Venture Capital Limited Partnership in Financing Innovation
A Comparative Study between the U.S. and China

Inauguraldissertation
zur Erlangung des Doktorgrades des Fachbereichs
Rechtswissenschaft der Johann Wolfgang Goethe-Universität,
Frankfurt am Main

vorgelegt von
XIAOXI ZHANG

Erstgutachterin: Prof. Dr. Isabel Feichtner
Zweitgutachter: Univ.-Prof. Dr. Moritz Bälz
Datum der mündlichen Prüfung: 09.02.2017

2017

Table of Contents

Abbreviations

ABC	Agricultural Bank of China
ARD	American Research and Development Corporation
Akron L. Rev.	Akron Law Review
Alb. L. Rev.	Albany Law Review
Am. Bus. L.J.	American Business Law Journal
Am. Econ. Rev.	American Economics Review
Am. Soc. Rev.	American Sociological Review
Am. U. L. Rev.	American University Law Review
Applied Fin. Econ.	Applied Financial Economics
BOT	build-operate-transfer
Bus. Law.	Business Lawyer
B.U. L. Rev.	Boston University Law Review
CAE	Chinese Academy of Engineering
Calif. L. Rev.	California Law Review
Cambridge L.J.	Cambridge Law Journal
CAS	Chinese Academy of Science
Case W. Res. L. Rev.	Case Western Reserve Law Review
CASS	Chinese Academy of Social Science
CCPCC	Chinese Communist Party Central Committee
CEO	Chief Executive Officer
CIRC	China Insurance Regulatory Commission
CNTVIC	China New Technology Venture Investment Corporation
Crt.	Court

CSRC	China Securities Regulatory Commission
Colum. Bus. L. Rev.	Columbia Business Law Review
Colum. L. Rev.	Columbia Law Review
Del. Code Ann.	Delaware Code Annotated
DHVC	Donghai Venture Capital Fund
DRULPA	Delaware Revised Uniform Limited Partnership Law
ECB	European Central Bank
Econ. Dev. Q.	Economic Development Quarterly
Econ. J.	Economic Journal
Emory L.J.	Emory Law Journal
ERISA	The Employee Retirement Income Security Act
EU	European Union
FDI	Foreign Direct Investment
Fed. Res. Bank Atlanta Econ. Rev.	Federal Reserve Bank of Atlanta Economic Review
Fin. Mgmt.	Financial Management
FoF	Fund of Funds
Fordham L. Rev.	Fordham Law Review
GDP	Gross National Product
GEM	Growth Enterprise Market
GERD	Gross Expenditure on Research and Development
Harv. Bus. Rev.	Harvard Business Review
Harv. L. Rev.	Harvard Law Review
Indu. & Corp. Change	Industrial and Corporate Change
Ind. L.J.	Indiana Law Journal
Int'l J. Entrepreneurial Behav. Res.	International Journal of Entrepreneurial Behavior Research

ICBC	Industrial and Commercial Bank of China
Int'l Small Bus. J.	International Small Business Journal
IPO	Initial Public Offering
ITIF	Information Technology and Innovation Foundation
J. Bus. Venturing	Journal of Business Venturing
J. Corp. L.	Journal of Corporation Law
J. Econ. Behav. & Org.	Journal of Economic Behavior and Organization
J. Econ. Persp.	Journal of Economic Perspectives
J. Econ. Surveys	Journal of Economic Surveys
J. Fin.	Journal of Finance
J. Fin. Econ.	Journal of Financial Economics
J. Fin. Intermediation	Journal of Financial Intermediation
J. Fin. Quantitative Analysis	Journal of Financial Quantitative Analysis
J.L. & Econ.	Journal of Law and Economics
J.L. Econ. & Org.	Journal of Law, Economics, & Organization
J. Pol. Econ.	Journal of Political Economics
J. Small. Bus. Fin.	Journal of Small Business Finance
J. Small & Emerging Bus. L.	Journal of Small and Emerging Business Law
JH Venture Capital	James & Hina Capital Management
Law & Contemp. Probs.	Law and Contemporary Problems
LLC	Limited Liability Company
LLLP	Limited Liability Limited Partnership
LP	Limited Partnership/Limited Partners
Md. L. Rev.	Maryland Law Review
Mgmt. Sci.	Management Science

Mich. L. Rev.	Michigan Law Review
MOC	Ministry of Commerce
MOE	Ministry of Education
MOF	Ministry of Finance
Monetary Econ.	Monetary Economics
Norton Ann. Surv. Bankr. L.	Norton Annual Survey of Bankruptcy Law
MOST	Ministry of Science and Technology
NASDAQ	National Association of Securities Dealers Automated Quotations
Nat'l People's Cong.	National People's Congress
NBER	National Bureau of Economic Research
NDRC	National Development and Reform Commission
NVCA	National Venture Capital Association
OECD	The Organization for Economic Co-operation and Development
PEL	Partnership Enterprise Law
PPP	Public-Private Partnership
Q. J. Econ.	Quarterly Journal of Economics
R&D	Research and Development
Res. Pol'y	Research Policy
Rev. Fin. Stud.	Review of Financial Studies
RMB	Ren Min Bi (Chinese Currency)
RULPA	Revised Uniform Limited Partnership Law
RUPA	Revised Uniform Partnership Law
S&T	Science and Technology
SAC	Securities Association of China

SAT	State Administration of Taxation
SEC	Security and Exchange Commission
Scot. J. Pol. Econ.	Scottish Journal of Political Economics
Small Bus. Econ.	Small Business Economics
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprises
Stan. L. Rev.	Stanford Law Review
Suffolk U. L. Rev.	Suffolk University Law Review
SZVCGF	Suzhou Industrial Park Venture Capital Fund
Tex. Tech L. Rev.	Texas Tech Law Review
TLVC	Tianlü Venture Capital
TTGG	Tiantang Guigu (Silicon Paradise) Venture Capital
U.C. Davis L. Rev.	University of California at Davis Law Review
U. Colo. L. Rev.	University of Colorado Law Review
U. Chi. L. Rev.	University of Chicago Law Review
U. Cin. L. Rev.	University of Cincinnati Law Review
U. Ill. L. Rev.	University of Illinois Law Review
U. Pa. L. Rev.	University of Pennsylvania Law Review
ULPA	Uniform Limited Partnership Law
UPA	Uniform Partnership Law
U. Pitt. L. Rev.	University of Pittsburgh Law Review
U.S.	United States
Va. L. Rev.	Virginia Law Review
Vand. L. Rev.	Vanderbilt Law Review
VC	Venture Capital
VCGF	Venture Capital Guiding Fund

VCGFNJ	Venture Capital Guiding Fund of Nanjing
VCGFSH	Venture Capital Guiding Fund of Shanghai
VCGFSZ	Venture Capital Guiding Fund of Shenzhen
Wash. & Lee L. Rev.	Washington and Lee Law Review
WTO	World Trade Organization

List of Figures

List of Tables

Introduction

The venture capital industry holds relevance for entrepreneurs looking for money to finance an innovative project, investors seeking to make money by investing in entrepreneurial firms and governments trying to promote innovation and entrepreneurship. Venture capital investment could facilitate innovation and thus a better economy.

