rafiq Dossani & Martin Kenney, *Creating an Environment: Developing Venture Capital in India*, BERKELEY ROUNDTABLE ON THE INTERNATIONAL ECONOMY (BRIE), #143 (May 2001), 8. Furthermore, non-resident Indians working in universities and corporations in the United States, including in the Silicon Valley, began investing in Indian venture capital firms. This too propelled the Indian venture capital sector. *Id.*, at 19.

⁵⁷ Bijal Ajinkya & Shefali Goradia, *Venture Capitalism*, ASIA PACIFIC TAX BULLETIN 379 (Nov/Dec 2002).

⁵⁸ *Id.* See SEBI (Venture Capital Funds) Regulations 1996 (hereinafter the "1996 Regulations").

⁵⁹ SEBI (Alternative Investment Funds) Regulations, 2012, §3(1).

⁶⁰ The precise nature and scope of these conditions and restrictions are beyond the scope of this paper. For further details, see, Bharathan & Rao, *supra* note 26; Rau, Ghosal & Sharma, *supra* note 26.

⁶¹ SEBI (Alternative Investment Funds) Regulations, 2012, §3(4).

⁶² Securities and Exchange Board of India, *Registered Alternative Investment Funds*, available at <https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16>. Since SEBI does not indicate the nature of business form of each AIF on its website, the numbers had to be computed through a process of elimination using the name of the AIF. Under Indian law, companies with limited liability must carry the word "Limited" in its name and LLPs

SEBI does not list out the categories of AIFs, its annual report for 2018 shows that there were 196 registered venture capital funds.⁶³

Why is there an overwhelming slant towards the trust as a business form? *First*, the trust structure provides considerable flexibility to the parties in organizing their relationship.⁶⁴ Parties are free to contractually provide for the terms and conditions, including their respective obligations. While the Indian Trusts Act, 1882 imposes duties and obligations on the parties, there is nevertheless sufficient room for determining specific aspects of the relationship through contract.⁶⁵ More importantly, trusts are simple to establish and to dissolve, and there are no capital requirements, thereby enabling investors to freely infuse capital and withdraw returns without restrictions. *Second*, there are no reporting or disclosure requirements under trust law, which allows parties to maintain confidentiality regarding their contractual arrangements. This is particularly useful in protecting business sensitive information. Although the AIF Regulations requires that the instrument of trust be registered under the Registration Act, 1908, parties have effectively sidestepped significant disclosure requirements by including only standard terms in the instrument of trust, such as the trust deed. The sensitive business-related information is instead incorporated in the accompanying documents such as the contribution agreement and the investment management agreement, which are not subject to public filing requirements.⁶⁶ *Finally*, among the various business forms, the trust has received the most beneficial treatment regarding its tax pass-through status.⁶⁷ Companies and LLPs are not popular as they deprive the parties of the aforesaid benefits, except for taxation.

Given the benefits of the trust structure, an established legal and commercial practice has developed around its formation and operation. The principal parties to a venture capital fund in the form of a trust are the trustee, investment manager and investors (in the form of beneficiaries of the trust) (Figure 2).⁶⁸ In most cases, the trusteeship duties are discharged by professional third party trustees, who undertake these roles for various funds.⁶⁹ The third party trusteeship phenomenon gives rise to a peculiar situation. Since these trustees undertake their role for a fixed fee, they only discharge a nominal role and the trustees' powers and duties are, for all practical purposes, delegated to the investment manager of the venture capital fund through an investment management agreement.⁷⁰ A contribution agreement between the

the word "LLP". Hence, from SEBI's list, the entities with the words "Limited" and "LLP" were eliminated to arrive at the remaining number that represent trusts.

⁶³ Securities and Exchange Board of India, *Annual Report 2017-18*, available at https://www.sebi.gov.in/reports/annual-reports/aug-2018/annual-report-2017-18_39868.html, 85

⁶⁴ Hans Tjio, *Lending to a Trust*, 19 TRUST LAW INTERNATIONAL 3, 4 (2005).

⁶⁵ For a more detailed discussion, see *infra* Part V.

⁶⁶ Lawyers we interviewed confirmed this approach.

⁶⁷ Although historically trusts have been favoured, the tax pass-through treatment currently in vogue is agnostic to business form, as it is uniformly available to all Category I and Category II AIFs, which include venture capital funds, regardless of whether it is a trust, company or LLP. Income Tax Act, 1961, §115UB. See also, *supra* note 37 (for the tenuous relationship between business form and taxation).

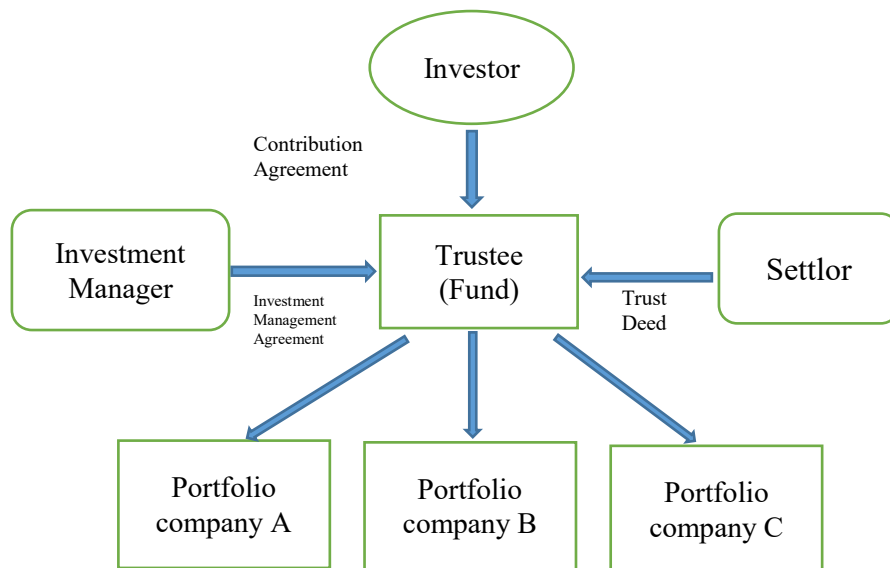
⁶⁸ While the trust requires a settlor, her role is minimal and limited to the establishment of the trust with a nominal corpus.

⁶⁹ Some of the prominent professional trustees in this space in India are Vistra ITCL (India) Limited (<https://www.vistraitcl.com/>), IDBI Trusteeship Services Limited (<http://idbitrustee.com/>), Beacon Trusteeship Limited (<http://beacontrustee.co.in/>) and Amicorp Trustees (India) Private Limited (<https://www.amicorp.com/offices/mumbai-trustees>).

⁷⁰ Bharathan & Rao, *supra* note 26, at 11.

investors, the trustee and the investment manager will capture the commercial terms of the investment in the venture capital fund.⁷¹

Figure 2. A Typical Indian Venture Capital Trust



Such a structure has been tried and tested in the Indian market and has effectively become a cookie cutter, as the market players and their advisors are entirely familiar and comfortable with the establishment and operation of such a trust arrangement.⁷² They do not perceive the need for a deviation from this well-worn path. While foreign investors who are less familiar with the trust structure for venture capital funding do occasionally raise concerns, Indian lawyers are able to address them not only by explaining the successful track record of the trust structure in India, but also through its flexibility and adaptability in terms of replicating the principal features of a limited partnership, namely passive ownership and active management.

