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Venture Capital in China and India: Does Business Form Matter?

Lin Lin[*] & *Umakanth Varottil*[**]

ABSTRACT

This Article reevaluates 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 noncharitable 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 Article 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 Article therefore 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 since 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 comprised of 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 Article—is whether any particular business form or organizational structure is the most desirable solution to incentivize venture capitalists and meet the needs of investors.

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

Conventional wisdom indicates that the limited partnership has become ubiquitous as the preferred business form for venture capital funds.[3] It allows venture capitalists to act as general partners (GPs) and engage in the management of the fund, while investors act as limited partners (LPs) with limited interventional capabilities in the control of the fund.[4] 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.[5]

Scholars have lauded the limited partnership as an appropriate vehicle for venture capital funds, referring to it as "venerable"[6] and as "the single most important organizational innovation of the modern venture capital system."[7] The limited partnership structure first became visible in the American venture capital arena in the 1960s,[8] and turned into the dominant organizational form starting in the 1970s,[9] due especially to the legal and tax incentives available to it.[10] Some have called for a widespread application of the United States–style limited partnership by other countries, especially in Europe.[11] 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,

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3. *See* David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 365 (2002).

4. *See id.* at 366.

5. *See* Lin Lin, *Engineering a Venture Capital Market: Lessons from China*, 30 COLUM. J. ASIAN L. 160, 181 (2017) [hereinafter Lin, *Engineering a Venture Capital Market*].

6. Joseph A. McCahery & Erik P.M. Vermeulen, *Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form*, 5 EUR. BUS. ORG. L. REV. 61, 65 (2004).

7. Martin Kenney & Richard Florida, *Venture Capital in Silicon Valley: Fueling New Firm Formation*, in UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION 98, 121 (2000).

8. *See* Rosenberg, *supra* note 3, at 365.

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

10. *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCIAL GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 69 (Michael J. Whincop ed., 2001); Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 469 (1996) (discussing the rise of limited partnerships as the dominant organizational form in venture capital); 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) (explaining that legal forms and contractual mechanisms support incentive alignment); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 489 (1990) (discussing the legal and tax benefits of limited partnerships).

11. *See* McCahery & Vermeulen, *supra* note 6, at 65.

Singapore, New Zealand, Taiwan, Japan, and Switzerland have introduced the limited partnership over the last decade,[12] while others such as the United Kingdom, the British Virgin Islands (BVI), and Australia modified their limited partnership law to meet changing business requirements.[13] This has propelled the limited partnership to be the dominant business form globally.[14]

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.[15] When a trust is used as an investment vehicle,[16] 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) is the active manager.[17] While the trust originated under the Anglo-American tradition, the concept has now been transposed to several civil law jurisdictions as well.[18] 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.[19]

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

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12. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 181.

13. *See id.*; *see also* Lin Lin, *Venture Capital in Singapore: The Way Forward*, 5 J. BUS. L. 363, 377 (2019) [hereinafter Lin, *Venture Capital in Singapore*].

14. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 180–81.

15. *See* John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145, 2149 (2016) (pointing out that trusts have received little attention from scholars); Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31, 31 (2005) [hereinafter Sitkoff, *Trust as "Uncorporation"*] (explaining that the modern trust has been less explored).

16. *See* 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, 170–73 (1997); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 564 (2003) [hereinafter Schwarcz, *Unraveling the Mystery*].

17. *See* Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 633 (2004) [hereinafter Sitkoff, *An Agency Costs Theory of Trust Law*].

18. *See* Steven L. Schwarcz, *Commercial Trusts as Business Organizations: An Invitation to Comparatists*, 13 DUKE J. COMP. INT'L L. 321, 322–23 (2003) [hereinafter Schwarcz, *An Invitation to Comparatists*].

19. *See* John H. Matheson, *Choice of Organizational Form for the Start-Up Business*, 1 MINN. J. BUS. L. & ENTREPRENEURSHIP 7, 11–15, 18 (2002) (discussing the proliferation of limited liability partnerships and limited liability companies in the context of start-up ventures choosing business forms); Callison, *supra* note 2, at 98. However, this paper is confined to an analysis of the limited partnership and the trust.

partnership and help engender a vibrant venture capital market? This Article 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.[20] 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).[21]

Recognizing the importance of limited partnerships to venture capital fundraising, the Chinese legislature introduced the limited partnership under the revised Partnership Enterprise Law (PEL), which became effective on June 1, 2007.[22] The adoption of the limited partnership was part of the government's strategy to develop the venture capital market.[23] Consistent with the benefits of limited partnerships in the United States, 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.[24] LPs are not permitted to "carry out partnership affairs," while GPs have the right to conduct the day-to-day management of the firm.[25] 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.[26] This is in order to assist LPs in demarcating the legitimate scope of their participation in the firm's activities.[27] The limited partnership has since become the most popular business vehicle among newly raised funds in China (see Table 1).[28] 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.[29]

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20. *See* PREQIN INSIGHT: ALTERNATIVE ASSETS IN INDIA, PREQIN 20 (2017), http://docs.preqin.com/reports/Preqin-Insight-Alternative-Assets-in-India-November-2017.pdf [https://perma.cc/5ZTV-QQUT] (archived Feb. 2, 2020) (showing that China is a major market and India is a growing venture market); *see also* Lin, *Venture Capital in Singapore*, *supra* note 13, at 365.

21. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 165, 167.

22. *See id.* at 182.

23. *See id.*

24. *See* Partnership Enterprise Law of the People's Republic of China, (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), ch. I, art. 2.

25. *Id.* at ch. I, art. 2, ch. III, arts. 67–68.

26. Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 182–83.

27. *See* Partnership Enterprise Law art. 68; Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 183.

28. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 175.

29. *See id.* at 184 (Table 5 shows the change of dominant business forms for funds in China over the years).

While the limited partnership has risen in popularity in China, venture capital funds in India are predominantly organized as private noncharitable trusts.[30] These trusts are governed by an age-old legislation in the form of the Indian Trusts Act, 1882,[31] which sets out the default terms governing such private trusts.[32] 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 to 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.[33] These proposals have not received significant attention from the legislature due to the lack of impetus from the industry and practitioners, who have simply enjoyed tremendous comfort with the trust structure over the years.[34] In fact, there is a perceptible resistance against a change in the business form, indicating the influence of path dependence.[35] Unlike in China, where the limited partnership represents a recent

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30. *See* Sai Krishna Bharathan & Ganesh Rao, *Alternative Investment Funds in India: Unlocking Sophisticated Investment*, 3 NAT'L L. SCH. BUS. L. REV. 1, 6 (2017); Abhinav Sharma & Apurva Kanvinde, *Private Equity in India: Market and Regulatory Overview*, THOMSON REUTERS PRACTICAL L., Nov. 1, 2016, WL 85042425; Ashwath Rau, Pallabi Ghosal & Vivaik Sharma, *Investment Funds 2019: India*, CHAMBERS & PARTNERS, https://practiceguides.chambers.com/practice-guides/investment-funds-2019/india (last updated July 15, 2019) [https://perma.cc/BG6R-9CNK] (archived February 2, 2020).

31. *See generally* The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882).

32. 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.

