

The China Business Review

September-October 2010



The PRC Partnership Enterprise Law permits foreign investors to establish general or limited partnerships.

Introducing the Foreign-Invested Partnership

There's a new option for structuring foreign investment in China, and it may offer companies greater flexibility.

Paul McKenzie, Thomas Chou, Adam Kearney, and Charles Coker

Foreign investors have pursued establishing joint ventures (JVs) and, later, wholly foreign-owned enterprises (WFOEs), since the inception of China's foreign-investment boom more than 30 years ago. Now, with the recent release of the Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals

(FIP measures) and the Administrative Provisions on the Registration of Foreign-Invested Partnership Enterprises (FIP registration procedures), both of which took effect March 1, 2010, there is a new structure to consider: the foreign-invested partnership (FIP).

The FIP option and its implementing regulations represent the culmination of PRC government efforts over the

past three years to expand the scope of foreign-investment legislation to include partnership entities under the 2006 PRC Partnership Enterprise Law. These developments, though monitored most closely by the private equity and real estate investment community, suggest new investment structure options for a broad range of foreign investors and businesses in China. In fact, the first FIP to be registered under the new regulations, the Jiangsu-based Kunshan Sun City Gardening Center, involves plant nurseries and gardening supplies rather than the fund formation activities that have been widely anticipated by foreign observers.

A closer look at FIPs

The basic contours of a partnership in China are similar to partnership structures in other countries, though China may pass legislation to clarify certain details in the coming years. Broadly speaking, a partnership provides more structural flexibility than equity joint ventures (EJV), cooperative joint ventures (CJV), and other investment vehicles (see p.14). The law provides guidance in five critical areas.

Partnership forms

The Partnership Enterprise Law provides for two basic forms: general partnerships under which all partners undertake unlimited liability for the debts of the partnership; and limited partnerships consisting of at least one general partner and one or more limited partners. Limited partners generally do not participate in the daily management of the entity's affairs and are liable for debts of the partnership only to the extent of their capital contributions to the partnership. Accordingly, limited partnership vehicles may be particularly relevant for forming investment funds, with the fund sponsor assuming the role of general partner and passive financial investors taking interests as limited partners. Certain early renminbi (RMB) fund test cases have made use of the limited partnership option, though others have been set up in the form of a general partnership.

Interestingly, the Partnership Enterprise Law also provides for "special" general partnerships for professional services firms such as law firms and accountancies. Preliminary indications suggest that additional legislative and regulatory developments on professional services partnerships are pending.

Capitalization

Partnerships, including FIPs, are not subject to statutory minimum capitalization requirements. The Partnership Enterprise Law provides for a more liberal scope of recog-

nized capital contributions compared to the more restrictive rules for EJVs, CJVs, and WFOEs. In addition to cash and in-kind contributions, labor services may also be contributed to a partnership, provided that the contributor is not a limited partner. In practice, services are often contributed by one or more partners, particularly in a limited partnership where the general partner manages cash contributions of the limited partners. Partnerships are also exempt from the 70 percent cap on the contribution of non-cash assets applicable to

foreign-invested enterprises (FIEs) and other domestic companies under the PRC Company Law—a key consideration for high-tech start-ups, where intangibles often represent the bulk of a venture's assets.

Finally, unlike the situation for corporate FIEs, the payment of contributions in a partnership is not subject to statutory time limits, which in turn facilitates "just-in-time" deployment of capital contributions. Observers expect this feature to be critical for investment fund partnerships as a means of enhancing the capital efficiency of fund operations and internal rates of return.

Beyond investment funds, the flexible capitalization rules for partnerships may prove useful for small enterprises for which corporate FIE forms can be ill-suited and cumbersome. The first batch of registered FIPs, in March 2010, included not only investment funds and managers, such as the

Fosun-Carlyle (Shanghai) Equity Investment Fund and Softbank-affiliated Shanghai Xinchuang Equity Investment Management Co., but also small and medium-sized non-financial enterprises such as plant nurseries and consultancies.