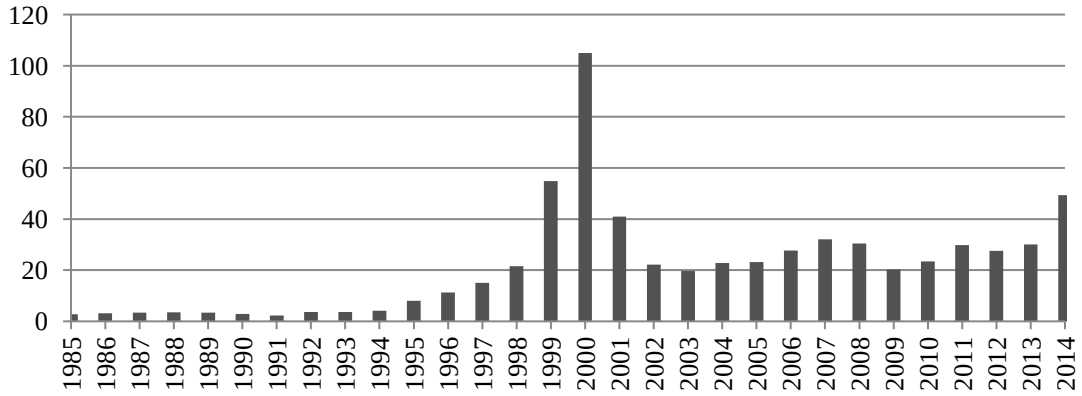
Venture capital has enabled the U.S. to support its entrepreneurial talent by turning ideas into world-famous products and services, building companies from mere business plans to mature and powerful organizations. Three of the five largest U.S. public companies by market capitalization – Apple, Google and Microsoft – received most of their early external funding from venture capital.[1] Having its ups and downs, venture capital investment in the U.S. expanded from virtually zero in the mid-1970s to $8 billion in 1995 and $49.3 billion in 2014 (Figure 1).[2] Venture backed companies have been a prime driver of economic growth in the U.S.

Figure 1 Venture Capital Investments in the U.S. (1985-2014, $Billion)

---

1 Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies*, Stan. U. Graduate School of Bus. Research Paper No. 15-55, 2 (2015).

2 NVCA, 2015 National Venture Capital Association Yearbook, 36.



Across the pacific, venture capital investment in China has grown out of the transition from a centrally planned economy to a free market economy over the past three decades, becoming an important pillar supporting China's innovation system. In 2015, a total of 2,824 venture capital investment deals provided an aggregate investment of $36.9 billion.[3] Venture capital has long been a hot topic in China's capital market, particularly since the government decided to boost "mass entrepreneurship and innovation" in 2014.[4]

In the U.S., most venture capital firms are organized as limited partnerships, with the venture capitalists being general partners and the investors limited partners. Studies have shown that investors choose to invest through venture funds as an intermediary rather than placing their investments directly with the entrepreneurs; because of the high risk nature of the entrepreneur's business, it is hard for them to get bank loans or direct equity investments. Conflicts may also arise, however, between the venture capitalists acting as agents and the investors as principals.[5] This agency problem may

---

3 ChinaVenture Report, 2015 VC/PE Market Fundraising Thrives, p.8 (2016). Available at: http://www.chinaventure.com.cn/cmsmodel/report/detail/1071.shtml.

4 State Council Opinion, China Boosts Mass Entrepreneurship and Innovation, Jun. 16, 2015. Available at: . The term "mass entrepreneurship and innovation" was first brought up by Premier Li Keqiang in the 2014 summer Davos Forum, and it has been used in the most recent 2016 Report on the Work of the Government Work. Available at: http://www.gov.cn/guowuyuan/2016-03/05/content_5049372.htm.

5 See, e.g. William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473 (1990); Michael D. Klausner & Litvak, Kate, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING

be particularly severe, since venture capital provides money for businesses with high potential and high risk, although the limited partnership has certain merits and is still most commonly chosen as the business form for venture capital funds.[6] At the same time, the fact that general partners have total control of the partnership business necessitates that the agency problem is addressed by legal rules, contracts and other mechanisms.[7]

Meanwhile, despite the rapid growth of venture capital investments in China, little attention has been paid to the organizational form of venture capital funds. In contrast to the U.S., most Chinese venture funds have been structured as corporations. One may argue that it was due to legislative reasons: that the limited partnership was not recognized by Chinese law when venture capital first appeared in China. However, after adopted a chapter was adopted in the Partnership Enterprise Law (PEL) governing limited partnerships in 2007, most of the venture funds abided by their choice, while those opting for the limited partnership have encountered difficulties: the limited partners are having trouble trusting the general partners with their money and are therefore interfering with the operation of the partnership business, which may lead to dissolution of the partnership.

This thesis applies transaction cost theory to explain the benefits and costs of choosing the limited partnership as a business form in the special context of venture capital investments, showing that the potential agency conflict between the general partners and the limited partners have been mitigated by legal and other mechanisms

---

GOVERNANCE WITH REGULATORY POLICY, 54 (Michael Whincop, ed., 2001).

6 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835 (1988).

7 See, e.g. Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004); Paul A. Gompers & Josh Lerner, *The Use of Covenants: An Analysis of Venture Partnership Agreements*, 39 J.L. Econ 463 (1996); Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 6 (1999); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1085 (2003) (discuss the role of a reputation market as an implicit contract to deal with the agency conflicts).

in the United States, and that the U.S. investors could therefore exploit the merit of the limited partnership form in venture capital financing. In China, investors have different answers to the agency problem. Similarly to the situation in the U.S., Chinese partners also employ contract terms to deal with agency problems, and the legislators enact laws that aim at regulating the limited partnership form; some legislation was even transplanted from the U.S., such as that part of the PEL which governs limited partnerships. It seems, then, that similar mechanisms that deal with agency problems also exist in China. However, given the unique history of the development of China's innovation system and venture capital market, the effectiveness of these constraints is questionable. Chinese venture capital investors have therefore characteristically behaved differently to U.S. investors. Rather than relying on these questionable mechanisms, Chinese investors as well as the Chinese government have developed different approaches to addressing these agency problems.

The thesis is structured as follows:

Chapter 1 provides an overview of the world market for innovation, highlighting the importance of venture capital in financing innovation by recounting the successful experience of the U.S. and introducing the evolution of China's innovation policies. I then apply transaction cost theory to discuss in detail the intermediary role of venture capital in financing innovation, as well as a general description of the venture capital investment process.