33. *See generally* REPORT OF K.B. CHANDRASEKHAR COMMITTEE ON VENTURE CAPITAL, SEC. & EXCH. BD. OF INDIA (2000) [hereinafter CHANDRASEKHAR COMMITTEE REPORT] (recommending limited partnerships); REPORT SUBMITTED BY ALTERNATIVE INVESTMENT POLICY ADVISORY COMMITTEE, SEC. & EXCH. BD. OF INDIA (2016) [hereinafter AIPAC REPORT – I] (making recommendations regarding limited partnerships in India).

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

35. *See* Callison, *supra* note 2, at 107; Sitkoff, *Trust as "Uncorporation"*, *supra* note 15, at 45–46.

innovation, the trust form has been tried and tested in India.[36] 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 Article 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.[37] 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.[38] 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 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 the 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.[39] In that sense, this Article challenges the

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36. *See* Vishal Gada & Zeel Jambuwala, *Documenting the Trust Framework*, ECON. TIMES (Apr. 23, 2019), https://economictimes.indiatimes.com/familybusinessforum/insights/documenting-the-trust-framework/articleshow/69003942.cms?from=mdr [https://perma.cc/84CT-Y2CR] (archived Feb. 2, 2020).

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

38. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 209.

39. 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 Lin, *Private Equity in Singapore*, *in* HANDBOOK ON FINANCIAL SERVICES LAW AND REGULATION IN SINGAPORE 563 tbl. 1 (Hans Tjio et al. eds., 2018). 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

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 Article 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 of the Article 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 Article seeks to demonstrate. In doing so, it is necessary to clarify that the Article 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 problem 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 displays certain fundamental characteristics, which include the exercise of control over management, the assumption of risk from the venture, and sharing of returns.[40] While this is enough for most business forms, venture capital funds have additional features 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, setting up the business, and exiting from it.[41] Such flexibility offers

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(general partnerships and sole proprietorships) and 35228 companies. *See* Lin, *Venture Capital in Singapore*, *supra* note 13, at 372.

40. *See* Callison, *supra* note 2, at 100.

41. *See* 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 3, at 376.

contractual freedom, which is of utmost importance to parties.[42] Second, the business of early stage portfolio companies is generally sensitive and there is considerable secrecy surrounding venture capital funds and their investors. Hence, venture capital funds flock to business forms that require no disclosures to government agencies or to the public.[43] 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.[44]

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 the trust.[45] However, these entities suffered from disadvantages that discouraged investment. LLCs and JSCs faced double taxation treatment, substantial formation costs, and considerable financial disclosure requirements.[46] General partnerships imposed unlimited liability on all partners and a similarly harsh tax burden on partners until the year 2000.[47]

The trust-type fund began to emerge in China in 2007, following the enactment of the first Trust Law in 2001.[48] In a typical trust-type

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42. *See* Conaway, *supra* note 41, at 790; *see also* Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17, at 638.

43. *See* Jonathan Axelrad, *Venture Capital's Need for Secrecy Collides with Public's Right to Know*, N.Y. TIMES (Apr. 2, 2014), https://dealbook.nytimes.com/2014/04/02/venture-capitals-need-for-secrecy-collides-with-publics-right-to-know/ [https://perma.cc/Q2EL-PGA5] (archived Feb. 11, 2020).

44. *See* Conaway, *supra* note 41, 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. *See* Hansmann & Mattei, *supra* note 16, at 478; Langbein, *supra* note 16, at 181. Taxation has also been considered an "exogenous effect" to business. Schwarcz, *Unraveling the Mystery*, *supra* note 16, at 580.

45. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 183. There are also contractual-type funds in China but they are rarely used by venture capital funds. *See id.* at 211-12.

46. *See id.*

47. *See id.* at 183–84 (explaining that, "[b]efore 2000, the PRC partnership enterprise was subject to taxation both at the enterprise level and upon distribution," until 2000, when the partnership enterprise became tax transparent).

48. *See generally* Rules Governing Trust Companies (promulgated by the China Banking Regulatory Commission, 2008); Trust Law of the People's Republic of China

fund, the trust company acts as the trustee of a fund and is responsible for fundraising and investments. The capital is pooled from investors by means of a trust plan. The trust company either employs a professional investment company (normally a private equity firm or an investment bank) as the investment consultant of the fund or conducts 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,[49] trusts have not been a popular business form for fundraising in China (see Table 1), due to the complex structure, insufficient protection available to investors,[50] as well as the lack of a registration regime.[51]

(promulgated by the President of the People's Republic of China, April 28, 2001). Before the enactment of these laws, trust companies were not allowed to invest in the private equity sector directly. Securities companies, trust companies or individuals in China can establish "the non-limitative aggregate asset management plan," Trial Implementation Measures for the Customer Asset Management Business of Securities Companies (promulgated by China Securities Regulatory Commission, Dec. 18, 2003, effective Feb. 1, 2004), or "the trus[t] plan of assembled funds," Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds (promulgated by China Banking Regulatory Commission, Jan. 23, 2007, effective Mar. 1, 2007), to engage in private equity investments. Under such trust plans, securities companies or trust companies enter into investment management contracts with individual investors. *See generally* Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds; Trial Implementation Measures for the Customer Asset Management Business of Securities Companies. 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. *See generally* Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds; Trial Implementation Measures for the Customer Asset Management Business of Securities Companies.

49. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 183. *See generally* DELOITTE, NEW BELGIUM-CHINA INCOME TAX TREATY APPLICABLE AS OF 1 JANUARY 2014 2 (2014).

50. 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.

51. Article 27 of the Trustee Company Management Guideline 2007 (CBRC 2007 No. 2) provides that the "trustee company has the duty toward 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

The very first Chinese Limited Partnership (*Nanhai Chengzhang Chuangye Touzi Hehuo Qiye*)[52] was set up on June 27, 2007, soon after the enactment of the revised PEL on June 1, 2007.[53] By the following year, more than half of the newly raised venture capital funds were organized as limited partnerships.[54] 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 toward 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.[55] 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.[56] 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.[57] Moreover, as compared to companies, partnerships enjoy lower formality costs and a greater degree of confidentiality in their financial information, which is advantageous to investors who do not wish to disclose their investment in the funds.[58] 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.[59]

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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.

52. *The First Venture Capital Limited Partnership was Established*, SHANGHAI SEC. NEWS (June 29, 2007).

53. CHINA ZHENGQUAN BAO (中国证券报) [CHINA SECURITIES DAILY] (June 29, 2007), HTTP://MONEY.BUSINESS.SOHU.COM/20070629/N250829110.SHTML.

54. CHINA VENTURE CAPITAL YEARBOOK 2009 252 (2009).

55. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 182 (pointing out that China recognized the importance of additional vehicles as a result of the importance of limited partnerships to venture capital).

56. *See id.* at 181.

57. *See* McCahery & Vermeulen, *supra* note 6, at 62–63.

58. *See* LAW COMMISSION & SCOTTISH LAW COMMISSION, LIMITED PARTNERSHIPS ACT 1907: A JOINT CONSULTATION PAPER, at 3.

59. *See* CHINA VENTURE CAPITAL YEARBOOK 2009, *supra* note 54, at 252.