At the same time, there have been calls to increase the number of business forms available for venture capital funds in India. In 2000, the K.B. Chandrasekhar Committee appointed by SEBI called for the creation of limited partnerships, LLPs and limited liability companies to provide greater flexibility and also make the Indian regime consistent with globally accepted practices.⁷³ Thereafter, LLPs were introduced by way of the Limited Liability Partnership Act, 2008. However, LLPs have not become popular in the venture capital industry because the structure does not allow for a bifurcation between passive investment and active management, as it does not bifurcate between GPs and LPs. Moreover, LLPs are not only subject to more detailed reporting requirements, but also face restrictions in making investments.⁷⁴ Hence, the

⁷¹ *Id.*

⁷² Conversations with practitioners confirmed this position

⁷³ *Chandrasekhar Committee Report*, *supra* note 28 at 4, 26 - 27. A subsequent committee established under the chairmanship of Ashok Lahiri refers to the existence of limited partnerships in jurisdictions such as the United Kingdom and Australia, but fails to make any recommendation for introducing the business form in India. Securities and Exchange Board of India, *Report of Advisory Committee on Venture Capital* (Oct. 15, 2003), available at https://www.sebi.gov.in/reports/reports/oct-2003/report-of-advisory-committee-on-venture-capital_12778.html.

⁷⁴ *AIPAC Report – I*, *supra* note 28 at 86.

Alternative Investment Policy Advisory Committee (AIPAC) established under the helm of Narayana Murthy, a well-known tech entrepreneur, called for the removal of restrictions on LLPs so that they could be set up as effective investment vehicles.⁷⁵ Over a two-year period ending January 2018, the AIPAC issued three reports totalling nearly 450 pages dealing with several aspects of the venture capital industry in India, but there was not even a whisper about the need for a different business form such as the limited partnership. On the contrary, the AIPAC was keen on relaxing restrictions on the LLPs that were by then made available in India, although that form is less suited to venture capital fund vehicles than the globally prominent limited partnership. All of these indicate the stickiness of the trust in India's venture capital industry, and there are no indications whatsoever of a transition away from this business form.

The above comparison shows how the divergence in practice between the Chinese and Indian venture capital markets came to be. The Chinese response of abandoning the trust was facilitated by the introduction of the limited partnership before the trust could take root as the main form chosen by funds and investors. On the other hand, the Indian funds have embraced the trust as it was, for a much longer period, the key investment vehicle available. In doing so, they have found ways around the limitations posed by the use of a trust form and have instead developed path dependence in favour of the trust as the default form, effectively stymying the introduction of the limited partnership as a form. This suggests that the presence of a sufficiently capable, although suboptimal, form is enough to facilitate the development of a venture capital market. The following analysis considers which factors are key to determining whether a specific form can be regarded as sufficiently capable and, as a result, might act as a guide for jurisdictions considering the introduction of a new corporate form.

III. VENTURE CAPITAL FUND: ENTITY CHARACTERIZATION

The nature of partnerships has long been addressed on a conceptual basis, determined by whether a partnership is viewed as an “entity” separate from its partners, or an “aggregate” of the partners.⁷⁶ In contrast to the US which considers the partnership as a separate legal entity, English law treats the partnership as an aggregate of its partners.⁷⁷ As a result, English partnerships do not have a legal personality separate from its partners. Many commonwealth jurisdictions, including Singapore⁷⁸ and Hong Kong⁷⁹ follow the English approach.

⁷⁵ *Id.*

⁷⁶ Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law* 42 ARK. L. REV. 395, 396 (1989).

⁷⁷ See T Prime & G Scanlan, *Limited Partnership Reform — The Entity, The Fiduciary Duties and The Execution of Deeds* COMP LAW 262, 265 (2007). The aggregate approach regards a partnership as an aggregation of the individual partners, whereas the entity approach views the partnership as an entity separate from its partners.

⁷⁸ The draftsman adopted the recommendation of the 2002 study team to not include the separate legal personality feature. Such a recommendation was made primarily because the study team was concerned that overseas tax authorities might treat the Singapore limited partnership as an opaque entity for tax purposes if it had a separate legal personality. See Lin, *Venture Capital in Singapore*, *supra* note 11.

⁷⁹ “Limited partnerships – overview”, *Lexis Practical Guidance*, available at https://www.lexisnexis.com/ap/pg/hkcorporate/document/410885/59HP-Y9P1-DYTB-M40X-00000-00/Limited_partnerships_overview.

The aggregate approach means that the English limited partnership cannot have perpetual succession. It also cannot hold property nor enter into contracts in its own name.⁸⁰ As the limited partnership would cease to exist and a new limited partnership would be created on each occasion when a partner retires or a new partner is admitted, the third party who deals with a limited partnership over time might have unknowingly transacted with several different partnerships.⁸¹ The legal characterization of the limited partnership is thus at odds with the commercial perception that the limited partnership is an entity.

The entity approach provides a better reflection of commercial reality and promotes consistency with legal developments in other jurisdictions where the entity feature is becoming an increasingly common feature of limited partnerships.⁸² It would also provide a more elegant solution to the various practical problems currently faced in the use of limited partnerships, such as continuity on change of partners, ownership and transfer of partnership property, and the procedure and substance of litigation.⁸³ The BVI has already adopted this approach and all BVI limited partnerships formed under the new BVI Limited Partnership Act 2017 (No. 24 of 2017) have the ability to elect whether they are to be formed with or without legal personality.⁸⁴

In China, partnerships, including limited partnerships, are not considered “legal persons” (*fa ren*). Under the PRC General Rules of Civil Law, a “legal person is an organization with capacity for civil rights and capacity for civil conduct, and enjoys civil rights and assumes civil obligations independently in accordance with the law.”⁸⁵ “A legal person shall have its own name, organs, domicile, and property or funding.”⁸⁶ Partnership enterprises are considered non-legal-person organizations (*fei fa ren zu zhi*), which refer to the organizations without legal personality but have the capacity to conduct civil actions in their own names.⁸⁷ Although Chinese partnerships do not have a separate legal personality, the general impression is that they appear to possess certain attributes that are consistent with the entity approach — for example, the ability to sue or be sued in its own name, the capacity to own assets, the continuity of the partnership despite the departure or death of an LP, and the postponement of recourse against the partners until a creditor has exhausted its remedies against partnership assets.⁸⁸

Comparing China and India, it would appear at the outset that they represent diametrically opposing positions. While the limited partnership in China possess certain attributes that are

⁸⁰ UK Partnership Act 1890.

⁸¹ The Law Commission and The Scottish Law Commission, “Partnership Law”, online: Law Commission UK, available at http://www.lawcom.gov.uk/app/uploads/2015/03/lc283_Partnership_Law.pdf, at 5.8. While the third party might be required to pursue legal remedies for past wrongs against different aggregations of persons, admittedly this is not a critical issue for limited partnerships since general partners are readily identifiable and limited partners’ liability is restricted to their capital contribution.

⁸² Elspeth Berry, *Limited partnership law in the United States and the United Kingdom: teaching an old dog new tricks?* 2 J. BUS. L. 160, 164 (2012).

⁸³ *Id.*

⁸⁴ Michael Killourhy, “BVI Limited Partnerships Act 2017” (Feb 12, 2018), available at <https://www.ogier.com/publications/bvi-limited-partnership-act-2017>.

⁸⁵ Article 57 of the General Rules of the PRC Civil Law.

⁸⁶ Article 58 of the General Rules of the PRC Civil Law.

⁸⁷ Article 102 of the General Rules of the PRC Civil Law.

