

Venture Capital Law in China BY LIN LIN [Cambridge: Cambridge University Press, 2021. xv + 340 pp. Hardcover: £85]

Venture capital (“VC”) is considered an essential component of any economy, as it engenders innovation and fosters the growth of early-stage business ventures. If so, how does one develop a VC market? This question has exercised the minds of scholars, and a number of theories have been proffered, including the reliance on private contracting and the intervention of the government (Ronald J Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience* (2003); Christopher Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience* (2005)).

While the scholarly discourse is afoot and economies and market regulators are constantly seeking to create the recipe for an optimal VC regime, China has demonstrated resounding success. Within a short span of time, it has grown to become the second largest VC market in the world, after the United States (“US”). This raises a number of interesting questions. What are the factors that contributed to the growth of the Chinese VC market? Are the lessons from the Chinese model replicable in other markets? Is the growth in the Chinese VC market sustainable? If so, how? It is precisely these questions that motivated the pathbreaking research carried out over a period of nearly a decade that has culminated in *Venture Capital Law in China*. Interestingly, the author of the book has already demonstrated her proficiency in the field through a number of notable papers on individual pieces of the puzzle, but in this work she skilfully builds up her research to a crescendo by presenting her findings in a consolidated fashion.

The comprehensiveness of the book is evident in the diversity of the methodological tools it employs to achieve the clear goals it sets out. It engages closely with the theoretical frameworks underpinning the analysis of the VC market, including the “simultaneity problem” referred to by Professor Gilson (*supra*). This suggests that the development of a VC market is premised on the presence of three factors simultaneously: (i) the availability of investment capital; (ii) the presence of sophisticated financial intermediaries operating as venture capitalists; and (iii) the existence of a cadre of entrepreneurs. As the book ably demonstrates, the interplay of these factors in China bears significant differences from the situation prevalent in other markets. The book is rich in its doctrinal analysis of various legislative instruments issued by the governmental bodies in China as well as the burgeoning local case law in the field.

One of the standout features of the work is its painstaking empirical analysis that uses a hand-collected dataset of 100 VC agreements (both at the fund as well as portfolio company levels) and interviews with 100 practitioners, including lawyers, venture capitalists, investors and entrepreneurs. This must surely have required unshakable perseverance, a healthy dose of patience and an immense amount of credibility to obtain first-hand insights from an industry that otherwise plays its cards close to its chest.

The comparative approach of the book is key, as it analyses the VC law in China both endogenously and through a comparison with markets such as the US. This expands the readership of the book at once, as it is of interest not merely for those focused on China, but also for anyone seeking an understanding of how law can

impact VC markets from a more jurisdiction-agnostic perspective. Finally, the author does not hesitate at all in engaging in a normative discussion of the reforms that must be introduced in China, or any other jurisdiction for that matter, to engender a vibrant VC market. Reasonable minds may disagree about the solutions for current problems plaguing the VC sector, but the author's boldness in holding out her views will indeed provide the necessary momentum for further research and debate.

In all, a multipronged approach towards addressing the issues in the VC market in China adds tremendous value. The work not only touches upon the legal aspects of the VC industry, but also deals with policy matters and examines trends in legal practice and contracting. It also meticulously uncovers the underlying factors behind why the VC law and practice in China developed the way it has.

The book begins by outlining the evolution of the VC market and its legal regime in China. Unlike the US VC market, the Chinese incarnation was not premised on private ordering. Instead, the government did play a significant role in charting the course of its development. The trajectory of VC regulation in China suggests the lack of a consistent policy, as the extent of regulatory interference in the market differed from time to time, and emerged in waves. For instance, in response to a range of scandals that surfaced from 2011, the regulatory framework was tightened with additional sets of regulations introduced in 2014. Ultimately, as the author notes, the story of China's VC regulatory framework is one of "piecemeal regulation". The impression one gets from this discussion is that given the novelty of the VC market in China, the regulators had to engage in experimental regulation, and to lay their course as they went along. In that sense, other jurisdictions would do well to view these developments purely on a context-specific basis.

The substantive parts of the book are structured elegantly along the three phases of the VC structure and contracting. These are the: (i) establishment of the VC entity and the raising of funds from investors, (ii) VC entity's investment into portfolio companies, and (iii) liquidation of investments by the VC entities and the return of profits, if any, to the investors. Each of these is discussed in turn.

First, the book considers whether the VC fund's entity form matters for the development of a mature market. While a number of investment vehicles are available globally, including the company, general partnership and trust, it is the limited partnership structure that has acquired ubiquity as a VC fund form. Cognisant of this phenomenon, the Chinese legislature introduced the limited partnership into the Chinese legal ecosystem in 2007. The success of the limited partnership is evident in as much as 82.3% of Chinese VC funds established in 2017 utilised that form.