Third, partnerships enjoy tax transparency at the entity level in China.[60] There are also a number of preferential tax policies for LPs and GPs at the local level.[61] For example, in Tianjin, a considerably low 20 percent individual income tax rate is applicable to GPs and LPs who are natural persons, and a 100 percent subsidy is granted for any tax above this 20 percent threshold.[62]

As of now, the limited partnership has become the dominant business form in China's venture capital market.[63] A typical Chinese fund has a fixed life and is organized as a limited partnership, wherein a venture capital firm raises and manages capital.[64] 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.[65] 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.[66] Investors serve as LPs and provide capital to the fund (Figure 1).[67] Most Chinese firms follow the internationally recognized two-and-twenty compensation structure for GPs, wherein GPs receive an annual management fee (2 percent of the committed capital) and carried interest (20 percent of the annual profits of the fund).[68] Furthermore, to align the interests of the GP and LPs, most of the Chinese firms would also require the GP to make a capital contribution to the fund.[69]

60. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 183.

61. *See id.* at 207–08.

62. *See id.* at 179.

63. *See id.* at 182.

64. *See id.* at 203 (discussing the typical structure of a Chinese venture capital fund).

65. *See id.* at 182, 201.

66. *See id.* at 182.

67. *See generally* Lin Lin, *Private Equity Limited Partnerships in China: A Critical Evaluation of Active Limited Partners*, 13 J. CORP. L. STUD. 185 (2013) [hereinafter Lin, *Private Equity Limited Partnerships in China*] (explaining the structure of PRC limited partnership in the context of China's private equity and venture capital market).

68. *See* Lin, *Engineering a Venture Capital Market*, *supra* note 5, at 196–97 (discussing variations in the Chinese compensation form).

69. Telephone Interview with Mr. Xu, Fund Manager, Shanghai Private Equity Fund (Aug. 29, 2019); Telephone Interview with Ms. Shao, Legal Counsel, Gaorong Capital (Aug. 29, 2019).

Figure 1. A Typical Chinese Venture Capital Limited Partnership

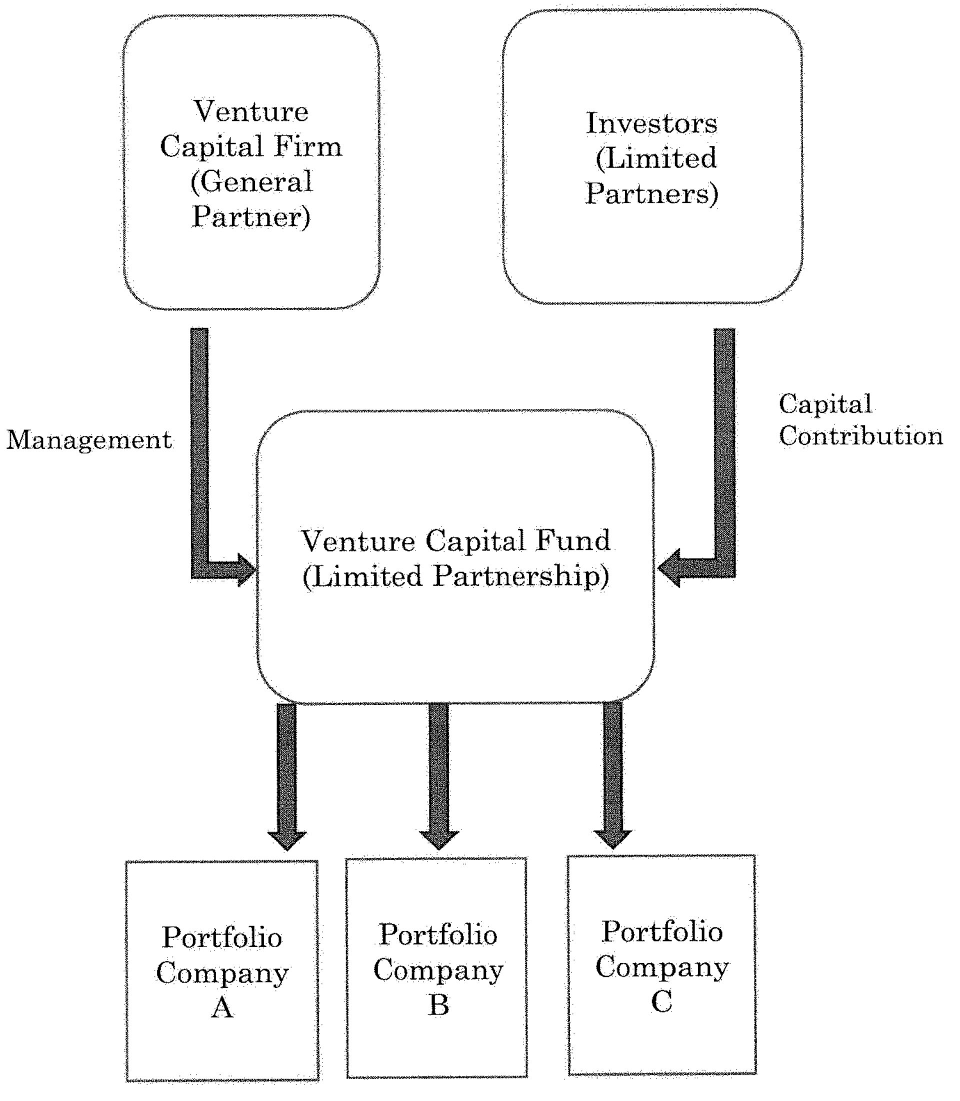

Table 1. Proportion of Different Types of Business Forms Used for Newly Raised Private Equity and Venture Capital Funds in China[70]

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 forms available for venture capital funds, the introduction of the limited partnership altered the scenario in China in such a way that the other forms, including the trust, effectively faded away within a rather short span of time.

B. *India: The Stickiness of the Trust*

Venture capital emerged as an investment form in India in the 1980s.[71] It received considerable impetus from the government.[72] 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.[73] It was only in 1996 that the industry began to be specifically regulated when India's securities

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70. *See generally* 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. *See id.* The 2017 figure was collected from ZERO2IPO, 2017 CHINA EQUITY INVESTMENT – FUND RAISING STRATEGIES RESEARCH REPORT, https://m.pedaily.cn/news/431823 (last visited Apr. 19, 2020) [https://perma.cc/U7SE-N6PJ] (archived Feb. 2, 2020).

71. *See* Manuel Gonzalo & Hugo Kantis, *Venture Capital in India: A Critical View from an Evolutionary and Systemic Perspective* 2 (Oct. 2017), http://liee.ntua.gr/wp-content/uploads/2018/02/532-Venture-capital-in-India-.pdf [https://perma.cc/Q97X-2WPG] (Feb. 2, 2020).

72. *See* Rafiq Dossani & Martin Kenney, *Creating an Environment: Developing Venture Capital in India* 8 (Berkeley Roundtable on the Int'l Econ., Working Paper No. 143, 2002). 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. *See id.* at 24–25. This too propelled the Indian venture capital sector. *See id.*

73. *See* Bijal Ajinkya & Shefali Goradia, *Venture Capitalism*, 8 ASIA-PAC. TAX BULL. 378, 379 (Dec. 2002).

regulator, the Securities and Exchange Board of India (SEBI), promulgated a set of regulations governing the sector.[74] Although registration was not mandatory under SEBI's regulations, the onerous nature of the legal regime imposed constraints on the sector.[75] 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 (AIF Regulations) which apply to several types of funds.[76] Apart from venture capital, the AIF Regulations also apply to private equity, hedge funds, and several others.[77] Unlike the 1996 regulations, the AIF Regulations require mandatory registration of alternative investment funds (AIFs) with SEBI.[78]

The AIF Regulations impose several conditions and restrictions on the ability of AIFs to carry out their investment activities.[79] In doing so, the AIF Regulations trifurcate AIFs into different categories.[80] Category I AIFs invest in start-up or early-stage ventures or in areas the government considers economically desirable.[81] Venture capital funds fall within this category. Category II AIFs are the residual category of funds that do not undertake leverage or borrowing.[82] Private equity, real estate, debt, and distressed asset funds populate this category. Finally, Category III funds employ diverse or complex trading strategies and may engage in leverage.[83] These include hedge funds.[84] 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.[85]

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74. *See id. See also generally* Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996.