⁸⁸ Lin Lin & HY Yeo, *Limited Partnership: A New Business Vehicle in People's Republic of China* 25(2) B.J.I.B.F.L. 104, 104 (2010).

consistent with the entity approach, the trust in India does not have any. However, as this paper argues, such an analysis would be superficial and it is essential to adopt a functional approach in examining the trust. In doing so, it is clear that even though the trust may not have a separate legal personality, it possesses entity-like features which makes it functionally similar to the Chinese limited partnership with separate legal personality.

To begin with, a trust is an obligation, and the trustee has legal ownership of the trust property.⁸⁹ Under Indian trust law, the beneficiaries have no interest, whether legal or equitable, in the trust property. As one commentary notes in the context of the use of the term “beneficial interest” in the Indian Trusts Act:

It is clear that the term has been introduced and defined with a view to eliminate any chance whatsoever of introducing the English concept of beneficiary having an ‘equitable estate’ in the trust property, the subject matter of the trust. The beneficiary has a mere ‘beneficial interest’, a right against the trustee as owner of the property, but *no estate or interest in the subject matter of the trust.*

[emphasis in original]

Indian trust law indicates a clear separation between the trust property that the trustee holds and the interest of the beneficiary, which is similar to that of property that a company holds in relation to its shareholders.⁹⁰

The trustee bears the obligation of protecting title to the trust property,⁹¹ and is expected to maintain the trust funds separate from the trustee’s own funds.⁹² Professor Langbein notes: “This segregation regime separates the trustee’s trust property from non-trust property without having to lodge ownership of the trust property in a distinct entity endowed with juridical personality, such as a corporation.”⁹³ Thus, even though the trust is not a separate legal personality, the segregation of assets introduces entity-like features.⁹⁴ Professors Hansmann and Mattei argue that such a segregation requirement ensures that trust assets are shielded from claims of the trustee’s personal creditors, and that such a protection is similar to that provided by a corporation.⁹⁵

⁸⁹ See, Indian Trusts Act, 1882, §3 (defining a trust as “an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner”).

⁹⁰ Corporate property is owned by the company, over which shareholders have no proprietary rights (neither legal nor beneficial). PAUL DAVIES & SARAH WORTHINGTON, GOWER’S PRINCIPLES OF MODERN COMPANY LAW, 10TH EDN, 35-36 (2016).
⁹¹ Indian Trusts Act, 1882, §13.

⁹² See, DHARAM PAL NIGAM (ED.), N. SURYANARAYANA IYER’S THE INDIAN TRUSTS ACT, 1882 166 (1997).

⁹³ Langbein, *supra* note 14, at 180.

⁹⁴ Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15, at 641. See, Morley, *supra* note 13, at 2154 (stating: “To be clear, a common law trust was never a distinct juridical personality. Under the common law, a trust has always been a personal obligation of the trustee.”).

⁹⁵ Hansmann & Ugo Mattei, *supra* note 14, at 438. See also, Schwarcz, *Commercial Trusts as Business Organizations*, *supra* note 16, at 325 (observing: “... the trust relationship provides for limited liability: beneficiaries of the trust may claim (absent breach of trust) only against the trust assets, not against personal assets of the trustee, nor may the trustee’s personal creditors claim against the trust assets”).

Moreover, trustees are not personally liable to the trust's creditors unless they have provided a guarantee.⁹⁶ The limited liability of the beneficiaries would ensure that they are not personally liable for liabilities incurred by the trust.⁹⁷ Similarly, beneficiaries are residual claimants in the trust property as they obtain the remainder of the trust's assets after settling other claims, subject to the trust instrument.⁹⁸ These features effectively ensure that the trust itself, although not a separate legal personality, is distinct from the trustee, the beneficiaries and the settlor.⁹⁹

The idea propagated by some scholars¹⁰⁰ that the trust is an entity or that it has *de facto* legal personality has come under attack.¹⁰¹ One critic argues that while trusts carry some characteristics of asset partitioning, "they are porous when compared to the corporation."¹⁰² While this theoretical debate continues, this paper does not take the stance that the trust is a separate legal personality or an entity. It is only concerned with the fact that the trust exhibits entity-like features purely from a functional standpoint rather than in terms of precise jurisprudential distinctions. Moreover, the aforesaid debate appears largely in the context of a comparison between the trust and a corporation, while this paper is concerned with the trust and the limited partnership. If one were to place the trust along a spectrum between a limited partnership with aggregate features (as found in the UK and Singapore) and a limited partnership with entity features (as found in the US and China), the trust is likely to be closer, but not identical, to the position in the US and China. To that extent, the entity features of the Indian trust make it a more optimal business form for venture capital than the limited partnership that carries the aggregate form, as prevalent in some jurisdictions.

This Part began with a discussion of the relevance of the entity status for the business form in a venture capital fund. While China's limited partnership law confers entity status on that form, the situation is less clear with the Indian trust. However, a functional analysis of the trust's features indicate that its characteristics share further similarity with the Chinese limited partnership than it appears to at first glance. After considering the entity features (complete or partial) of the business forms for venture capital in China, the next Part considers the management structure and liability issues in these forms.

IV. MANAGEMENT STRUCTURE AND INVESTOR LIABILITY

The limited partnership has been a successful business form in the venture capital industry because it provides for a unique combination of GPs who are managers with unlimited liability and LPs who cannot take part in management and hence are conferred the benefit of limited

⁹⁶ Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15, at 641.

⁹⁷ Hansmann & Mattei, *supra* note 14, at 462. The aspect of limited liability of the beneficiaries is discussed in greater detail later. *See infra* Part IV.

⁹⁸ Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15, at 646-47.

⁹⁹ *Id.*, at 470.

¹⁰⁰ Hansmann & Mattei, *supra* note 14. *See also*, Langbein, *supra* note 14; Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15.

¹⁰¹ *See, e.g.*, M.W. LAU, THE ECONOMIC STRUCTURE OF TRUSTS 61-79 (2011). *See also*, Tjio, *supra* note 64, at 5 (noting that the UK does not treat the trust as a separate legal entity).

¹⁰² LAU, *supra* note 101, at 79.

liability.¹⁰³ The management-liability correlation is rather stark. In fact, as one commentator observes, “a limited partnership is the only entity some of whose owners have a full liability shield (LPs) and some of whose owners have no liability shield (GPs)”¹⁰⁴ and that “[n]o other business form provides this dual-track liability construct.”¹⁰⁵

Such a management-liability correlation arises on account of the “control rule”, which provides that LPs would become liable if they take part in management of the limited partnership.¹⁰⁶ This compels LPs to take a passive stance. The control rule has inevitably invoked a comparison between LPs and shareholders in a company. Despite the separation between ownership and management in a company,¹⁰⁷ shareholders possess more intervention rights than LPs.¹⁰⁸ For example, shareholders may intervene on key matters involving a company that are allocated to shareholder decision-making.¹⁰⁹ Shareholders may elect or remove directors and thereby indirectly influence the management of the company through their control over the composition of the board.¹¹⁰ Shareholders may also elect themselves as directors.¹¹¹ However, LPs cannot carry out such actions in a limited partnership without potentially losing their limited liability shield.¹¹² To mitigate the harshness of this situation, several jurisdictions have introduced safe harbour provisions in limited partnership statutes whereby certain specified acts of shareholders would not be considered acts of management, and hence would not attract liability.¹¹³ The Uniform Limited Partnership Act (2001) has gone even further by eliminating the control rule.¹¹⁴

The control rule still exists in many jurisdictions, such as Delaware,¹¹⁵ New Zealand,¹¹⁶ Singapore¹¹⁷ and the UK.¹¹⁸ Chinese law does not clearly provide that a LP will lose the limited liability protection if she participates in the control of the firm under Article 68 of the PEL. Rather, the PEL merely provides a list of activities not viewed as taking part in partnership management (also known as the “safe-harbor activities” list) in order to assist the LPs in demarcating the legitimate scope of their participation in the fund’s activities.¹¹⁹ Article 68 of the PEL provides that:

¹⁰³ Ribstein, *Limited Partnerships Revisited*, *supra* note 2, at 974-75.