Flexibility of profit and dividend distribution

In some ways, the FIP structure is more flexible than the JV structure. A key aspect of EJVs is the rigid linkage between capital contributions and profit distribution. Each investor is entitled to a pro rata share of profits strictly in accordance with their pro rata contribution of equity. Foreign investors requiring more flexibility have formed CJVs, which permit the investors, subject to foreign investment approvals, some discretion in adjusting the linkage between capital contributions and profit shares. Though originally used principally for natural resource development projects, the CJV has become increasingly popular in recent years for real estate-related investments. In addition, several onshore venture capital funds set up under the PRC Ministry of Commerce's (MOFCOM) foreign-invested venture capital enterprise (FIVCE) scheme have made use of the non-legal person CJV, given the unavailability of a limited partnership vehicle.

Quick Glance

- China's new investment option—foreign-invested partnerships—generally provides more flexibility than cooperative or equity joint ventures.
- The related Partnership Enterprise Law guides investors on partnership forms, capitalization requirements, profit and dividend distribution, management structure and governance, and tax treatment.
- PRC regulations are unclear about the new structure's approval processes and downstream investment options, however.

Though CJVs have served as a workable solution in some cases, provided that requisite foreign investment approvals are forthcoming, a limited partnership affords investors the ability to structure their interest-sharing relationship without any reference to capitalization. This flexibility is critical to setting up the kind of carried-interest arrangements that are typically the centerpiece of investment-fund structures. It may also come into play for other closely held businesses where value-added strategic relationships play an important role.

A limited partnership affords investors the ability to structure their interest-sharing relationship without any reference to capitalization.

Management structure and governance

All FIPs require the preparation and registration of a partnership agreement that sets out the governance arrangements of the partnership, as well as other key details. Though the Partnership Enterprise Law requires certain specified coverage in a partnership agreement, including governance provisions, the law offers a great deal of flexibility in structuring these provisions. For example, Article 31 enumerates certain matters as subject to unanimous partnership consent but provides for an opt-out under which a partnership agreement may provide for alternative procedures. A similar approach applies to other vital matters such as profit distribution and admission of new partners. At the same time, the Partnership Enterprise Law provides partners with basic oversight and information rights that may not be eligible to be contracted away under the partnership agreement.

Notwithstanding the general flexibility provided under the Partnership Enterprise Law, certain mandatory governance provisions apply to limited partnerships. In particular, limited partners may not act on behalf of the partnership or represent the partnership to third parties, though Article 68 further specifies that this prohibition does not apply to internal management of the partnership. This feature is typical of limited partnership structures in most other jurisdictions and can be viewed as an equitable trade-off for the limited liability enjoyed by such partners. Thus, the limited partnership will likely be viewed as an attractive option for investment management and other businesses combining owner-managers with passive financial investors.

Corporate vehicle FIEs typically are subject to management by a board of directors and certain hard-wired governance features such as unanimous board approval of specified key decisions. Foreign-invested JVs that involve a significant number of parties with board representation thus often have proven unwieldy from a governance perspective. The partnership vehicle promises much more flexibility and may appeal to investment firms in particular.

Pass-through tax treatment

The Partnership Enterprise Law exempts partnerships from income tax at the enterprise level; partnerships are subject to pass-through taxation, whereby each partner is responsible for income tax on its share of the partnership's income instead. Currently, entities with legal person status, such as FIEs that may be established as general partners of an onshore partnership, are subject to a 25 percent enterprise income tax, while individuals are subject to a graduated income tax. Neither the Partnership Enterprise Law nor

the FIP measures address the question of how a foreign limited partner's interest in an FIP is to be taxed in China. Under general tax rules applicable to foreign taxpayers, withholding tax would apply.

The venture capital and private equity community has welcomed the additional clarity provided by the Partnership Enterprise Law on pass-through taxation. In practice, existing onshore venture capital funds established under the FIVCE regime in non-legal person CJV form have in many cases been able to obtain pass-through taxation on a case-by-case basis with special approval. The legal basis and availability of such treatment has been a murky area, however. The PRC State Administration of Taxation and Ministry of Finance will likely issue specific guidance on tax issues associated with FIPs.

Lingering approval process questions...

The FIP measures and the FIP registration procedures provide guidance on the process for establishing an FIP. Under the FIP measures, an FIP must register with the local branch of the State Administration of Industry and Commerce (AIC) but does not need to seek approval from MOFCOM or its local branches. This is a striking departure from the existing FIE regulatory system, under which MOFCOM exercises tight supervision over FIE establishment on a discretionary, case-by-case basis.