75. *See* Rohan Chinchwadkar & Vidhu Shekhar, *Evolution of Private Equity Regulations in Emerging Markets: A Case of India*, 20 J. PRIV. EQUITY 38, 40 (2016).

76. *See id.*

77. *See id.* (explaining that the new regime is an umbrella regulatory framework to manage the alternative investments industry).

78. *See* Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, ch. II sec 3(1).

79. The precise nature and scope of these conditions and restrictions are beyond the scope of this paper. For further details, *see generally* Bharathan & Rao, *supra* note 30; Rau, Ghosal & Sharma, *supra* note 30.

80. *See* Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, ch. II sec 3(4).

81. *See* Bharathan & Rao, *supra* note 30, at 7; Rau, Ghosal & Sharma, *supra* note 30.

82. *See* Bharathan & Rao, *supra* note 30, at 7; Rau, Ghosal & Sharma, *supra* note 30.

83. *See* Bharathan & Rao, *supra* note 30, at 7; Rau, Ghosal & Sharma, *supra* note 30.

84. *See* Bharathan & Rao, *supra* note 30, at 7; Rau, Ghosal & Sharma, *supra* note 30.

85. *See* Bharathan & Rao, *supra* note 30, at 7; Rau, Ghosal & Sharma, *supra* note 30.

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, thirteen are LLPs, and only three are companies.[86] In other words, 97.3 percent of registered AIFs operate in the form of trusts. Although SEBI does not list out the categories of AIFs, its annual report for 2018 shows that there were 196 registered venture capital funds.[87]

Why is there an overwhelming slant toward the trust as a business form? *First*, the trust structure provides considerable flexibility to the parties in organizing their relationship.[88] Parties are free to contractually provide for the terms and conditions, including their respective obligations.[89] 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.[90] 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 require 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.[91] 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.[92] *Finally*, among the various business

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86. *See Registered Alternative Investment Funds*, SEC. & EXCH. BD. OF INDIA, https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16, (last visited Jan. 30, 2020) [https://perma.cc/AU9V-PMYE] (archived Jan. 30, 2020). 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 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.

87. *See* SEC. & EXCH. BD. OF INDIA, ANNUAL REPORT 2017–18, 85 (2018).

88. *See* Hans Tjio, *Lending to a Trust*, 19 TR. L. INT'L 3, 4 (2005).

89. *See id.*

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

91. Lawyers we interviewed confirmed this approach.

92. *See id.*

forms, the trust has received the most beneficial treatment regarding its tax pass-through status.[93]

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).[94] In most cases, the trusteeship duties are discharged by professional third-party trustees, who undertake these roles for various funds.[95] 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.[96] A contribution agreement between the investors, the trustee, and the investment manager will capture the commercial terms of the investment in the venture capital fund.[97]

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93. Although historically trusts have been favored, 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. *See* Income Tax Act, § 115UB (1961) (India), https://www.hostbooks.com/in/income-tax-act-1961/section-115ub-tax-income-investment-fund-unit-holders/ (last visited Jan. 31, 2020) [https://perma.cc/6MQW-5RKF] (archived Jan. 31, 2020); *see also* CHANDRASEKHAR COMMITTEE REPORT, *supra* note 33, at 21 (for the tenuous relationship between business form and taxation).

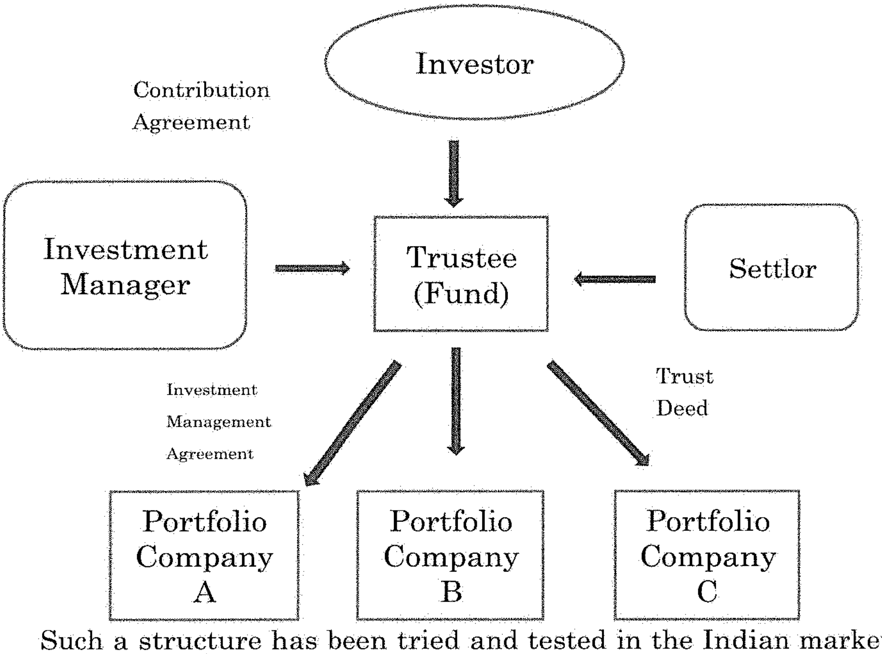
94. While the trust requires a settlor, her role is minimal and limited to the establishment of the trust with a nominal corpus.

95. For examples of the prominent professional trustees in this space in India, *see Amicorp Trustees (India)*, AMICORP GRP., https://www.amicorp.com/offices/mumbai-trustees (last visited Apr. 19, 2020) [https://perma.cc/6BP7-LBTF] (archived Jan. 31, 2020); BEACON TRUSTEESHIP, http://beacontrustee.co.in (last visited Apr. 19, 2020) [https://perma.cc/7E7W-Z2PW] (archived Jan. 31, 2020); IDBI TRUSTEESHIP SERVICES LTD., http://idbitrustee.com/ [https://perma.cc/WY9S-RKG6] (archived Jan. 31, 2020); VISTRA ITCL LTD., https://www.vistraitcl.com (last visited Apr. 19, 2020) [https://perma.cc/WN5Y-SEDM] (archived Jan. 31, 2020).

96. *See* Bharathan & Rao, *supra* note 30, at 11.

97. *See id.*

Figure 2. A Typical Indian Venture Capital Trust



Such a structure has been tried and tested in the Indian market and has effectively become cookie cutter, as the market players and their advisors are entirely familiar and comfortable with the establishment and operation of such a trust arrangement.[98] 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. The lawyers not only explain the successful track record of the trust structure in India but also its flexibility and adaptability in terms of replicating the principal features of a limited partnership, namely passive ownership and active management.[99]

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.[100] Thereafter, LLPs were

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98. Conversations with practitioners confirmed this position.