¹⁰⁴ Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partners Estoppel Liability as Well as Full General Partner Liability*, 37 SUFFOLK U.L. REV. 667, 668 (2004).

¹⁰⁵ *Id.*, at 674.

¹⁰⁶ Lin, *Private Equity Investor Protection: Conceptualizing the Duties of the General Partners in China*, 15 BERKELEY BUS. L.J. 43, 52 (2018). *See also*, Christopher Morris, *The Private Fund Limited Partnership: The Reform Company Lawyers Have Been Waiting For?* 38(6) COMP. LAW. 192, 192-93 (2017).

¹⁰⁷ ADOLF A. BERLE & GARDINER C., MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 66 (1940 [c1932]).

¹⁰⁸ Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 294 (2009).

¹⁰⁹ Lin, *Private Equity Investor Protection*, *supra* note 106, at 52.

¹¹⁰ *Id.*

¹¹¹ Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, *supra* note 31, at 320.

¹¹² Lin, *Private Equity Investor Protection*, *supra* note 106, at 52.

¹¹³ *See*, Deborah A. DeMott, *Our Partners’ Keepers? Agency Dimensions of Partnership Relationships*, 58 LAW AND CONTEMPORARY PROBLEMS 109, 115 (1995); McCahery & Vermeulen, *supra* note 4 at 79.

¹¹⁴ *See* NCCUSL’s ULPA Summary, www.nccusl.org/Update/uniformact_summaries/uniformacts-s-ulpa.asp.

¹¹⁵ *Delaware Revised Uniform Limited Partnership Act* § 17-303.

¹¹⁶ *Limited Partnership Act 2008* (New Zealand), §30.

¹¹⁷ *Limited Partnership Act 2008* (Singapore), §6.

¹¹⁸ *Limited Partnership Act 1907* (UK), §4 (2).

¹¹⁹ Lin, *The Private Equity Limited Partnership in China*, *supra* note 51, at 201.

“a limited partner may neither carry out the partnership affairs nor represent the limited partnership when dealing with other parties. The following activities of limited partners shall not be deemed as ‘executing the partnership affairs’:

- (1) participation in a collective decision to admit or remove a general partner;*
- (2) making a proposal relating to the business management of the LP firm;*
- (3) participation in the selection of an accounting firm to audit the LP firm;*
- (4) receiving an audited financial report of the LP firm;*
- (5) inspection of accounting books and other financial information of the LP business which involve self-interest;*
- (6) commencement of legal proceedings against an accountable partner when the LP’s interests have been infringed;*
- (7) initiation of legal action in one’s own name to safeguard the LP’s interests where the partner responsible for the conduct of partnership affairs has neglected the exercise of his rights; and providing guarantee for the LP”.*

This provision is arguably defective as it does not define what constitutes “carrying out the partnership affairs” and it is unclear whether this list of activities is exhaustive.¹²⁰ There is reasonable doubt as to whether this short list is sufficient to cover all situations in different business environments. Such legal uncertainty has created problems in judicial practice.¹²¹ Even in the US state of Delaware, where there is a lengthy safe-harbour list, the courts have not yet been able to provide a satisfactory interpretation of the extent of the control rule and when LPs should be regarded as subject to unlimited liability.¹²² Moreover, the test for finding a LP liable for breaching the control rule has been evolving, and varies from country to country.¹²³

Moving to the trust structure, there is no explicit control rule in such a business form. The beneficiaries of a trust are usually passive (unless the trustee is one of the beneficiaries) and they enjoy the advantage of limited liability.¹²⁴ One commentator has remarked that historically the limited liability feature of a trust has not been as strong as that in a company, but that it has always been much stronger than in a general partnership.¹²⁵ In such a scenario, beneficiaries in a trust structure need not be concerned about unlimited liability, especially because trust law knows of no explicit control rule. This is also a significant reason why the trust has been a popular business form in India.

¹²⁰ Some commentators suggest that it is not an exhaustive list. See 刘庆飞, “论有限合伙人的“执行合伙事务行为”《政治与法律》2007年第6期 [Liu Qingfei, “Discussion on Limited Partner’s Execution of Partnership Affairs” (2007) 6 Politics and Law]; [Liu] at 101.

¹²¹ Many Chinese funds set up the investment committees for LPs to participate in the management of the firm and this has led to internal conflicts between LPs and the GP. See Lin, *The Private Equity Limited Partnership in China*, *supra* note 51.

¹²² Lin, *The Private Equity Limited Partnership in China*, *supra* note 51, at 204.

¹²³ *Id.*

¹²⁴ See, e.g., Hansmann & Mattei, *supra* note 14, at 463; Tjio, *supra* note 64, at 9-10; Robert D. M. Flannigan, *Beneficiary Liability in Business Trusts*, 6 Est. & Tr. Q. 278, 279 (1984)..

¹²⁵ Morley, *supra* note 13, at 2174.

Under the Indian Trusts Act, 1882, the explicit liability of beneficiaries is confined to certain specific scenarios, such as where a beneficiary (a) joins in a breach of trust, (b) knowingly obtains any advantage from such breach without the consent of the other beneficiaries, (c) fails to take action after becoming aware of a breach of trust or a potential breach, and (d) deceives and induces the trustee to commit a breach of trust.¹²⁶ In the absence of such a specific act or omission on their part, beneficiaries will not carry any liability for loss caused to the trust property.

The contracting provisions and market practice in India reinforce the limited liability of the beneficiaries, being investors in a venture capital fund. Parties are able to further limit the liability of the beneficiaries contractually in trust, which adds to the attractiveness of that business form.¹²⁷ As a practitioner publication notes in the context of the Indian AIF trust structure:

Structurally, an investor's liability is limited to its commitment. Typical indemnity provisions may be agreed by investors to indemnify the trustee, manager or other committee member (indemnitees) for claims against the indemnitees due to activities of the AIF (with usual "bad act" carve-outs, such as for reason of fraud, misconduct or gross negligence). However, this indemnification is also limited to an investor's commitment. Irrespective of the manner in which the AIF is set up or the indemnification obligations of the investors, contractually the liability of the investors in their capacity as investors are typically restricted to their commitment amount. While the liability of investors is limited in all available structures, if investors participate in the management of the AIF the liability may extend beyond their contracted capital commitment.¹²⁸

As the last sentence in the above quote cautions, beneficiaries cannot always seek and utilize limited liability protection even in the absence of an explicit control rule for a trust.¹²⁹ The gap in trust law may likely be filled by other branches of the law, thereby extending the liability of beneficiaries beyond their commitments in venture capital trusts in India. The remainder of this Part briefly considers circumstances where alternative forms of liability could arise to beneficiaries.¹³⁰ First, excessive intervention by the beneficiaries in the management of the trust could lead to the relationship between the parties being characterized as a general partnership, which would impose liabilities on the beneficiaries as if they were partners.¹³¹ The Indian Partnership Act, 1932 defines a "partnership" as "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."¹³²

¹²⁶ Indian Trusts Act, 1882, §68.

¹²⁷ Rau, Ghosal & Sharma, *supra* note 26.