The author engages in a detailed and critical analysis of the partnership enterprise law in China. While the law bears superficial resemblance with that in jurisdictions such as the US, there are fundamental differences in function. Similarly, the identity of the limited partners, being investors in the fund, in China demonstrate considerable divergence from their counterparts in the US. The author shows that Chinese limited partners are largely retail investors with short-term investment horizons rather than institutional investors with longer-term perspectives prevalent in the US. Curiously, even though the limited partnership structure requires the limited partners to take a back seat from management, the investors in Chinese funds are more interventionist, thereby causing distortions in the management of the funds, as well as to the incentives of the fund managers. Perhaps it is the lack of investor protection due to the

absence of general fiduciary duties of general partners and an inchoate regime for derivative actions in limited partnerships that leads limited partners in China to rely on self-help mechanisms.

One may think of the prevailing business form in China as that of the “limited partnership with Chinese characteristics”, which has nevertheless played a significant role in the expansion of the VC market in China. Of course, as the author forcefully argues, there is reason for legal reform on various fronts relating to the limited partnership structure in China.

Second, the book goes on to examine the structure and documentation of investments by VC funds into portfolio companies. Pioneer VC markets such as the US have adopted standardised legal documentation in the VC industry (National Venture Capital Association, *Model Legal Documents*, online: <<https://nvca.org/model-legal-documents/>>), which have often found their way into other jurisdictions as well. One of the key hurdles in the Chinese market is the lack of either the availability or full utility of investment structures and clauses that are all too familiar in the US markets, such as convertible preferred stock, liquidation preference and antidilution rights. Here, the author carries out the admirable task of examining each such clause that is well-known in the VC industry generally and opining on the extent to which it is workable in China. The analysis indicates a somewhat pragmatic outcome whereby parties are willing to incorporate universally accepted clauses into Chinese VC documentation without necessarily ensuring their legal enforceability. It might very well be that parties are willing to rely on non-legal factors to bind them to the deal with minimal expectation of dragging parties to court.

One remarkable contractual innovation in China, however, is the value adjustment mechanism (“VAM”) clause, which is a common feature in VC portfolio documentation. Under a VAM clause, if the company fails to meet certain predefined conditions (whether financial or non-financial), the investor is compensated by the company or a controlling shareholder either by payment of cash or the issue or transfer of additional shares in the company. The VAM clause in China effectively makes up for the lack of convertible preferred stock or other protective measures that investors in other VC markets enjoy. At the same time, there is criticism that the VAM clause offers downside protection to investors and induces greater risk averse behaviour in them, which runs contrary to the entire theme of VC investing in the first place.

Given the uniqueness of the VAM, the book adeptly undertakes a thorough analysis of the clause, its enforceability and practical operation. The author notes that the absence of information would make it difficult to ascertain the precise origins of the VAM such as who drafted it and when. However, a historical analysis of the VAM would add considerable value to the field of contracting innovation in general and VC documentation in particular. This is perhaps a fascinating area for further research by the author to supplement the present work and add to her repertoire. Normatively speaking, the author asserts that the VAM ought to be replaced by a more stable and well-recognised mechanism such as the convertible preferred stock. An alternative view, though, could be that path dependency could militate against the introduction of instruments such as the convertible preferred stock, which are less familiar to the Chinese VC market. It is useful to consider whether a more effective method would be to recognise the stickiness of contractual terms, and to fine-tune the terms and functioning of the VAM to enhance its optimality than to jettison it.

Third, exit options are crucial for a VC market, as they enable investors to liquidate their investments and realise any profits. The book reveals, using statistical data, that initial public offerings (“IPOs”) are the most common form of VC exits in China. This stands in contrast to the US where mergers and acquisitions constitute the predominant form of exit. The author rationalizes this outcome on the basis of several dynamics, including that China not only has a limited market for corporate control, but that cultural factors inhibit entrepreneurs therein from relinquishing control over their companies. Interestingly, the discussion also divulges the fact that the growth of Chinese VC markets corresponds closely with the expansion of its capital markets during the same period, which culminated in the launch of the STAR Market aimed specifically at the start-up sector. One of the novel features of the STAR Market is the availability of the dual class share (“DCS”) structure. The book undertakes a detailed analysis of the DCS in the STAR Market, with handy comparisons to Hong Kong and Singapore, which too recently introduced the DCS structure.

The discussions surrounding IPO exits could not have been timelier. Even as the book was being published, the listings of Chinese companies in the US have attracted a great deal of controversy, attributable largely to the strained economic relations between the two countries (“China signals end to \$2.7 trillion US stock listing juggernaut”, *The Straits Times*, 19 July 2021). There is reason to believe that Chinese companies are more likely to list domestically, at least in the near future, which makes the evaluations and prognostications by the author even more significant.

Finally, the book answers the questions it laid out upfront, that too in a clear and convincing manner. The author supports her thesis and arguments using theory, doctrine and empirical data. Even though set in the context of China, the style of presentation of this book and the lessons therefrom would command more universal interest and utility. Overall, *Venture Capital Law in China* is a book that should find a prominent place in the library of anyone interested in the fields of corporate finance, corporate governance and securities regulation, including law firms, law schools, venture capitalists, financial institutions, entrepreneurs and financial regulators.

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