99. *See id.*

100. *See* CHANDRASEKHAR COMMITTEE REPORT, *supra* note 33, 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. *See Report of Advisory Committee on Venture Capital*, SEC. & EXCH. BD. OF INDIA 10 (2003), https://www.sebi.gov.in/reports/reports/oct-2003/report-of-advisory-

introduced by way of the Limited Liability Partnership Act, 2008.[101] 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.[102] Hence, the 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.[103] Over a two-year period ending January 2018, the AIPAC issued three reports, totaling 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 remained the key investment vehicle for a long period of time. 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 favor 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.

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committee-on-venture-capital_12778.html [https://perma.cc/GJ9T-VEVD] (archived Jan. 31, 2020).

101. *See generally* The Limited Liability Partnership Act, 2008, No. 6, Acts of Parliament, 2009 (India).

102. *See* AIPAC REPORT – I, *supra* note 33, at 86.

103. *See id.*

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.[104] In contrast to the United States, which considers the partnership as a separate legal entity, English law treats the partnership as an aggregate of its partners.[105] As a result, English partnerships do not have a legal personality separate from its partners. Many commonwealth jurisdictions, including Singapore[106] and Hong Kong,[107] follow the English approach.

The aggregate approach means that the English limited partnership cannot have perpetual succession. Nor can it hold property or enter into contracts in its own name.[108] Whenever a partner retires or a new partner is admitted, the limited partnership would cease to exist and a new limited partnership would be created. Third parties who deal with a limited partnership over time would then have unknowingly transacted with several different partnerships.[109] This characterization of the limited partnership is unfortunately inconsistent with commercial perception of the limited partnership as a separate legal 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.[110] It would also provide a more elegant solution to the various practical problems currently faced

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

105. *See* T. Prime & G. Scanlan, *Limited Partnership Reform — The Entity, The Fiduciary Duties and The Execution of Deeds*, COMP. L. 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. *See id.* at 403.

106. *See* Lin, *Venture Capital in Singapore*, *supra* note 13, at 377 ("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.").

107. *See* LEXIS PRACTICE ADVISOR, LIMITED PARTNERSHIPS—OVERVIEW, Lexis (database updated Oct. 12, 2019).

108. *See* Partnership Act 1890, 53 & 54 Vict. c. 39, §2 (U.K.).

109. *See* LAW COMM'N & THE SCOTTISH LAW COMM'N, PARTNERSHIP LAW: REPORT ON A REFERENCE UNDER SECTION 3(1)(E) OF THE LAW COMMISSIONS ACT 1965 § 5.8 (2003). 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.

110. *See* 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).

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.[111] 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.[112]

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, civil conduct, enjoys civil rights, and assumes civil obligations independently in accordance with the law.[113] A legal person shall have its own name, organs, domicile, and property or funding.[114] Partnership enterprises are considered non-legal-person organizations (*fei fa ren zu zhi*), which refer to the organizations without legal personality but with the capacity to conduct civil actions in their own names.[115] 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."[116]

Comparing China and India, it would appear at the outset that they represent diametrically opposing positions. While the limited partnership in China possesses certain attributes that are consistent with the entity approach, the trust in India does not have any. However, as this Article 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 a separate legal personality.

To begin with, a trust is an obligation, and the trustee has legal ownership of the trust property.[117] Under Indian trust law, the

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111. *See id.*

112. *See* Michael Killourhy, *BVI Limited Partnerships Act 2017*, OGIER (Feb. 12, 2018), https://www.ogier.com/publications/bvi-limited-partnership-act-2017 [https://perma.cc/CX66-85YL] (archived Jan. 31, 2020).

113. General Rules of the Civil Law of the People's Republic of China (promulgated by the Nat'l People's Cong., Mar. 15, 2017, effective Oct. 1, 2017), art. 57.

114. *See id.* at art. 58.

115. *See id.* at art. 102.

116. *See* Lin Lin & Hwee Ying Yeo, *Limited Partnership—New Business Vehicle in People's Republic of China*, 25 BUTTERWORTH'S J. INT'L BANKING & FIN. L. 104, 104 (2010).

117. *See* The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882), § 3 (defining a trust as "an obligation annexed to the ownership of property, and arising out of a

beneficiaries have no interest, whether legal or equitable, in the trust property.[118] 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.[119]

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.[120]

The trustee bears the obligation of protecting title to the trust property[121] and is expected to maintain the trust funds separate from the trustee's own funds.[122] Professor John Langbein notes: "This segregation regime separates the trustee's trust property from nontrust property without having to lodge ownership of the trust property in a distinct entity endowed with juridical personality, such as a corporation."[123] Thus, even though the trust is not a separate legal personality, the segregation of assets introduces entity-like features.[124] Professors Henry Hansmann and Ugo 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.[125]

Moreover, trustees are not personally liable to the trust's creditors unless they have provided a guarantee.[126] The limited liability of the

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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"). The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882).

118. *See* H.C. JOHARI, MUKHERJEE'S COMMENTARY ON INDIAN TRUSTS ACT, 1882, 94 (1999).

119. *Id.* (emphasis in original).

120. Corporate property is owned by the company, over which shareholders have no proprietary rights (neither legal nor beneficial). *See* GOWER: PRINCIPLES OF MODERN COMPANY LAW 35–36 (Paul Davies & Sarah Worthington eds., 10th ed. 2016).

121. *See* Indian Trusts Act, 1882, §13.

122. *See* DHARAM PAL NIGAM, N. SURYANARAYANA IYER'S THE INDIAN TRUSTS ACT, 1882, at 166 (1997).

123. Langbein, *supra* note 16, at 180.

124. *See* Morley, *supra* note 15, at 2154 (stating that "[t]o 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.") (alteration in original); Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17, at 641.

125. *See* Hansmann & Mattei, *supra* note 16, at 438; *see also* Schwarcz, *An Invitation to Comparatists*, *supra* note 18, at 325 (observing that "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") (internal footnotes omitted).

126. *See* Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17, at 641.

beneficiaries would ensure that they are not personally liable for liabilities incurred by the trust.[127] 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.[128] These features effectively ensure that the trust itself, although not a separate legal personality, is distinct from the trustee, the beneficiaries, and the settlor.[129]

The idea propagated by some scholars[130] that the trust is an entity or that it has *de facto* legal personality has come under attack.[131] One critic argues that while trusts carry some characteristics of asset partitioning, "they are porous when compared to the corporation."[132] While this theoretical debate continues, this Article 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 the corporation, while this Article 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 United Kingdom and Singapore) and a limited partnership with entity features (as found in the United States and China), the trust is likely to be closer, but not identical, to the position in the United States 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 is 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 similarities 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.

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127. *See* Hansmann & Mattei, *supra* note 16, at 462. The aspect of limited liability of the beneficiaries is discussed in greater detail later. *See infra* Part IV.

128. *See* Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17, at 646–47.

129. *See* Hansmann & Mattei, *supra* note 16, at 470.

130. *See generally* Hansmann & Mattei, *supra* note 16; Langbein, *supra* note 16; Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17.

131. *See, e.g.*, M.W. LAU, THE ECONOMIC STRUCTURE OF TRUSTS 61–79 (2011); *see also* Tjio, *supra* note 88, at 5 (noting that the UK does not treat the trust as a separate legal entity).