¹²⁸ *Id.*

¹²⁹ Some argue that there is a rationale for a control test in the case of a trust that is similar to such a test in a limited partnership. See, Flannigan, *supra* note 124, at 284; *Liability of Shareholders in a Business Trust-The Control Test*, 48 VA. L. REV. 1105, 1108-09 (1962).

¹³⁰ The details of such liability forms are beyond the scope of this paper.

¹³¹ The authors thank Kelly Loi for highlighting this possibility. See also, Flannigan, *supra* note 124, at 286.

¹³² Indian Partnership Act, 1932, §4.

Moreover, partnership status is determined by the contract between the parties,¹³³ taking into account all relevant facts.¹³⁴ Given that partnership is created by contract, the contribution agreement must be structured in a manner that significant management rights are not conferred upon beneficiaries so as to make them partners in a firm that will, in addition to their status as beneficiaries, impose unlimited liability on them as partners.

Second, excessive interference by a beneficiary in the management of the trust could lead to the creation of an agency relationship whereby the substantial control exercised by the beneficiary over the trustee would make the trustee an agent and the beneficiary the principal.¹³⁵ Under Indian law, an “agent” is a “person employed to do any act for another, or to represent another in dealings with third persons.”¹³⁶ In such a scenario, the beneficiary as principal will be subject to liabilities undertaken by the trustee as the agent.¹³⁷ The imposition of such liability would depend upon how courts interpret the legal effect of the substantial control exercised by the beneficiary over the trustee.¹³⁸

Third, commentators have argued that even in the absence of an explicit control rule, investors could be subject to liability on the ground of estoppel if the actions of the investors provide sufficient indication to third parties that the investors will assume liabilities of the trust, and the third parties thereby place reliance upon that fact when contracting with the fund.¹³⁹ This issue first arose after the elimination of the control rule by the Uniform Limited Partnership Act of 2001 in the US, where commentators have cautioned of the possibility that LPs could nevertheless be liable through estoppel.¹⁴⁰ While minimal, such a risk could potentially arise for beneficiaries in a venture capital fund organized as a trust in India.

Investors in an Indian venture capital fund who are beneficiaries in a trust vehicle enjoy greater assurance when it comes to limited liability, as Indian trust law does not appear to carry the equivalent of a control rule. This confers a significant advantage to the trust as a business form over the limited partnership, in which the management-liability correlation is premised on the control rule. However, should the beneficiaries exercise interference in management of the trust, they would then run the risk of incurring liabilities under any of the alternative areas of the law such as partnership, agency or estoppel. Nevertheless, this has yet to be tested in India and, as such, remains an uncertain possibility.

As the discussion above shows, both the Chinese limited partnership and Indian trust are functionally similar in that they provide a division of management responsibilities and liabilities. While the Chinese limited partnership does this by providing limited liability to all

¹³³ *Id.*, §5.

¹³⁴ *Id.*, §6. This provision also contains some safe harbor situations which will not lead to the formation of a partnership.

¹³⁵ See, Flannigan, *supra* note 124, at 279-81.

¹³⁶ Indian Contract Act, 1872, §182.

¹³⁷ Indian Contract Act, 1872, §226 (which provides: “Contracts entered into through an agent, and obligations arising from acts done by an agent, may be enforced in the same manner, and will have the same legal consequences, as if the contracts had been entered into and the acts done by the principal in person.”).

¹³⁸ For the US position, see, Hansmann & Ugo Mattei, *supra* note 14, at 474.

¹³⁹ Bishop, *supra* note 104, at 668.

¹⁴⁰ *Id.*

LPs, subject to the control rule, the Indian trust does this through the inherent shielding effect of the trust. The Indian trust also provides a functional equivalent to the control rule through the presence of other doctrines which allow the court to recharacterize the relationship should the investor excessively intervene with the management or operations of the fund. It must be recognised that the two forms, while not directly similar, serve as functional equivalents.

V. ADDRESSING THE AGENCY PROBLEM IN A VENTURE CAPITAL FUND

The structure of a venture capital fund in which an active manager operates the fund for the benefit of passive investors raises a significant agency problem.¹⁴¹ This is exacerbated by the information asymmetry problems associated with venture capital funds, which result in investors being less able to monitor managers.¹⁴² In addition, venture capital investments lack liquidity, precluding investors from easily exiting their investments.¹⁴³ In view of the early-stage nature of the investments that venture capital funds make, managers may be under pressure to demonstrate their success to increase the marketability of their future funds.¹⁴⁴

The venture capital fund structure could also lead to shirking and rent seeking behaviour among managers. They may fail to exert the required effort to generate returns to the investors, such as when their time and effort are divided among the many funds they manage.¹⁴⁵ Crucially, venture capital funds may suffer from conflicts of interest that are distinct to the industry. For example, fund managers may co-invest with the fund by cherry picking lucrative investments;¹⁴⁶ they may seek to exit prematurely from funds to prove their track record, thereby generating less than optimal returns for their investors;¹⁴⁷ they may raise new funds even before the tenure of an existing fund;¹⁴⁸ or they may misappropriate or convert fund assets for personal interests.¹⁴⁹

The presence of a corporate manager in the venture capital industry aggravates the agency problem. It is customary in the venture capital marketplace for the manager to be established as a company, whether it is a GP in a limited partnership (as in China) or a trustee in the case of a trust (as in India). This effectively shields the individuals behind the manager from personal liability.¹⁵⁰ Through this hybrid structure, venture capital entrepreneurs enjoy the dual

¹⁴¹ For a detailed discussion on the concept of the agency problems, see Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976); Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

¹⁴² Sahlman, *supra* note 8, at 493; Securities and Exchange Board of India, *Report Submitted by Alternative Investment Policy Advisory Committee* (Dec. 1, 2016), available at https://www.sebi.gov.in/reports/reports/dec-2016/2nd-report-submitted-by-alternative-investment-policy-advisory-committee_33746.html.

¹⁴³ Gompers & Lerner, *supra* note 8, at 476-77.

¹⁴⁴ Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 47, 72-73 (2006).

¹⁴⁵ Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, *supra* note 31, at 341-42; Klausner & Litvak, *supra* note 8, at 62.

¹⁴⁶ Lin, *Private Equity Investor Protection*, *supra* note 106, at 62.

¹⁴⁷ Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role – Was it Something Lawyers Helped Structure*, 77 Chi.-Kent L. Rev. 211, 231 (2001); Klausner & Litvak, *supra* note 8, at 69-70.

¹⁴⁸ Klausner & Litvak, *supra* note 8, at 69.

¹⁴⁹ Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U.L. REV. 927, 936. (2004).

¹⁵⁰ Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 74 (1997)

advantages of exercising complete control over management and simultaneously overcoming liability issues by interspersing the company as a liability backstop.¹⁵¹ Moreover, decision-making by the corporate manager is carried out through its directors and officers who generally owe their duties to the corporation (and sometimes to its shareholders). While an individual manager owes duties to the investors (whether in the form of LPs or beneficiaries), directors and officers of a corporate entity owe no such duties directly to the investors. This creates a conflict between two sets of duties, i.e., one that the corporate manager owes to the investors, and the other that the corporate manager's directors and officers owe to the corporation itself, thereby giving rise to a dual agency problem.¹⁵²

One solution could be to establish a mechanism whereby the individual directors and officers of the corporate manager owe their duties directly to the fund's investors, allowing these investors to directly enforce them against such individuals.¹⁵³ Another supplementary solution would be to address the double agency problem by clarifying that in the event of a conflict between the duties of the directors and officers to the investors and to the corporate managers, that they shall accord priority to the interests of the investors in the fund.¹⁵⁴ However, such treatment has yet to find its way into the laws in China and India. Despite the clear-cut market practice of using corporate general partners and corporate trustees in China and India respectively, the investors must contend with the liability shield behind which individual directors and officers of corporate managers operate.