Chapter 2 offers an explanation of the structure of a limited partnership venture capital fund and the fund's cyclical nature. Transaction cost theory is then applied again to explain the benefits and costs of the limited partnership as an organizational form in the particular case of venture capital investments. This analysis suggests that, along with the benefits in financing innovation, the limited partnership form itself

comes with a cost, namely, the agency conflict between the general partner and the limited partners.

Chapter 3 discusses the solution to the agency problem in the United States. The covenants and compensation provisions in the partnership agreement can be used as one way of mitigating the conflicts of interest between the partners; fiduciary duties are another way to deal with such problems from both a statutory approach and judicial practice perspective. Further, the reputation constraint is also essential for completing the venture capital cycle, and the so-called "control rule" in limited partnership legislation could be beneficial to the reputation mechanism.

Chapter 4 provides a brief history of venture capital development in China, and thus a foundation for understanding the role of the players, e.g. investors and the government, in the Chinese venture capital market.

Chapter 5 highlights the active nature of Chinese investors, and hence their choice of organizational form in venture capital investments, and their worries when choosing the limited partnership. To compare with the situation in the U.S., I also present the covenants and compensation schemes in the Chinese limited partnership agreement, as well as fiduciary duties and control rule in Chinese law. I show that contractual constraints and incentives in China may not be as strong as those of the U.S., and that China does not have an equivalent concept of fiduciary duties for partners. As for the transplanted control rule, it is contradictory with the active nature of Chinese investors. The reason that these mechanisms which deals with agency problems are in doubt in China probably lies deep within the Chinese culture.

Chapter 6 then discusses the role of government in China's venture capital market and its responsibilities and efforts to mitigate the trust issues of Chinese limited partners. The government uses the venture capital guiding fund and participates in venture

capital investments as a limited partner, trying to bridge the gap between the private investors and the venture capitalists. Further, the government has issued several tax policies to guarantee a favorable policy environment for venture capital funds to invest in innovative projects.

This thesis aims to show how legal measures – including regulations and contracts – are designed to mitigate the classic agency problems in the special scenario of venture capital investment. Moreover, it explores how economic agents consequently make choices that adapt to the agency costs when certain measures are absent or incomplete, as in the case of China. Rather than completely transplanting the laws and regulations as well as the western standard way of doing business when adopting a series of legal strategies to align the interests between the partners and hoping for better designed contracts, the investment culture in China should be respected. This will enable a healthy venture capital market that adapts to the particular characteristics of the Chinese market, and therefore smooth the financing of innovative projects.

Chapter 1 Innovation and Venture Capital Investments

The world economy has outgrown the old concept, which focused on one area's unique input and local endowment as a comparative advantage. Owing to the rapid advancements in transportation and communication technologies in recent decades, innovation is the catalyst of development, holding vast importance on different levels. For nation states, innovation is a driver of long-term productivity and economic growth, while for firms, innovation can help to gain competitive advantages and survive adverse changes in the marketplace. Furthermore, the economy is made up of firms and businesses, whereby its growth depends on the industrial leaders' ability to adapt so as to fulfill the ever-changing needs of the community. The economy would not survive with a non-sustainable business environment and a vibrant market would not exist without industrious and innovative entrepreneurship.

Empirical evidence has shown a positive link between innovation and economic performance. For example, patent performance (number of patents generated per firm per year) in the German biotech industry has increased as a result of R&D subsidies to joint projects and close collaborating partners within a cluster.[8] Among the world's competitive economies, the U.S. has gained "a disproportionate share of the world's wealth" through technological change and innovation since the 1970s,[9] while as a new rising world power, China's economic growth can be strongly explained by the innovation capacity that the country has developed, as well as by the strengthening of

---

[8] Dirk Fornal, et al., *What Drives Patent Performance of German Biotech Firms? The Impact of R&D Subsidies, Knowledge Networks and Their Location*, 90 REGIONAL SCIENCE 395 (2011).

[9] BENN STEIL ET AL., TECHNOLOGICAL INNOVATION AND ECONOMIC PERFORMANCE ix (2002).

innovation capacity with the formation of a national innovation system.[10]

Among all concepts relating to innovation, a healthy national innovation system is an important link between technological change and real economic growth. Moreover, to facilitate the transformation from innovation to industry, venture capital investment plays an important role in financing and providing know-how to innovative entrepreneurship. The venture capital industry is well developed in the U.S., while in China the fairly young venture capital industry has grown out of a rapidly developing and changing economy with numerous characteristics distinguishing it from the western world.

1.1 The Worldwide Competition for Innovation

1.1.1 The Importance of Innovation for the Global Economy

The question of economic growth lies at the heart of every economic theory, yet theories differ concerning the primary drivers. One does not have to believe in innovation economics – the economic theory that emphasizes entrepreneurship, innovation and a knowledge-based economy[11] – to realize how important innovation is; rather, taking a step back, we remember that the foundation of all economic growth – at least according to mainstream economics – is the optimization of utilities. The extent to which the factors of utilities can be optimized is the measure of the success of economic growth. These factors can all be boiled down to whatever is unique: special endowments, special production processes, price advantages, etc. Therefore, one can easily imagine that whoever brings something new to the market will have a greater chance of achieving an optimized utility, and innovation then naturally takes

---

[10] Peilei Fan, *Innovation capacity and economic development: China and India*, 44 ECON. CHANGE & RESTRUCTURING 49 (2011).

[11] CRISTIANO ANTONELLI, THE ECONOMICS OF INNOVATION, NEW TECHNOLOGIES AND STRUCTURAL CHANGE 33 (Routledeg, 2003).

center stage.

Innovation here does not just mean inventing new products or ideas as scientists do in their laboratories, but rather it focuses on bringing them to market. As Schumpeter once put it, invention is "the introduction of a new good … a new method of production … the opening of a new market … the conquest of a new source of supply … the carrying out of the new organization ..."[12]. Invention is the technical part of innovation, which is an ongoing process of generating new ideas, products and services and – most importantly – their commercial application.

Entrepreneurs are integral to the economy and important innovators in the market. Entrepreneurs and business begin with a need. They seize the opportunity of satisfying the need of the community while making a fortune for themselves. To protect their market share, gain a leading place in the market and reinforce their reputation as a market leader, entrepreneurs continuously seek better ways to satisfy their customers with better quality, price and services. These factors can all result in advanced technologies and organizational strategies.

Silicon Valley is a prime example of entrepreneurial innovation. In 1951, Stanford Industrial Park was established as a high-tech center by businesses working in close partnership with the university. In 1957, eight employees left Shockley Semiconductor to found Fairchild Semiconductor, and then two of them again left Fairchild Semiconductor to found Intel. This phenomenon repeated over the course of the next 20 years, until eventually, by the time the press gave the area the name "Silicon Valley" in 1971, these eight former employees of Shockley had given birth to 65 new enterprises and launched the start-up company explosion of information

---

[12] JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 66 (Redvers Opie trans., Harvard University Press 1961) (1934).

technology firms.[13]

As well as the private sector, the public sector also plays an important role in undertaking the most risky research, and the government has been leading in funding the "most radical, path-breaking types of innovation".[14] Companies, as profit maximizers, will invest less in basic research and more in applied research, since the former has a very high risk and the latter will generate more immediate returns. The government then steps in in such areas and eventually pushes the innovation forward, to flourish again through the private sector. As examples,, the algorithm behind Google's search engine was initially sponsored by NASA[15] and 75% of NMEs (new molecular entities, a type of ground-breaking drug) can be traced back to the research of National Institute of Health (NIH) labs.[16] Indeed, it turns out that government has been very successful at simulating scientific and technological advancement.