132. LAU, *supra* note 131, at 79.

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 the management and hence are conferred the benefit of limited liability.[133] 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 (limited partners) and some of whose owners have no liability shield (general partners)"[134] and that "[n]o other business form provides this dual-track liability construct."[135]

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.[136] 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,[137] shareholders possess more intervention rights than LPs.[138] For example, shareholders may intervene on key matters involving a company that are allocated to shareholder decision-making.[139] Shareholders may elect or remove directors and thereby indirectly influence the management of the company through their control over the composition of the board.[140] Shareholders may also elect themselves as directors.[141] However, LPs cannot carry out such actions in a limited partnership without potentially losing their limited liability shield.[142] To mitigate the harshness of this situation, several jurisdictions have introduced safe harbor provisions in limited partnership statutes whereby certain specified acts of shareholders would not be considered acts of management, and hence would not

133. *See* Ribstein, *Limited Partnerships Revisited*, *supra* note 2, at 974–75.

134. 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, 667 (2004).

135. *Id.* at 674.

136. Lin, *Private Equity Investor Protection: Conceptualizing the Duties of General Partners in China*, 15 BERKELEY BUS. L.J. 43, 52 (2018) [hereinafter Lin, *Private Equity Investor Protection*]; *see also* Christopher Morris, *The Private Fund Limited Partnership: The Reform Company Lawyers Have Been Waiting For?*, 38 COMP. L. 192, 192–93 (2017).

137. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 66 (1933).

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

139. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 52.

140. *See id.*

141. *See* Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, *supra* note 37, at 320.

142. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 52.

attract liability.[143] The Uniform Limited Partnership Act of 2001[144] in the United States has gone even further by eliminating the control rule.[145]

The control rule still exists in many jurisdictions, such as Delaware, [146] New Zealand, [147] Singapore, [148] and the United Kingdom.[149] 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.[150] 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.[151] Article 68 of the PEL provides that:

> [A] limited partner shall neither execute the partnership affairs, nor represent the limited partnership outside. The following acts of a limited partner shall not be deemed as executing the partnership affairs:
>
> (1) participating in making a decision on the admission or withdraw of a common partner; (2) bringing forward a proposal on the business management of the enterprise; (3) participating in selecting an accounting firm to cope with the audit business of the limited partnership enterprise; (4) obtaining a financial report of the limited partnership enterprise upon audit; (5) consulting the account books of the limited partnership enterprise and other financial materials which concern the limited partner's own interests; (6) filing claims or lodging a lawsuit against the liable partner(s) when this limited partner's interests in the limited partnership enterprise are impaired; (7) When the partner responsible for executing the partnership affairs fails to exercise his right, to urge them to exercise their rights or initiate a lawsuit for protecting the interests of the enterprise; and (8) offering a guarantee for this enterprise according to law.[152]

This provision is arguably defective as it does not define what

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143. *See* Deborah A. DeMott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, 58 LAW & CONTEMP. PROBS. 109, 115 (1995); McCahery & Vermeulen, *supra* note 6, at 79.

144. *See generally* Uniform Limited Partnership Act (ULPA) (2001).

145. *See* Uniform Limited Partnership Act (ULPA) (2001) (last amended 2013): A Summary, Uniform Law Comm'n 2, https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=ba658bd6-ac05-be85-fc99-178fd09f21da&forceDialog=0 (last visited Mar. 28, 2020) [https://perma.cc/6F3W-RDBZ] (archived Feb. 3, 2020).

146. *See* DEL. CODE tit. 6, §17-303 (2017), https://law.justia.com/codes/delaware/2017/title-6/chapter-17/subchapter-iii/section-17-303/ (last visited Feb. 1, 2020) [https://perma.cc/K7DM-2V8U] (archived Feb. 1, 2020).

147. *See* Limited Partnerships Act 2008, § 30 (N.Z.).

148. *See* Limited Partnerships Act 2008, § 6 (Sing.).

149. *See* Limited Partnerships Act 1907, § 4(2) (U.K.).

150. *See* Lin, *Private Equity Limited Partnerships in China*, *supra* note 67, at 201.

151. *See id.*

152. Partnership Enterprise Law of the People's Republic of China, (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), ch. I, art. 68.

constitutes "carrying out the partnership affairs" and it is unclear whether this list of activities is exhaustive.[153] 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.[154] Even in the US state of Delaware, where there is a lengthy safe harbor 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.[155] Moreover, the test for finding a LP liable for breaching the control rule has been evolving and varies from country to country.[156]

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.[157] 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.[158] 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.

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, or (d) deceives and induces the trustee to commit a breach of trust.[159] 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.[160]

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 the trust, which adds to the

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153. 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*, 6 POL. & L. (2007)]; *id.* at 101.

154. 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, *Private Equity Limited Partnerships in China*, *supra* note 67, at 193–94.

155. *See id.* at 204.

156. *See id.*

157. *See, e.g.*, Robert D. M. Flannigan, *Beneficiary Liability in Business Trusts*, 6 EST. & TR. Q. 278, 279 (1984); Hansmann & Mattei, *supra* note 16, at 463; Tjio, *Lending to a Trust*, *supra* note 88, at 9–10.

158. *See* Morley, *supra* note 15, at 2174.

159. *See* The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882), § 68.

160. *See* NIGAM, *supra* note 122, at 166.

attractiveness of that business form.[161] 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.[162]

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.[163] 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.[164] *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.[165] 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." [166] Moreover, partnership status is determined by the contract between the parties, [167] taking into account all relevant facts. [168] Given that a 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

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161. *See* Rau, Ghosal & Sharma, *supra* note 30, at § 1.5.

162. *Id.*

163. 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* P.W.L., *Liability of Shareholders in a Business Trust–The Control Test*, 48 VA. L. REV. 1105, 1108–09 (1962); Flannigan, *supra* note 157 , at 284.

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

165. The authors thank Kelry Loi for highlighting this possibility. *See also* Flannigan, *supra* note 157, at 286 ("The existence of control rights in the trust agreement is said to effectively create a partnership relationship among the beneficiaries (with the trustees as their agents) and thereafter liability follows for all beneficiaries.").

166. The Partnership Act, No. 9 of 1932, INDIA CODE (1932), § 4.

167. *See id.* at § 5.

168. *See id.* at § 6 (highlighting some safe harbor situations which will not lead to the formation of a partnership).

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.[169] Under Indian law, "[a]n 'agent' is a person employed to do any act for another, or to represent another in dealings with third persons."[170] In such a scenario, the beneficiary as principal will be subject to liabilities undertaken by the trustee as the agent.[171] 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.[172]

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.[173] This issue first arose after the elimination of the control rule by the Uniform Limited Partnership Act of 2001 in the United States, where commentators have cautioned of the possibility that LPs could nevertheless be liable through estoppel.[174] 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

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169. *See* Flannigan, *supra* note 157, at 279–81.

170. The Indian Contract Act, INDIA CODE (1872), §182.

171. *See id.* at §226 (stating that, "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.").

172. For the US position, *see* Hansmann & Mattei, *supra* note 16, at 474.

173. *See* Bishop, *supra* note 134, at 667–68.