The literature also abounds with assertions that the imposition of onerous duties on venture capital managers is unnecessary. Parties in the venture capital industry rely on implicit contracts and reputational incentives more than they do specific legal contracts or enforceable duties.¹⁵⁵ The staged contribution structure permits investors to walk away from unsuccessful ventures. The cyclical nature of the venture capital industry, wherein the reputation of venture capitalists will draw investors to invest in newer funds that such venture capitalists may form in the future, motivates venture capital managers to act in the interests of investors.¹⁵⁶ As one commentator noted, "the importance of reputation in the venture capital industry, made possible by the cyclical nature of investment in venture capital limited partnerships, provides sufficient safeguards to ensure that managers act in the best interests of their investors."¹⁵⁷ While this may hold true, at least partially, in the more developed markets for venture capital financing such as the US, the veracity of such a theory is likely to be much weaker in markets such as China and India, where reputational sanctions may not pose much of a deterrent against misconduct by managers.¹⁵⁸

¹⁵¹ Lin, *Private Equity Investor Protection*, *supra* note 106, at 63.

¹⁵² Lin & Yeo, *supra* note 88, at 105-106.

¹⁵³ See, Hamilton, *supra* note 150, at 107. This approach has already been legislated in Singapore for one type of business form. Business Trusts Act (Cap 31A), §10(2)(a).

¹⁵⁴ This too has received statutory recognition in Singapore. Business Trusts Act (Cap 31A), §11(1)(b).

¹⁵⁵ Kate Litvak, *Governance through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLIAMETTE L. REV. 771, 772 (2004); Gregory G. Oehler, *The Wider Implications of Implicit Contracts in Venture Capital Partnerships*, 1 N.Y.U. J.L. & BUS. 489, 490 (2005); McCahery & Vermeulen, *supra* note 4 at 82.

¹⁵⁶ David Rosenberg, *The Two Cycles of Venture Capital*, 28 J. CORP. L. 419, 421 (2003).

¹⁵⁷ Rosenberg, *supra* note 5, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, at 365.

¹⁵⁸ For a detailed discussion of the reasons in the context of China, see, Lin, *supra* note 51, at 213-14 (2013).

In this background, the remainder of this Part will critically analyse the law and practice in China and India in their ability to address the agency problems arising from their respective business forms. It first examines the duties of the managers to act in the interest of the investors, and then the powers available to such investors to enforce their rights effectively against the managers.

A. *Duties of Managers towards Investors*

Given China's status as a civil law jurisdiction, there is no concept equivalent to equity and common law fiduciary duties under Chinese law.¹⁵⁹ Although there are no duties of loyalty and care specified under the PEL, the PEL outlines several provisions on the duties of partners, which play analogous roles to the duties of loyalty and care in common law:

- (1) The partners should not engage in activities which may harm the interests of the partnership.
- (2) The general partners should not carry out any business competing with that of the partnership solely or cooperatively.
- (3) The partners should not engage in any self-dealing business with the partnership.
- (4) The partner should not abuse any benefit of the partnership by taking advantage of his position or misappropriating any property of the partnership by other illegal means. If he does so, he shall return the benefit or property to the partnership. If his act results in any loss to the partnership or to other partners, he shall be liable for compensation.
- (5) The partner owes a duty to account to the firm for any benefit derived by him from any transaction competing with that of the partnership, or from any self-dealing business by him with the partnership. The partner shall bear compensation liabilities if any loss is caused to the partnership or to other partners.
- (6) The managing partner should regularly report to the other partners on the process of partnership activities as well as the business and financial status of the partnership.¹⁶⁰

Although these limited duties fail to clearly and adequately stipulate the partners' statutory duties,¹⁶¹ arguably, the above rule stipulating non-competition (Article 32(1) and Article 99 of the PEL), the duty not to misappropriate company property (Article 96 of the PEL), and the duty to not engage in self-dealing (Article 32(2) and Article 99 of the PEL) are similar to the duty of loyalty found in the US.¹⁶²

In addition, the China Securities Regulatory Commission (CSRC) has also issued the Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds 2014

¹⁵⁹ Lin, *Private Equity Investor Protection*, *supra* note 106. For the fiduciary principles in China, see further in Nicholas C. Howson, "Fiduciary Principles in Chinese Law", in Van J. Criddle, Paul B. Miller, and Robert H. Sitkoff eds, *The Oxford Handbook of Fiduciary Law*, (Oxford University Press, 2019), pp 603-22.

¹⁶⁰ *Id.*, at 75.

¹⁶¹ *Id.* at 47.

¹⁶² *Id.*, at 76.

(2014 CSRC Interim Measures)¹⁶³ to supplement the PEL with a list of scenarios which are similar to the duty of loyalty.¹⁶⁴ For example, Article 23 of the 2014 CSRC Interim Measures stipulates nine prohibitions for fund managers, including, *inter alia*: “not to treat the assets of different funds under management in an unfair manner,” “not to take advantage of fund assets or their positions to seek benefits for, or transfer benefits to, themselves or persons other than investors,” “not to divulge undisclosed information obtained by virtue of their positions, or make use of such information to engage in, or expressly ask or imply others to engage in, related trading activities,” “not to engage in investment activities detrimental to fund assets and investor interests,” “not to neglect duties, or fail to perform duties as required,” and “not to engage in insider trading, market manipulation or other improper trading activities.” However, as the CSRC Interim Measures is an interim measure, the effectiveness of the Measures is undermined. Also, the CSRC Interim Measures are promulgated by the CSRC, which is a department under the State Council. Such a departmental regulation is ranked lower than the legislation made by the National People’s Congress in the hierarchy of legal sources under Chinese law. The People’s Courts have the discretion whether to refer to the CSRC Interim Measures in relation to cases addressing venture capital but cannot directly apply these measures in making judgments.¹⁶⁵

Trust law in India imposes an array of obligations on the trustee in dealing with the trust property. The trust statute elaborates these duties extensively.¹⁶⁶ These include fiduciary duties to act in the interest of the beneficiaries and to avoid conflicts of interest,¹⁶⁷ as well as the duty of care.¹⁶⁸ The fiduciary nature of the trusteeship position imposes onerous obligations on the trustee to act in the interest of the investors.

At one level, the obligations of a trustee can be said to be more onerous than that of a director of a company or even a partner in a partnership. Trust statutes generally tend to incorporate strict duties on trustees as compared to corporate law.¹⁶⁹ The law governing fiduciary duties tends to be prophylactic in nature¹⁷⁰ and “the functional core of the fiduciary obligation is deterrence.”¹⁷¹ For example, trustees may be held liable for a self-dealing transaction even if it

¹⁶³ The CSRC Interim Measures set forth the regulatory regime for private funds under five key topics: (i) registration and filing; (ii) qualified investors; (iii) fundraising; (iv) fund operation; and (v) special rules for venture capital funds. Simu Touzi Jijin Jiandu Guanli Zhanxing Banfa [Interim Measures for Supervision and Administration of Privately-Raised Investment Funds] (promulgated by the China Sec. Reg. Comm’n, Aug. 21, 2014, effective Aug. 21, 2014), Decree No. 105 of the China Sec. Reg. Comm’n, art. 12 (China) [hereinafter CRSC Interim Measures], read with Simu Touzi Jijin Muji Xingwei Guanli Banfa [Private Investment Fundraising Behavior Management Approach] (promulgated by the China Fund Industry Ass’n, Apr. 15, 2016, effective July 15, 2016), art. 28, CHINA SEC. REG. COMM’N, http://www.csrc.gov.cn/tianjin/xxfw/scyw/201606/t20160608_298472.htm (China) [hereinafter Private Investment Fundraising Behavior Management Approach].