Due to the recent financial crisis and the fact that the global economy remains fragile, predictions of the global GDP growth rate have not been optimistic. Even today, the impact of the crisis has not yet been fully absorbed, with investment and employment remaining below pre-crisis levels.[17] Although the GDP growth rate remains relatively high in emerging markets, the unemployment rate is high in many developed countries.[18] Policy debates have thus focused on a framework that fosters growth and employment. Although innovation is not an immediate cure for these economic difficulties, as a forward-looking measure it has always been crucial to sustainable growth.

---

13 Gregory Gromov, Silicon Valley History, (last visited Jul. 4, 2012).
14 MARIANA MAZZUCATO, THE ENTREPRENEURIAL STATE 55, Demos (2011).
15 *Id*., at 19.
16 *Id*., at 55.
17 See e.g. IMF, WORLD ECONOMIC OUTLOOK: GROWTH RESUMING, DANGER REMAIN. XV (Apr. 2012); OECD, SCIENCE, TECHNOLOGY AND INDUSTRY OUTLOOK 26 (2014).
18 THE GLOBAL INNOVATION INDEX (GII) 2012 3 (Soumitra Dutta & INSEAD ed., 2012).

The economic downturn is affecting the innovation climate, albeit with ambiguity and complexity.[19] On the one hand, negative effects exist in terms of innovation expenditure and R&D investments[20] due to reduced demand and increased uncertainty.[21] The world's top R&D investors reduced their R&D spending by 1.9% in 2009, and the US government started to reduce its holdings in research fields such as health and energy.[22] On the other hand, past experience suggests that new growth regions and entrepreneurship may be stimulated by the crisis.[23] For example, the 1990 crises are said to have put the entire nation of South Korea on a new growth path.[24]

However, reduction in innovation investments or R&D expenditure does not necessarily lead to declining research outputs or innovation if efficiency is improved. Therefore, policy reforms to promote innovation should feature prominently in enhancing innovation efficiency, strengthening the linkage between science and industry.

1.1.2 Global Innovation

While advanced transportation and communication technologies have provided firms with a global market, these factors have also placed firms under greater pressure to become more competitive. Firms and nations now compete more based upon knowledge and innovation; the global economic recession only highlights the urgency of creating a better market for innovation.

---

19 See e.g. OECD, SCIENCE, TECHNOLOGY AND INDUSTRY OUTLOOK 24 (2012); Andrea Filippetti & Danile Archibugi, *Innovation in Times of Crisis: National System of Innovation, Structure, and demand*, 40 RES. POL'Y. 179, 179 (2011).

20 Research and development activities can be undertaken by both corporations and government; the investment they make is not often intended to yield immediate profit, and generally carries great risk and uncertain returns.

21 THE GLOBAL INNOVATION INDEX (GII) 2012 3 (Soumitra Dutta & INSEAD ed., 2012).

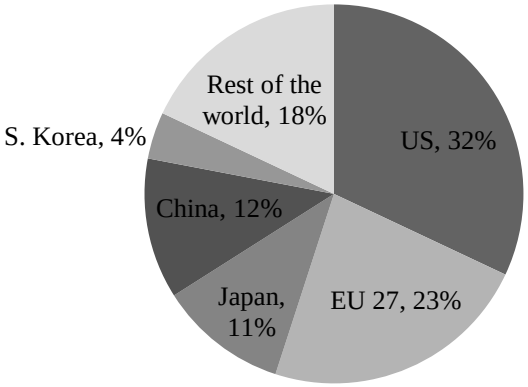
22 EC, THE 2011 EU INDUSTRIAL R&D INVESTMENT SCOREBOARD 5 (2011).

23 For example, low-cost airlines grew out of the recession in the early 1990s. See OECD, SCIENCE, TECHNOLOGY AND INDUSTRY OUTLOOK 28 (2012).

24 *Id*., at 118.

In recent years, the growth of R&D spending worldwide has been vigorous, with governments making innovation a national priority. The U.S. remains the largest spender, followed by Europe (Figure 2).

Figure 2 Gross R&D Expenditure (2009, World Total $1,276 Billion)



Source: Bruegel Policy Contribution Issue Feb. 2013.

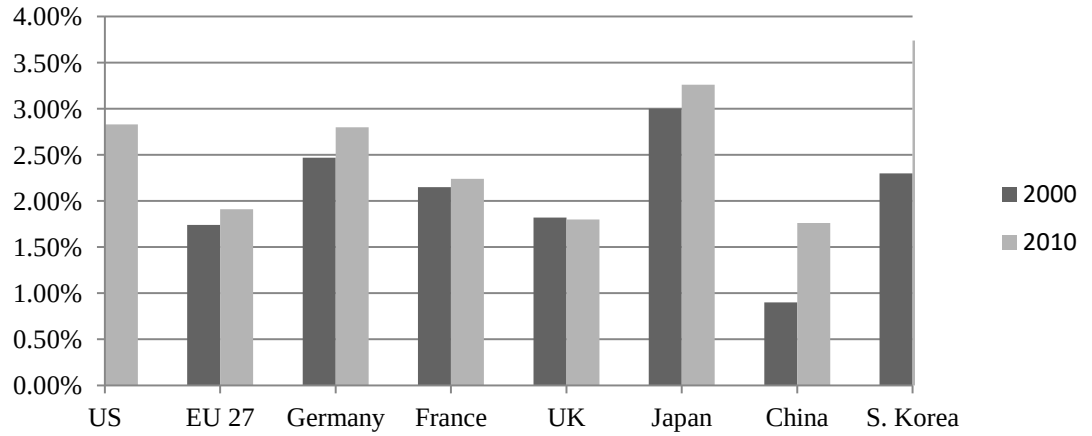
R&D spending has, however, risen rapidly in Asia, particularly in China. Some sources indicate that, due to high R&D spending growth, China has become the world's second R&D spender, just behind the U.S.[25] The percentage of innovation spending as a proportion of GDP was 0.9% in 2000, before subsequently almost doubling over the next 10 years (Figure 3). The real growth in overall R&D in China during this ten-year period was exceptionally high at about 22% per annum. Another rapidly rising Asian research economy is that of South Korea, averaging 12% per annum during the same period.[26]

Figure 3 Gross Domestic Expenditure on R&D as % of GDP (2000 and 2010)

---

[25] See e.g. Reinhilde Veugelers, *The World Innovation Landscape: Asia Rising?*, BRUEGEL POL'Y CONTRIBUTION, Feb 2013, at 1.