174. *See id.*

the Chinese limited partnership does this by providing limited liability to all 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 recognized 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.[175] This is exacerbated by the information asymmetry problems associated with venture capital funds, which result in investors being less able to monitor managers.[176] In addition, venture capital investments lack liquidity, precluding investors from easily exiting their investments.[177] 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.[178]

The venture capital fund structure could also lead to shirking and rent-seeking behavior among managers.[179] 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.[180] Crucially, venture capital funds may suffer from conflicts of interest that are distinct to the industry.[181] For example, fund managers may coinvest with the fund by cherry picking lucrative investments;[182] they

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

176. *See* Sahlman, *supra* note 10, at 493; *see also* AIPAC REPORT – I, *supra* note 33, at 23, 24, 30.

177. *See* Gompers & Lerner, *supra* note 10, at 476–77 ("No liquid market for partnership interests exists, and limited partners are frequently restricted from selling their partnership interests.").

178. *See* Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 72–73 (2006).

179. *See generally* Haitian Lu, Yi Tan & Hong Huang, *Why Do Venture Capital Firms Exist: An Institution-Based Rent-Seeking Perspective and Chinese Evidence*, 30 ASIA PAC. J. MGMT. 921 (2013) (explaining the rent-seeking perspective of venture capitalists).

180. *See* Klausner & Litvak, *supra* note 10, at 62; Gulinello, *supra* note 37, at 341–42.

181. *See* Gulinello, *supra* note 37, at 341–42.

182. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 62.

may seek to exit prematurely from funds to prove their track record, thereby generating less than optimal returns for their investors;[183] they may raise new funds even before the tenure of an existing fund;[184] or they may misappropriate or convert fund assets for personal interests.[185]

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).[186] This effectively shields the individuals behind the manager from personal liability.[187] Through this hybrid structure, venture capital entrepreneurs enjoy the dual advantages of exercising complete control over management and simultaneously overcoming liability issues by interspersing the company as a liability backstop.[188] 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).[189] 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).[190]

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.[191] 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

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183. *See* 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 10, at 69–70.

184. *See* Klausner & Litvak, *supra* note 10, at 69.

185. *See* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 936 (2004) [hereinafter Ribstein, *Fiduciary Duties*].

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

187. *See id.*

188. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 63.

189. *See* Lin & Yeo, *supra* note 116, at 105–06.

190. *See id.*

191. *See* Hamilton, *supra* note 186, at 107. To see how this approach has already been legislated in Singapore for one type of business form, *see* Business Trusts Act 2004, c. 31A, §10(2)(a) (Sing.).

fund.[192] 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.[193] Parties in the venture capital industry rely on implicit contracts and reputational incentives more than they do specific legal contracts or enforceable duties.[194] The staged contribution structure permits investors to walk away from unsuccessful ventures.[195] 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.[196] 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."[197] While this may hold true, at least partially, in the more developed markets for venture capital financing such as the United States, 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.[198]

In this context, the remainder of this Part will critically analyze 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.

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192. This too has received statutory recognition in Singapore, see Business Trusts Act 2004, c. 31A, §11(1)(b) (Sing.).

193. *See, e.g.*, Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 772 (2004); McCahery & Vermeulen, *supra* note 6, at 82; Gregory G. Oehler, *The Wider Implications of Implicit Contracts in Venture Capital Partnerships*, 1 N.Y.U. J.L. & BUS. 489, 490 (2005).

194. *See* McCahery & Vermeulen, *supra* note 6, at 82; Gregory G. Oehler, *The Wider Implications of Implicit Contracts in Venture Capital Partnerships*, 1 N.Y.U. J.L. & BUS. 489, 490 (2005).

195. *See* David Rosenberg, *The Two Cycles of Venture Capital*, 28 J. CORP. L. 419, 420–21 (2003) (providing explanations for the absence of litigation in the venture capital industry).

196. *Id.* at 421.

197. Rosenberg, *supra* note 3, at 366.

198. For a detailed discussion of the reasons in the context of China, *see* Lin, *Private Equity Limited Partnerships in China*, *supra* note 67, at 213–14.

A. *Duties of Managers toward 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.[199] 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:

> The partners should not engage in activities which may harm the interests of the partnership.
>
> The general partners should not carry out any business competing with that of the partnership solely or cooperatively.
>
> The partners should not engage in any self-dealing business with the partnership.
>
> 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.
>
> 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.
>
> The managing partner (*zhixing shiwu hehuoren*) should regularly report to the other partners on the process of partnership activities as well as the business and financial status of the partnership.[200]

Although these limited duties fail "to clearly and adequately stipulate the partners' statutory duties,"[201]

> [a]rguably, 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 [United States].[202]

In addition, the China Securities Regulatory Commission (CSRC) has also issued the Interim Measures for the Supervision and

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199. Lin, *Private Equity Investor Protection*, *supra* note 136, at 43. For the fiduciary principles in China, *see* Nicholas C. Howson, *Fiduciary Principles in Chinese Law*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 603–22 (Evan J. Criddle et al. eds., 2019).

200. Lin, *Private Equity Investor Protection*, *supra* note 136, at 75.

201. *Id.* at 47.

202. *Id.* at 76.

Administration of Privately Raised Investment Funds 2014 (2014 CSRC Interim Measures)[203] to supplement the PEL with a list of scenarios which are similar to the duty of loyalty.[204] 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." [205] However, as "the CSRC Interim Measures is an interim measure, the effectiveness of the measures is undermined."[206] Also, the CSRC Interim Measures are promulgated by the CSRC, which is a department under the State Council.[207] 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.[208] 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.[209]

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.[210] These include fiduciary duties to act in the

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203. 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 *CSRC 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. REGULATORY COMM'N, http://www.csrc.gov.cn/tianjin/xxfw/scyw/201606/t20160608_298472.htm (China) [hereinafter *Private Investment Fundraising Behavior Management Approach*] [https://perma.cc/TCU3-CFSD] (archived Feb. 2, 2020).

204. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 85.

205. CSRC Interim Measures, *supra* note 203, at art. 23.

206. Lin, *Private Equity Investor Protection*, *supra* note 136, at 78,

207. *See* *About CSRC*, CHINA SEC. REGULATORY COMM'N, http://www.csrc.gov.cn/pub/csrc_en/about/ (last visited Apr. 19, 2020) [https://perma.cc/TDC4-VEQW] (archived Feb. 2, 2020).

208. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 70.

209. *Id.* at 78.

210. *See* The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882), §§ 11–30.

interest of the beneficiaries and to avoid conflicts of interest,[211] as well as the duty of care.[212] The fiduciary nature of the trusteeship position imposes onerous obligations on the trustee to act in the interest of the investors.[213]

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.[214] The law governing fiduciary duties tends to be prophylactic in nature[215] and "the functional core of the fiduciary obligation is deterrence."[216] For example, trustees may be held liable for a self-dealing transaction even if it is shown to be fair,[217] and they cannot derive the benefit of a business judgment rule available in several jurisdictions under corporate law.[218] 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.[219]

However, the law in the books seems to be somewhat at odds with the market practice on the ground. As seen earlier,[220] the venture capital industry in India is replete with fixed-fee-earning third party trustees whose incentives may not necessarily be aligned with those of the investors. These institutional trustees in turn delegate their responsibilities to the investment manager under the investment management agreement.[221] 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

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211. *See, e.g.*, *id.* at § 13 ("Trustee to protect title to trust- property."); *id.* at § 14 ("Trustee not to set up title adverse to beneficiary."); *id.* at § 17 ("Trustee to be impartial.").

212. *See, e.g.*, *id.* at § 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. . . .").