¹⁶⁴ Lin, *Private Equity Investor Protection*, *supra* note 106, at 85.

¹⁶⁵ *Id.* at 78.

¹⁶⁶ *See*, Indian Trusts Act, 1882, Part III, §§11-30.

¹⁶⁷ *See e.g.*, Indian Trusts Act, 1882, §13 (trustee to protect title to trust property), §14 (trustee not to set up title adverse to beneficiary), §17 (trustee to be impartial).

¹⁶⁸ *See e.g.*, Indian Trusts Act, 1882, §15 (providing: “A trustee is bound to deal with the trust property as carefully as a man of ordinary prudence would deal with such property if it were his own ...”).

¹⁶⁹ A. Joseph Warburton, *Trusts versus Corporations: An Empirical Analysis of Competing Organizational Forms*, 36 J. CORP. L. 183, 186 (2010); Sitkoff, *Trust as “Uncorporation”*, *supra* note 13, at 37.

¹⁷⁰ *See e.g.*, Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 LQR 452, 453, 468-69 (2005).

¹⁷¹ Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1043 (2011).

is shown to be fair,¹⁷² and they cannot derive the benefit of a business judgment rule available in several jurisdictions under corporate law.¹⁷³ At least in terms of the law on the books, these duties are considerably onerous on the trustees in the case of a venture capital fund that is organized as a trust, thereby arguably giving more than adequate cover to the investors.¹⁷⁴

However, the law in the books seems to be somewhat at odds with the market practice on the ground. As seen earlier,¹⁷⁵ the venture capital industry in India is replete with fixed-fee earning third party trustees whose incentives may not necessarily align with that of the investors. These institutional trustees in turn delegate their responsibilities to the investment manager under the investment management agreement.¹⁷⁶ Justifications have been proffered for such delegation on the ground that venture capital funds are specialized vehicles comprising investors who need less protection for their decisions and that, in any event, these vehicles hold passive investments rather than carry out an active business.¹⁷⁷

Indian trust law permits delegation of the trustee's office or duties only under certain circumstances.¹⁷⁸ The trust law, therefore, takes cognizance of the reality that trustees cannot be expected to perform the entire role themselves, especially when it involves specialized fields such as venture capital investments. This, in turn, complicates the extent to which beneficiaries may have a cause of action for breaches of duties. Given the extensive delegation permitted by the venture capital documentation, in reality the investors will have to proceed against the investment manager under the contribution agreement, although the trustee will likely nominally be included as a defendant in a suit.¹⁷⁹ In addition, it is also suggested that an agent of the trustee, such as the investment manager, who has been delegated powers "is in the position of a constructive trustee by reason of acceptance of the delegation of the trust and, therefore is not absolved from liability."¹⁸⁰

Finally, trust documentation in Indian venture capital firms tend to contain waiver, exculpation and indemnification clauses that inure to the benefit of the trustee.¹⁸¹ Trust law generally looks at such clauses favourably, except when they cover extreme situations such as bad faith involving the trustee.¹⁸² Under Indian trust law, the trustee would be liable for breach of trust except when (a) the beneficiary has by fraud induced the trustee to commit the breach, or (b) the beneficiary has concurred in the breach, or (c) the beneficiary has subsequently acquiesced

¹⁷² Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565 (2003).

¹⁷³ Warburton, *supra* note 169, at 186; Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 15, at 656.

¹⁷⁴ However, limiting the flexibility to management through onerous fiduciary duties can constrain efficient business decision-making. Warburton, *supra* note 169, at 184.

¹⁷⁵ *See supra* notes 69-70.

¹⁷⁶ *Id.*

¹⁷⁷ *See*, in the context of limited partnerships, Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, *supra* note 149, at 941-43.

¹⁷⁸ Indian Trusts Act, 1882, §47 (wherein delegation is permitted only when "(a) the instrument of trust so provides, or (b) the delegation is in the regular course of business, or (c) the delegation is necessary, or (d) the beneficiary, being competent to contract, consents to the delegation").

¹⁷⁹ For further discussion, *see infra* Part VB.

¹⁸⁰ *Koka Sivananda Sastry v. Samasthanam Choultry*, (1968) 2 Andh WR 260; NIGAM, *supra* note 92, at 293.

¹⁸¹ Shreya Rao & Vakasha Sachdev, *Can Trustees Contract Out of Fiduciary Liabilities?*, INDIA CORPLAW (Mar. 25, 2017), available at <https://indiacorplaw.in/2017/03/can-trustees-contract-out-of-fiduciary.html>.

¹⁸² Sitkoff, *Trust as "Uncorporation"*, *supra* note 13, at 39. Commentators argue this to be the state of Indian trust law as well. Rao & Sachdev, *supra* note 181.

in the breach with full knowledge of facts.¹⁸³ However, the question of whether, apart from these specific situations, the trust documents can contractually limit the liabilities of the trustee is less clear. In the absence of specific indications from the legislature or the courts in India, it seems likely that waiver, exculpation and indemnity provisions ought to be sustainable, except when they relate to serious forms of breaches such as fraud, bad faith or gross negligence.¹⁸⁴

In all, the agency problems for Indian venture capital managers are dealt with through a combination of trust law and contract law. While the organizational features are dictated by trust law, the position is complicated by the fact that third party trustees play only a nominal role as they effectively pass on all their roles and duties to the investment manager, who performs an active role. Although the duties under trust law are substantially strong in the Indian context, the bifurcation of managerial roles between the trustee and the investment manager introduces a level of murkiness as far as the rights of the investor are concerned. Moreover, given the relative novelty of venture capital structures in India, these matters have yet to be tested before the Indian courts.

As the above analysis shows, both in China and India the relevant statutes impose duties and liabilities on the persons managing the venture capital fund to act in the interests of the investors. However, in both cases, there are several practical considerations that cast some doubt on the extent to which these duties will have the consequent impact on manager conduct.

B. Enforcement of Duties

Regardless of the legal position concerning the duties owed by fund managers to the investors, these are ineffective if the investors do not have any means of enforcing these duties. Having examined the extent of duties, this paper now turns towards how they may be enforced.

In China, enforcement of partners' duties is problematic. Although Article 68(7) of the PEL allows the LPs to bring a lawsuit in their own names in the interest of the enterprise when the GP has "neglected the exercise of his rights", LPs can rarely obtain the evidence required to prove such negligence.¹⁸⁵ As LPs have no right to participate in the actual management and operation of the partnership, it is difficult for them to collect relevant evidence through legitimate channels. Moreover, key evidence is often retained by the GP. Further, the GP is often a management company with few assets. Even if the LPs successfully obtain a favorable judgment or arbitral award, it is unlikely that any significant assets will be available for execution of such judgment or award.

There are 11 cases in which LPs have successfully litigated against the GP in China under the PEL as of July 2019, since the limited partnership, together with the LP's derivative action was

¹⁸³ Indian Trusts Act, 1882, §23.

¹⁸⁴ Rao & Sachdev, *supra* note 181.