[26] *Id*., at 3.

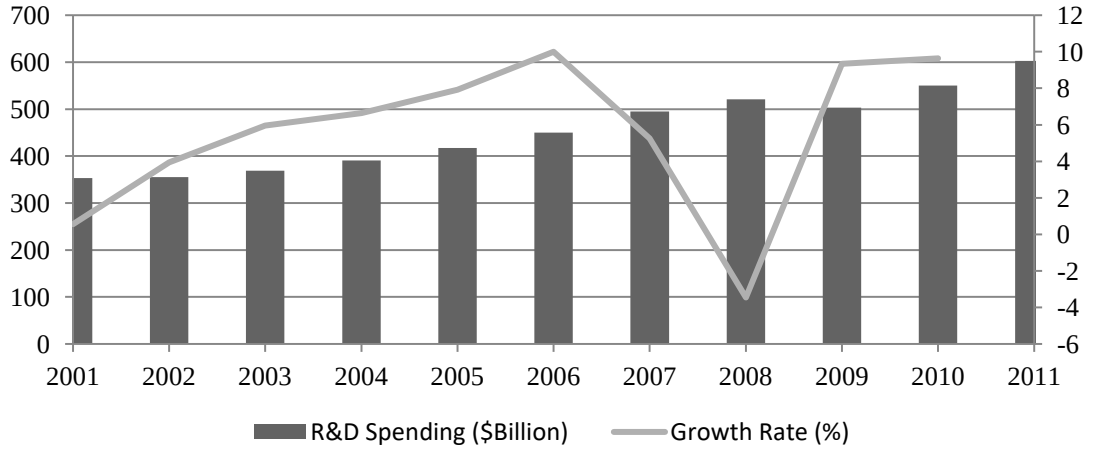


Source: OECD, Main Science and Technology Indicators, Volume Feb. 2012

As previously discussed, the fear of losing innovation capacity contributed to the expectation of a slow recovery from the recent global economic downturn. In the private sector, despite a slight decline in innovation spending in the years of the crisis, the growth rate soon recovered to the pre-recession level in 2011 (Figure 4). Some companies quickly came out with new technologies and products despite the spending constraints. Furthermore, there is no long-term correlation between the financial status of companies and their innovation spending; rather, how they use the money, talent and other resources available to them determines the execution of their innovation strategy and, consequently, the financial outcome.[27]

Figure 4 Global Innovation 1000 R&D Spending Trend (private sector) (2001-2011)

[27] BOOZ&CO., THE 2012 GLOBAL INNOVATION 1000 STUDY 2-3 (2012).



Source: Booz&co., The 2012 Global Innovation 1000 Study

1.1.3 The U.S. Experience of Success

The United States has an enviable record in scientific and industrial innovation. The nation has the world's strongest university system, significant public and private spending on research, very productive workers and prolific patent generation. More importantly, the U.S. has a well-developed system of commercializing the results of innovation, marking the strongest link between creation and industry. The key players in this innovation system are the innovative firms.

The U.S. leads the world in innovation capacity such as research spending and patents. While its position has been weakened by fierce competition, numerous technological breakthroughs are still produced in U.S. universities and research laboratories, while industry-transforming products and business models are still created in U.S. companies. Most importantly, the U.S. still enjoys the advantage of a highly dynamic ecosystem in terms of knowing how to turn inventions into market-ready products.[28]

The U.S. is ahead of Europe in global innovation rankings. According to an

[28] RISING TO THE CHALLENGE: U.S. INNOVATION POLICY FOR GLOBAL ECONOMY 13 (Charles W. Wessner & Alan Wm. Wolff eds., 2012).

innovation and competitiveness report issued by the European-American Business Council and the Information Technology and Innovation Foundation (ITIF) in 2011,[29] the overall competitiveness score of the EU-15 is just 80% of the U.S. score, while the EU-10 score is even lower at just 60% of the U.S. level, due to the recent emergence of the constituent countries as market economies.[30]

The U.S. leads Europe in 12 of the 16 indicators for innovation competitiveness, including higher education, number of researchers, business and government R&D, IT investments, e-government, broadband telecommunications, new firms, venture capital investment, overall business climate and productivity. [31] Among these indicators, the U.S. significantly outperforms Europe in corporate R&D with the EU-15 at 55% and government R&D at 83% of the U.S. level. Moreover, consistent with its long-standing entrepreneurial culture, the U.S. leads the EU-15 with 30% more new firm formations.

Table 1 Major elements of innovation in comparison

	EU-27	U.S.	Japan
New doctoral graduates (per 1000 population aged 25-34)	1.4	1.6	0.9
Tertiary educated population (% of population aged 25-34)	34	42	54
Expenditure on R&D (% of GDP)	2.0	2.8	3.4
Public-private joint publications (per million population)	36	70	56
Patents invented (per billion GDP in PPS Euro)	4	4.3	8.3
Medium-high and high-tech product exports (% of total)	47	59	75
License and patent revenues from abroad (% of GDP)	0.2	0.63	0.53

Source: European Commission, Innovation Union Scoreboard 2010

In the recent Global Innovation Index released by Bloomberg Rankings, the U.S.

---

[29] ROBERT D. ATKINSON & SCOTT M. ANDES, ITIF, THE ATLANTIC CENTURY II (July 2011), *available at* .

[30] The EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. The EU-10 comprises the ten new member states that joined the EU in 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

[31] The EU-15 outperforms the U.S. in four indicators: academic publications, a lower effective corporate tax, trade performance and foreign direct investment inflows.

ranked first among 96 countries. This index comprises seven factors and the final scores are derived from the weighted average of factors, including R&D intensity (20%), productivity (20%), high-tech density (20%), researcher concentration (20%), manufacturing capability (10%), tertiary efficiency[32] (5%) and patent activity (5%). The U.S. ranked first for high-tech density, third for productivity, sixth for patent activity and ninth for R&D intensity.[33]

Despite the claim that the U.S.'s leading position in the global innovation competition has been weakened, consensus remains that the U.S. plays a central role.[34] With its universities and research institutions, innovation clusters and first-class corporations – and especially its ability in creating and hosting innovative technology start-ups with excellent interconnectedness with the research system – the U.S. remains the global leader in innovation.[35]

U.S. universities play an important role in the process of invention, innovation and commercialization. With the adoption of the Bayh-Dole Act in 1980, universities are able to claim legal rights to innovations developed by their faculty using federal funds.

Before the Bayh-Dole Act, federal research funding contracts obligated inventors to assign inventions they made using federal fund to the federal government.[36] The Bayh-Dole Act create a favorable environment for the transfer of government-funded

---

32 A measure that includes enrollment in higher education and the concentration of science and engineering graduates, see *50 Most Innovative Countries*, BLOOMBERG RANKINGS, http://www.bloomberg.com/slideshow/2013-02-01/50-most-innovative-countries.html#slide52 (last visited Mar. 19, 2013).