But the extent to which the FIP regime will provide a liberalized avenue for foreign investment remains to be seen. Preliminary indications suggest that although foreign investors do not need MOFCOM approval to establish an FIP, they cannot use the FIP vehicle for regulatory arbitrage or to circumvent sector-specific foreign investment restrictions or ownership caps. For example, Article 3 of the FIP registration procedures sets out a blanket restriction on the use of the FIP vehicle for sectors in which Sino-foreign JVs (as opposed to WFOEs) are required, such as the establishment of medical institutions and the distribution of audio-

visual products.

In addition, current regulations are unclear about whether MOFCOM will retain any involvement in the vetting of FIP establishment applications. The FIP measures expressly provide that once an AIC agrees to register an FIP, it shall notify the relevant local branch of MOFCOM with respect to such registration. Therefore, discretionary foreign investment review by local MOFCOM or other regulators may play a role in FIP-based projects. Notably, sources indicate that in process-

invest in “encouraged” and “permitted” categories under the Catalogue Guiding Foreign Investment in Industry through a regulatory filing with a local AIC, rather than through a discretionary foreign-investment approval process.

“Restricted” categories, on the other hand, will continue to require foreign-investment approvals, though a local MOFCOM branch may be authorized to handle an FIP application, thereby avoiding the need for central-level review. Overall, the FIP vehicle will likely not enable significant regulatory arbitrage opportunities for foreign investors.

The extent to which the FIP regime will provide a liberalized avenue for foreign investment remains to be seen.

ing the Carlyle-Fosun general partnership application, Shanghai AIC consulted with the Shanghai Financial Services Offices prior to granting the registration. Similarly, the interface between FIP registration and approvals by the PRC National Development and Reform Commission and its local branches remains unclear, though some analysts expect that this commission will not cede its jurisdiction provided under existing PRC laws and regulations.

...and downstream investment

One of the most widely anticipated aspects of the FIP vehicle involves the potential for “national treatment,” or the ability of FIPs to invest free of restriction from the Catalogue Guiding Foreign Investment in Industry (see p.17), foreign investment approvals generally, and State Administration of Foreign Exchange (SAFE) Circular 142. (Issued in August 2008, the circular aims to slow the inbound flow of portfolio investments by restricting an FIE from re-investing its registered capital into other entities.) In recent years, offshore investment funds have been increasingly disadvantaged in deal-sourcing over home-grown RMB funds. These domestic funds are able to close investments without time-consuming and uncertain foreign investment approvals.

Preliminary indications suggest that regulators may adopt a halfway approach to regulating FIP investments that is similar to current policy on FIVCEs and second-tier FIE investments (such as subsidiaries). FIPs may be permitted to

It is also unlikely that FIPs will be exempted altogether from foreign currency controls implemented under SAFE Circular 142. Though exemptions may be made available in the future for foreign general partners of investment funds to contribute a small percentage of the fund’s initial capital, China is in the process of developing a Qualified Foreign Limited Partner scheme to severely limit inbound portfolio investment by financial investors. For FIPs that are not established as investment funds, the circular likely will continue to apply much as it currently applies to FIEs, since SAFE does not wish to open loopholes under which foreign “hot money” portfolio investment can readily be deployed into onshore targets.

An investment structure to embrace?

The FIP vehicle represents a logical evolution of China’s foreign-investment regime toward more flexible structures based on well-tested foreign legal models. For certain types of investment cooperation, particularly investment funds, investors may be drawn to the FIP, given its flexibility in the areas of capitalization, profit distribution, and governance—as well as its potential tax advantages. 完

Paul McKenzie (pmckenzie@mof.com) is a partner and **Adam Kearney** (akearney@mof.com) is of counsel at Morrison & Foerster LLP’s Beijing office. **Thomas Chou** (tchou@mof.com) is a partner at Morrison & Foerster’s Hong Kong office, and **Charles Coker** (ccoker@mof.com) is an associate at the firm’s Shanghai office.

ABOUT MORRISON & FOERSTER

We are Morrison & Foerster— global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, Fortune 100 companies, investment banks and technology and life science companies. Our clients count on us for innovative and business-minded solutions. Our commitment to serving client needs has resulted in enduring relationships and a record of high achievement. For the last six years, we’ve been included on *The American Lawyer’s* A-List. *Fortune* named us one of the “100 Best Companies to Work For.” We are among the leaders in the profession for our longstanding commitment to pro bono work. Our lawyers share a commitment to achieving results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mof.com. Our iPhone/iPod Touch app is available for free from Apple’s App Store.