¹⁸⁵ Lin, *Private Equity Investor Protection*, *supra* note 106, at 80-81.

introduced in 2006 under the Revised PEL.¹⁸⁶ The first successful derivative action lawsuit occurred on 29 March 2017 - *Anhui Ruizhi Real Estate Development Co. Ltd v. Jiao Jian and others*.¹⁸⁷ In this case, the Supreme Court of People's Republic of China ruled in favor of the LPs. Apart from failing to initiate any legal proceedings on behalf of the partnership after two entrusted loans were due for collection, the GPs also ignored the LPs' repeated requests to exercise the partnership's creditor rights, failed to respond to subpoenas and did not appear before the Court of First Instance. Given that the GP had *de facto* abandoned the partnership's debt claims, China's apex court held that the GP had "neglected the exercise of [its] right." However, the law remains silent as to whether LPs have to exhaust other remedies before bringing a derivative action.¹⁸⁸

Turning to India, there is no need for derivative actions in view of the fact that the trust does not constitute a separate legal personality.¹⁸⁹ Investors as beneficiaries are entitled to initiate legal action against the trustee under the trust document and pursuant to trust law. In addition, they may have contractual recourse against the investment manager. However, given the well-known delays in the Indian courts, venture capital players have indicated a preference for arbitration as a means of dispute resolution. This augurs well given the need for confidentiality. But, in a setback to the industry, the Supreme Court of India in 2016 ruled that disputes arising out of trusts deeds cannot be subject to arbitration.¹⁹⁰ Nevertheless, from a practical standpoint, this has failed to constitute a significant concern as the principal commercial terms are contained in the contribution agreement, the breaches of which can still be subject to arbitration.¹⁹¹

In addition to civil remedies, investors are entitled to approach SEBI for regulatory action. SEBI's role is confined to ensuring compliance with the AIF Regulations. This could arise when the venture capital fund carries out its investment in breach of the AIF Regulations. This is a case of public enforcement which is focused on deterring the venture fund and their managers, and the extent to which it will result in a remedial measure offered to the aggrieved investors is unclear.

As yet, there is no evidence of significant enforcement of duties by investors. There have been at least two cases of note. One relates to a regulatory action by SEBI, which imposed a penalty on an errant AIF, which lent loans to a company in breach of the AIF Regulations.¹⁹² Although

¹⁸⁶ These cases include such as: *Shixingronghe Investment Management Ltd. v Changan International Trust Co. Ltd and Tianjin Dinghui PE*, 2016 SUP. People's CT.GAZ 19(China); *Wangyufeng v. Guangzhou international procurement Co. Ltd* (2015) Huitianfajinminchuzi No.5345 Guangzhou Tianhe District Court, Civil Judgement. For the discussion of limited partners' derivative action, see further on Lin Lin, *Limited Partners' Derivative Action: Problem and Prospects in the Private Equity Market of China*, 41(2) HONG KONG LAW JOURNAL 517 (2011).

¹⁸⁷ The High Court of Anhui Province made the judgement on 26 February 2016 (2015) [Wan Min Er Chu Zi No. 00005] (皖民二初字第 00005 号), and ruled in favour of the LPs. An Hui Rui Zhi appealed to the Supreme Court and the Supreme Court upheld the High Court of An Hui's judgement.(2006) Zuigaofaminzhong No. 756, [(2016) 最高法民终 756].

¹⁸⁸ See Lin, *Private Equity Investor Protection*, *supra* note 106, at 80-81 (2018).

¹⁸⁹ Berry, *supra* note 82 at 177.

¹⁹⁰ *Shri Vimal Kishor Shah v. Jayesh Dinesh Shah*, 2016 (8) SCALE 116.

¹⁹¹ See also, Rau, Ghosal & Sharma, *supra* note 26.

¹⁹² Securities and Exchange Board of India, Order in respect of SREI Multiple Asset Investment Trust and SREI Alternative Investment Managers Limited (Nov. 29, 2017), available at <https://www.sebi.gov.in/enforcement/orders/nov->

the matter went on appeal, it was later settled.¹⁹³ In another case, the investors of ICICI Venture Funds Management Company initiated legal action in Mauritius, in which the trustee company was also impleaded,¹⁹⁴ which is stated to be pending resolution.¹⁹⁵

While the investor protection regime appears to be more robust in India, a factor which is likely to boost investor confidence, there are concerns regarding the ability of Indian courts to effectively enforce investor rights in a timely manner. This shows that investor protection goes beyond the mere form in which the fund is established. Attention also has to be paid to the surrounding legal and quasi-legal mechanisms which give teeth to the protections provided by the legal form.

VI. CONCLUSION

This paper challenges the extent to which the presence of an optimal business form (i.e. the limited partnership) is determinative of whether a venture capital market is able to flourish. As this analysis shows, the organizational form may play a lesser role than what the existing literature suggests. While the limited partnership has been gaining prominence in the venture capital industry and jurisdictions such as China have wholeheartedly embraced such a business form, it is not the sole optimal structure.

Conversely, as the Indian experience shows, it remains possible for the venture capital market to develop even if it utilizes a business form that is widely considered to be sub-optimal. The crucial point here is not the theoretical optimality of the business form available to venture funds, but whether the form is able to meet the practical needs of fund managers and investors in light of the prevailing legal and institutional considerations in each jurisdiction. To that end, the Indian private non-charitable trust has proven itself by the way in which it replicates the tax benefits and the division of control and liability provided by the limited partnership. While there are indeed problems with the form, as this paper has analyzed, these are eventually resolved by way of creative contracting or by resorting to doctrines from other sources of law. When this occurs, the effect of path dependence sets in as the market becomes conditioned to the manner in which venture capital funds are organized. The lack of enthusiasm of Indian market participants to the introduction of the limited partnership suggests that even if it were introduced now, it may be possible that the market will retain the trust as the main business form in venture capital.

This is an important lesson for jurisdictions seeking to introduce newer business forms to enliven their venture capital scene. In some cases, it is better not to meddle with what is not

[2017/adjudication-order-in-respect-of-1-srei-multiple-asset-investment-trust-2-srei-alternative-investment-managers-limited-in-the-matter-of-srei-multiple-asset-investment-trust_36736.html](https://www.sebi.gov.in/enforcement/orders/jul-2018/settlement-order-in-respect-of-srei-multiple-asset-investment-trust-and-srei-alternative-managers-limited-36736.html).

¹⁹³ Securities and Exchange Board of India, Settlement Order filed by SREI Multiple Asset Investment Trust and SREI Alternative Investment Managers Limited (Jul. 25, 2018), available at <https://www.sebi.gov.in/enforcement/orders/jul-2018/settlement-order-in-respect-of-srei-multiple-asset-investment-trust-and-srei-alternative-managers-limited-39703.html>.

¹⁹⁴ Sobia Khan & Kailash Babar, *NRI's Move Mauritius Supreme Court against ICICI Venture; Accuse PE Firm of Misleading Them*, ECONOMIC TIMES (Jul. 24, 2014).

¹⁹⁵ See, ICICI Bank Limited, *Form 20-F filed with the United States Securities and Exchange Commission* (July 31, 2019), available at https://www.icicibank.com/managed-assets/docs/investor/annual-reports/2019/form_20f_2019.pdf, at 22.

broken. In the end, the precise nature of the business form may matter less. Instead, regulators looking to develop their venture capital market may wish to find ways to increase the pool of available funds, encourage innovation and entrepreneurship within the market or introduce new measures that facilitate the exit of venture capital. Furthermore, any regulatory oversight must be accompanied by robust enforcement mechanisms. Ultimately, fund raising is only one stage in the venture capital cycle. In order to develop a robust venture capital market, improving the regulatory environment for investments, and exits, encouraging capital supply, boosting entrepreneur participation are also important and regulators would do well not to miss the forest for the trees.