33 See *id*.

34 See e.g. THE ECONOMIST INTELLIGENCE UNIT, A NEW RANKING OF THE WORLD'S MOST INNOVATIVE COUNTRIES 9 (2009); THE GLOBAL INNOVATION INDEX (GII) 2012 15 (Soumitra Dutta & INSEAD ed., 2012). According to the GII 2012, the U.S. ranked tenth on a global scale. The competitive advantage of the U.S. is declining in areas relating to human resources and openness to global talent. R&D as a share of GDP has declined from 2.8% in 1996 to 2.6% in 2006, although it is still almost double the ratio in China, while the growth of patent filing has slowed and other countries continue to catch up.

35 GII 2012, see *id*., at 39.

36 Ashley J. Stevens, The Enactment of Bayh-Dole, 29 *Journal of Techonology Transfer* 93, 2004.

inventions to the private sector for commercialization. Non-profit institutions, including universities, and small business may elect to retain title to innovations developed under federally funded research programs; universities are encouraged to collaborate with commercial enterprises to promote the utilization of inventions arising from federal funding.[37]

This piece of legislation "dramatically improved the nation's ability to move ideas from R&D into the marketplace and into commerce,"[38] and it is generally accepted as the catalyst for the process of technology commercialization, substantially contributing to the competitiveness of the U.S. economy. Notable among the collaborations between the academic world and industry is the Semiconductor Research Corporation Focus Center Research Program, a multi-million-dollar collaboration involving 30 universities established to address long-term technology issues of relevance to the semiconductor industry.[39]

According to the Association of University Technology Managers (AUTM) Licensing Survey, there were 5,742 new spin-offs from the fiscal years 1980 through 2006, and from the fiscal year 2002 to 2010 about 600 new commercial products and 600 new companies were launched each year.[40] For example, 110 patents are filed and 40 license deals are completed on average by North Carolina State University each year. Six companies were formed based upon intellectual property (IP) from the university in 2006, with NCSU taking 5-10% equity in each company created on the basis of university IP. MIT receives 20% of its research income from industry and it licenses

---

37 PRESIDENT'S COUNCIL OF ADVISORS ON SCIENCE AND TECHNOLOGY, REPORT ON TECHNOLOGY TRANSFER OF FEDERALLY FUNDED R&D 3 (May 12, 2003),
Available at .

38 *Id.*, at 1.

39 RISING TO THE CHALLENGE: U.S. INNOVATION POLICY FOR GLOBAL ECONOMY 110 (Charles W. Wessner & Alan Wm. Wolff eds., 2012).

40 AUTM Liscensing Activity Surveys, (last visited Jul. 5, 2012). The surveys included data from around 200 respondents each year.

IP to around 20-30 new companies each year.[41] In the U.S., the university research and science parks act as a path through which innovation flows from the lab to the marketplace, while in Europe this role is often undertaken by government agencies or the private sector.[42]

Typically with universities at the core, science and technology parks serve as platforms for launching new companies and creating regional innovation clusters such as Silicon Valley and Boston's Route 128.[43] Similar industries tend to be located close to each other and flourish close to the research institutions without government coordination.[44] This phenomenon and the advantages of industrial clusters were first studied by Alfred Marshall as "Marshall's trinity", which includes a pool of skilled labor, knowledge spillovers and inter-firm linkages.[45] In addition, more recent analyses have argued that clusters in which intense new idea competition occurs are more conducive to innovation.[46]

Early innovation clusters such as Silicon Valley are the result of interactions between the private sector and universities receiving federal funding, albeit with little government design.[47] At present, the U.S. state and regional governments are focusing more on strategies to nurture new concentrations of innovative industries. It is more than simply funding university research so that companies will take root in a certain region; rather, an entire ecosystem of innovation is required in order to develop new

---

41 PROTON EUROPE, EXPERIENCES ON THE US KNOWLEDGE TRANSFER AND INNOVATION SYSTEM 15 (Apr. 2007).

42 *Id*., at 24.

43 RISING TO THE CHALLENGE: U.S. INNOVATION POLICY FOR GLOBAL ECONOMY 111 (Charles W. Wessner & Alan Wm. Wolff eds., 2012).

44 *Id*., at 113.

45 The British economist Alfred Marshall pioneered studying the localization of industry and Sheffield's cluster. See ALFRED MARSHALL, PRINCIPLES OF ECONOMICS, BOOK IV 120 (London Macmillan and Co. 8th ed. 1920).

46 See e.g. Michael E. Porter, *Location, Competition, and Economic Development: Local Clusters in a Global Economy*, 14 ECON. DEV. Q. 15, 19 (2000).

47 See ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 161 (1994).

innovative products, and all talents must be actively involved, including researchers, entrepreneurs and investors.[48] Facing global challenges, the U.S. state and regional authorities are today more engaged in launching studies and policies fostering innovation industry clusters.[49] The Obama Administration's budget for fiscal year 2011 included more than $300 million in new funding for federal agencies to assist regional innovation cluster initiatives,[50] and new federal programs like the Energy Innovation Hubs program[51] and the i6 Challenge program[52] have been deployed in the wake of the financial crisis and the deep recession that followed.

1.1.4 China's Innovation Evolution

China has maintained rather rapid economic growth over the past several decades, while also facing great challenges, social, environmental and economic in nature. In order to maintain sustainable and comprehensive progress, fostering innovation is a key requirement.

Economic reform of the past decades has tremendously increased the role of the market economy in China, moving from a rigid planned economy to the so-called "socialist market economy". Although there remains a long road ahead to achieve an efficient market economy, the market as a key economic institution has reached a rather advanced level.[53] The "open door" policy is an integral part of this economic reform. It has resulted in an opening to foreign trade and investment, which has

---

48 See Robert E. Lucas Jr., *On the Mechanics of Economic Development*, 22 J. MONETARY ECON. 3, 39 (1988).

49 RISING TO THE CHALLENGE: U.S. INNOVATION POLICY FOR GLOBAL ECONOMY 439 (Charles W. Wessner & Alan Wm. Wolff eds., 2012).

50 *Id*.

51 The Energy Innovation Hubs program, also led by the Department of Energy, provides funds for multidisciplinary teams to deploy new clean-energy technologies at scale. See id.

52 The i6 Challenge program, announced by the Department of Commerce in May 2010, announced a $12 million partnership with the National Institutes of Health and the National Science Foundation to award grants to six teams around the country with the most innovative ideas to drive technology commercialization and entrepreneurship. See National Science Foundation press release, May 3, 2010.

53 OECD, OECD REVIEWS OF INNOVATION POLICY: CHINA 2008, 446.

played an important role and facilitated the country's integration into the global economy. The openness to international trade and foreign direct investments (FDI) has made China a major export and manufacture platform for multinational companies,[54] earning the country the epithet, the "workshop of the world".