213. *See* GRAHAM MOFFAT ET AL., TRUSTS LAW: TEXTS AND MATERIALS 806 (5th ed., Cambridge Univ. Press 2005).

214. *See* 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 15, at 37.

215. *See, e.g.*, Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 L.Q. REV. 452, 453, 468–69 (2005).

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

217. *See* Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 573 (2003).

218. *See* Sitkoff, *An Agency Costs Theory of Trust Law*, *supra* note 17, at 656–57; Warburton, *supra* note 214, at 186.

219. However, limiting the flexibility to management through onerous fiduciary duties can constrain efficient business decision-making. *See* Warburton, *supra* note 214, at 184.

220. *See supra* notes 95–96.

221. *See id.*

decisions and that, in any event, these vehicles hold passive investments rather than carry out an active business.[222]

Indian trust law permits delegation of the trustee's office or duties only under certain circumstances.[223] 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.[224] 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 he is not absolved from liability."[225]

Finally, trust documentation in Indian venture capital firms tend to contain waiver, exculpation, and indemnification clauses that inure to the benefit of the trustee.[226] Trust law generally looks at such clauses favorably, except when they cover extreme situations such as bad faith involving the trustee.[227] 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 in the breach with full knowledge of facts.[228] 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

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222. In the context of limited partnerships, *see* Ribstein, *Fiduciary Duties*, *supra* note 185, at 941–43.

223. *See* The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882), § 47 (stating that 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").

224. For further discussion, *see infra* Part V(B).

225. Koka Sivananda Sastry v. The Samasthanam Choultry, (1968) 2 Andh WR 260; *see also* NIGAM, *supra* note 122, at 293.

226. *See* Shreya Rao & Vakasha Sachdev, *Can Trustees Contract Out of Fiduciary Liabilities?*, INDIACORPLAW (Mar. 25, 2017), https://indiacorplaw.in/2017/03/can-trustees-contract-out-of-fiduciary.html [https://perma.cc/6ZD6-F35J] (archived Feb. 2, 2020).

227. *See* Sitkoff, *Trust as "Uncorporation"*, *supra* note 15, at 39. Commentators argue this to be the state of Indian trust law as well. *See* Rao & Sachdev, *supra* note 226.

228. The Indian Trusts Act, No. 2 of 1882, INDIA CODE (1882), § 23.

to serious forms of breaches such as fraud, bad faith or gross negligence.[229]

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 Article now turns toward 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.[230] 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."[231] Moreover, "[k]ey evidence is often retained by the GP."[232] 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.[233]

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229. *See* Rao & Sachdev, *supra* note 226.

230. Lin, *Private Equity Investor Protection*, *supra* note 136, at 80–81 (internal quotation marks omitted).

231. *Id.* at 81.

232. *Id.* at 80.

233. *Id.* at 81.

There are 22 cases in which LPs have successfully litigated against a GP in China under Article 68 of the PEL as of December 2019.[234] In 8 out of the 22 cases, LPs won the cases. The first successful derivative action lawsuit occurred on March 29, 2017: *Jiao Jian et al. v. Anhui Ruizhi Real Estate Development Co.*[235] In this case, the Supreme Court of People's Republic of China ruled in favor of the LPs.[236] Not only had the GPs failed to initiate legal proceedings on behalf of the partnership after two entrusted loans were due for collection, they also ignored the LPs upon their repeated requests to exercise the partnership's creditor rights, failed to respond to subpoenas, and failed to appear before the Court of First Instance.[237] Evidently, the GPs had *de facto* abandoned the partnership's debt claims, leading to the Chinese apex court's holding that the GP had "neglected the exercise of [its] right."[238] "However, the law remains silent as to whether LPs have to exhaust other remedies before bringing a derivative action."[239]

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.[240] 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.[241] 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.[242] Nevertheless, from a practical standpoint, this has failed to constitute a significant concern

234. These cases were found in the judgement database maintained by the Chinese courts. *See* WENSHU COURT, http://www.court.gov.cn/wenshu.html (last visited Apr. 19, 2020) [https://perma.cc/YQP3-B39F] (archived Feb. 24, 2020). These cases include such as: Shixingronghe Inv. Mgmt. Ltd. v. Changan Int'l Trust Co. and Tianjin Dinghui PE, 2016 SUP. PEOPLE'S CT. GAZ. 19 (China); Wangyufeng v. Guangzhou Int'l Procurement Co. (2015) Huitianfajinminchuzi No.5345 Guangzhou Tianhe District Court, Civil Judgement. For the discussion of limited partners' derivative action, *see generally* Lin Lin, *The Limited Partner's Derivative Action: Problem and Prospects in the Private Equity Market of China*, 41 H.K. L.J. 201 (2011).

235. The High Court of Anhui Province made the judgement on February 26, 2016 Wan Min Er Chu Zi No. 00005 (皖民二初字第 00005 号), and ruled in favor 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].

236. Zuigaofaminzhong No. 756.

237. *Id.*

238. *Id.*

239. *See* Lin, *Private Equity Investor Protection*, *supra* note 136, at 80–81.

240. *See* Berry, *supra* note 110, at 177.

241. *See* Rau, Ghosal & Sharma, *supra* note 30, at § 6.2.

242. *See generally* Shri Vimal Kishor Shah v. Jayesh Dinesh Shah, (2016) 8 SCR 116 (India).

as the principal commercial terms are contained in the contribution agreement, the breaches of which can still be subject to arbitration.[243]

In addition to civil remedies, investors are entitled to approach SEBI for regulatory action.[244] SEBI's role is confined to ensuring compliance with the AIF Regulations.[245] 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.[246] Although the matter went on appeal, it was later settled.[247] In another case, the investors of ICICI Venture Funds Management Company initiated legal action in Mauritius, in which the trustee company was also impleaded,[248] which is stated to be pending resolution.[249]

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.

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243. *See* Rau, Ghosal & Sharma, *supra* note 30, at § 6.2.

244. *See id.* at § 6.3.

245. *See id.*

246. *See generally* 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, SEC. & EXCH. BD. OF INDIA (2017), https://www.sebi.gov.in/enforcement/orders/nov-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://perma.cc/2HY3-8P4A] (archived Feb. 2, 2020).

247. *See generally* SETTLEMENT ORDER IN RESPECT OF SREI MULTIPLE ASSET INVESTMENT TRUST AND SREI ALTERNATIVE INVESTMENT MANAGERS LIMITED, SEC. & EXCH. BD. OF INDIA (2018), 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 [https://perma.cc/X77Q-2HXB] (archived Feb. 2, 2020).

248. *See* Sobia Khan & Kailash Babar, *NRIs Move Mauritius Supreme Court Against ICICI Venture; Accuse PE Firm of Misleading Them*, ECON. TIMES (July 24, 2014), https://economictimes.indiatimes.com/mf/mf-news/nris-move-mauritius-supreme-court-against-icici-venture-accuse-pe-firm-of-misleading-them/articleshow/38942748.cms?from=mdr [https://perma.cc/A987-9SMD] (archived Feb. 2, 2020).

249. *See* ICICI Bank Ltd., Annual Report (Form 20-F) 22 (July 31, 2019).

VI. CONCLUSION

This Article 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 suboptimal. 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 noncharitable 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 Article 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 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, fundraising 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, and boosting entrepreneur participation are also important. Regulators would do well not to miss the forest for the trees.

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