However, export-led growth has its limitations. While FDI has provided access to technology and know-how and foreign investors have served as a major channel of technology imports, little technological innovation or product design has been performed independently by Chinese firms.[55] At the same time, the pool of cheap labor is drying up and the demographic bonus has been shrinking. Under such circumstances, China is eager to move the economy from "Made in China" to "Innovated in China".

The state's involvement in innovation and the science and technology policy development evolved in four main phases, marked by the National Science and Technology Conferences held in 1978, 1985, 1995 and 2006. The roles of the government, public laboratories, universities and firms are constantly changing. The Deng Xiaoping theory of science and technology has been the theoretical and ideological foundation of policy reform. The central theme is that science and technology are a primary productive force. As Deng once said:

"The reform of the system for managing science and technology, like the reform of the economic structure, is designed to liberate the productive forces. The new economic structure should promote technological progress, and the new science and technology management system should promote economic development."[56]

The 1978 conference started the process of science and technology reform. The

---

54 OECD, OECD REVIEWS OF INNOVATION POLICY: CHINA 2007, Synthesis Report, 11.

55 *Id*, at 12.

56 Deng Xiaoping, The Reform of the System for Managing Science and Technology is Designed to Liberate the Productive Forces (Speech at the National Conference on Work in Science and Technology on Mar. 7, 1985).

"Cultural Revolution" ended shortly before that, and the nation had an urgent need for modernization of the economy. Prior to the conference, there were very limited roles for universities and firms in the innovation system, while the government issued direct funding to the public laboratories that were designated for special projects (such as nuclear weapon experiments and man-made satellites) for scientific research. At the 1978 conference, Deng argued in his speech that science and technology constitute a productive force and intellectuals are mental laborers, belonging to the working class.[57] This liberated science and technology and its workers politically.[58] Since then, the central government has devoted serious efforts to rebuilding the education and innovation system, especially focusing on restoring the science-industry links.[59] At this stage, the government retained a central role in funding and planning of the innovation system, with the relaxation of control over other funding channels.

In March 1985, the Decision on Reforming the Science and Technology System was issued by the Chinese Communist Party Central Committee (the CCPCC) (the Decision), marking the official start of the science and technology reform. The Decision set out the guiding principle for science and technology policy, namely that economic development must rely on science and technology, while science and technology must be oriented to economic development.[60] After the Decision, China launched a series of reform programs and institutional changes, for instance, the

---

57 Deng Xiaoping, Speech at the Opening Ceremony of the National Conference on Science (Mar. 18, 1978).

58 Maria Hsia Chang, *The Thought of Deng Xiaoping*, 29 COMMUNIST & POST-COMMUNIST STU. 377, 388 (1996). In the Culture Revolution, intellectuals were identified as member of the capitalist class and because of their knowledge, training, and critical disposition; they were political suspects, and were repeatedly subjected to special abuse. Deng however recognized intellectuals in a socialist society differed from other workers only as they performed different roles in the social division of labor. Therefore intellectuals were freed from vilification and abuses.

59 OECD, OECD REVIEWS OF INNOVATION POLICY: CHINA 2007, Synthesis Report, 45.

60 Decision on Reforming the Science and Technology System (关于科学技术体制改革的决定), para.1 (issued by CCPCC, Mar. 13, 1985).

National Natural Science Foundation, the 863 Program[61] and the Spark Program[62] in 1986, the Torch Program[63] in 1988, the Technology Spreading Program in 1990, the Provisional Bankruptcy Law for SOEs in 1986, the stock exchange (launched in Shenzhen in 1990) and the first Company Law (established in 1994). During this time, the government's central role in the innovation system was weakened, public laboratories that specialized in applied research were converted into business entities with the state as controlling shareholder.

The 1995 Decision on Accelerating Scientific and Technological Progress proposed a national development strategy to revitalize the nation through science, technology and education.[64] During this period, the Chinese economy grew quickly but with many problems, such as, for example, an inefficient industrial structure, poor technological levels, and low labor productivity.[65] Furthermore, in the 1990s, the knowledge economy was recognized in advanced industrial nations and China began to engage in great efforts to join the WTO. The knowledge economy and WTO membership could provide China with both opportunities and challenges. Further programs were launched, such as the 973 program[66] and Knowledge Innovation Program.[67] Besides finally joining the WTO in 2001, the most significant institutional/ideological change

---

61 The 863 Program was named after its date of establishment (March 1986) and mainly focused on information and communication technologies. See http://www.most.gov.cn/eng/programmes1/200610/t20061009_36225.htm

62 The Spark Program aimed to promote the rural economy using science and technology and its main contents focused on developing high yield agricultural products.

63 The Torch Program aimed to commercialize new and high technologies and encouraged investing in high technology zones.

64 Decision on Accelerating Scientific and Technological Progress (关于加速科学技术进步的决定) (issued by CCPCC & State Council, May 6, 1995).

65 OECD, OECD REVIEWS OF INNOVATION POLICY: CHINA 2008, 389.

66 The 973 Program was also named after its date of establishment (March 1997) and is also known as the National Basic Research Program. It aimed to achieve technological and strategic edge in various scientific fields, especially the development of the rare earth minerals industry. See (last visited Aug. 04, 2015).

67 The Knowledge Innovation Program (KIP) was inaugurated by the (CAS) in 1998. The KIP provides funds to research institutes affiliated with CAS based upon their achievement, aiming to allocate additional resources to the most promising institutes and research fields. See http://www.most.gov.cn/eng/programmes1/200610/t20061009_36224.htm.

was that private ownership was officially recognized in the 1999 Amendment of the Constitution.[68] During this period, the firm's role continued to gain significance in the innovation system, with stronger links to university research, while the commercialization of public research was enhanced. Notably, new funding channels such as venture capital were introduced at this stage.[69]

During the 2006 national conference on science and technology, the State Council issued the Medium- and Long-term Strategic Plan for the Development of Science and Technology (2006-20). This signifies that China is adopting an innovation-driven development model.[70] The plan states that China wants to become an innovation-oriented society by 2020 and a world leader in science and technology by 2050.[71] The plan sets out the goal that the nation's gross expenditure on R&D (GERD) is expected to rise to 2.5% or more of the gross domestic product (GDP) by 2020, with the rate of science and technology's contribution to the economy reaching 60% or above and dependence on imported technology reduced to 30% or below, as well as the goal that the annual invention patents granted to Chinese nationals and the international citations of scientific papers will rank among the top five countries.[72] To achieve these goals, China is trying to complete the shift from a government and public laboratory-centered innovation system to a firm-centered one. The science and technology development also aims at becoming market-led and mission-oriented, a development which can be supported with a mixture of funding instruments.

---

68 Xian Fa (宪法) [Constitution] (amended by the Nat'l People's Cong., Mar. 15, 1999) Art. 11. English version available at: http://en.pkulaw.cn/display.aspx?cgid=46441&lib=law.

69 See Chapter 4.

70 OECD, OECD REVIEWS OF INNOVATION POLICY: CHINA 2008, 391.

71 国家中长期科学和技术发展规划纲要, English version available at: http://www.cistc.gov.cn/introduction/Notice_4.asp?column=739&id=77583.

72 *Id*.

1.2 Venture Capital in Financing Innovation

There are many critical elements to a successful innovation project, with scientific research, technology standards, human resources and networks all being important for the development of a new product. It often takes a long time and costs a great deal of money for the new technology to move from the laboratory to the marketplace. The availability of capital can become a bottleneck for innovators and entrepreneurs as they attempt to move their idea and technology closer to the marketplace.

This section provides an explanation of the problem of financing innovation using the theory of information asymmetry, and then describes venture capital's function as a solution to the financing problem;. among other things, venture capital has become one important element of the U.S. innovation system. According to the National Venture Capital Association (NVCA), venture capital has enabled the U.S. to "support its entrepreneurial talent and appetite by turning ideas and basic science into products and services that are the envy of the world".[73]

1.2.1 Information Asymmetry as the Core Problem of Financing Innovation

In the world of financing innovation, information asymmetry refers to the situation that the entrepreneur knows more about his project than the investor does. The investor often has no insight into the validity or value of the sophisticated innovation technology and process, while the innovative product/service may only reveal its true quality after being fully adopted and repeatedly used. Furthermore, by definition, there is no similar product/service in existence that can serve as a benchmark.

Firms may finance their innovation projects internally by reinvesting their profits. Firms that lack sufficient internal finance and do not choose to abandon the project

---

[73] NATIONAL VENTURE CAPITAL ASSOCIATION, YEARBOOK 2012 7 (2012)

will have to seek access to external capital, although this comes at a cost. For debt financing, the cost is the interest payment and the risk of bankruptcy in the event of non-payment, whereas for equity financing the cost is ownership dilution in case of selling equity.

1.2.1.1 The Problem of Funding with Debt

While it is possible for large and established corporations to finance their own innovative projects with internally-generated resources, the requirement for a considerable amount of pre-sale investment often precludes the exclusive use of internal funds within small innovative firms.[74] The discussion would subsequently concentrate on the innovative firm's ability to access bank debt under the obvious information asymmetry. Put differently, the question emerges as to whether firms are "credit rationed".

Credit rationing generally refers to the situation in which lenders limit additional credits to borrowers even if the latter are willing to pay a higher rate of interest. Under such circumstances, banks as the lenders are rationing credit.[75]

An adverse selection problem represents the reason for credit rationing. While the bank obviously cares about the probability of the borrower's repayment of the loan, it is difficult to identify "good borrowers". Therefore, the bank uses the interest rate that the borrower is willing to pay as a "screening device", because one's willingness to pay a higher rate implies a higher risk and thus a lower expected probability of repayment. Given the imperfect information setup, the lender does not know each

---

[74] See Kevin McNally, Corporate Venture Capital: the Financing of Technology Businesses, 1 INT'L J. ENTREPRENEURIAL BEHAV. RES. 9, 11 (1995).

[75] See, e.g. Robert Cressy, *Are Business Startups Debt-Rationed?*, 106 ECON. J. 1253 (1996); Simon Parker, *Do Banks Ration Credit to new Enterprises? And Should Governments Intervene?*, 49 SCOT. J. POL. ECON. 162 (2002); Luigi Guiso, *High-tech Firms and Credit Rationin*, 35 J. ECON. BEHAV. & ORG. 39 (1998); Mark S. Freel, *Are Small Innovators Credit Rationed?*, 28 SMALL BUS. ECON. 23 (2007).

borrower's type (whether they are good or bad) and thus lender's will formulate the terms of the loan contract in favor of their own interest to attract safer, lower risk type borrowers.[76]

Moreover, a moral hazard problem can also exist.[77] The entrepreneurs can influence the outcome of the investment by exerting high or low effort. Since the lenders cannot observe the borrowers' behavior, it is necessary to invest a certain amount of the borrowers' own money in the project to ensure that they will exert high effort to achieve a successful outcome, serving as a necessary guarantee that they have a personal stake in the investment. If a firm does not have the assets available for this guarantee, then its project might not be financed. Thus, credit rationing also occurs due to a moral hazard problem.

The presumed high level of risk is one principal reason behind small firms' disadvantage in the loan market. The risk may be due to various reasons, including the higher relative probability of failure,[78] the higher due diligence and monitoring costs,[79] the greater scope of information asymmetry and moral hazard.[80] These issues are more or less related to the uncertain and intangible paybacks.[81] Thus, one may expect that a firm undertaking innovation projects would be more likely to face a credit constraint than one undertaking traditional investments, since even less information about the technological viability and market potential is accessible to the

---

76 Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981).

77 See Bengt Holmström & Jean Tirole, *Private and Public Supply of Liquidity*, 106 J. POL. ECON. 1, 6-12 (1998).

78 Firm size and age are important factors determining business performance. See Bradford J. Jensen & Rober H. McGuckin, *Firm Performance and Evolution: Empirical Regularities in the U.S. Microdata*, 6 INDUS. CORP. CHANGE 25, 31-33 (1997).

79 Grahame Boocock & Margaret Woods, *The Evaluation Criteria used by Venture Capitalists: Evidence from a UK Venture Fund*, 16 INT'L SMALL BUS. J. 36, 37 (1997).

80 Christine Ennew & Martin Binks, *The Provision of Finance to Small Firms: Does the Banking Relationship Constrain Performance?*, 4 J. SMALL BUS. FIN. 69 (1995).

81 HM TREASURY, FINANCING OF HIGH TECHNOLOGY BUSINESSES: A REPORT TO THE PAYMASTER GENERAL 15 (Nov., 1998).

lenders. Accordingly, even greater uncertainty of the likely future success is associated with an innovation project.

1.2.1.2 The Problem of Funding with Equity

Given that the entrepreneur always has more information regarding the feasibility of a business plan than uninformed investors, this asymmetric information results in an adverse selection problem, commonly known as the "lemon problem".[82]

In this lemon market dynamic, since the investors have little information about the quality and riskiness of the proposed innovation projects, they tend to price the projects with an average value from the project pool. However, above-average firms would subsequently decline such an offer. Anticipating this decline, the investors will adjust the price accordingly, namely lowering the offer price since the good ones leaving the pool would lower the average. However, once again, the above-average firms would withdraw until the market for financing new projects disappears. This anticipation of the lemon dynamic is precisely the reason for the non-existence of a direct financing market from investors to entrepreneurs.

Even if there exists a market for direct financing for entrepreneurs, a moral hazard problem can take a severe form. Managers have an incentive to engage in wasteful expenditure (like luxury offices) when the firm raises funds from outside investors, because they can gain disproportionately from these activities without bearing the entire cost.[83] From the outside investor's perspective, when the outcome of the firm cannot be foreseen and the effort of the managers cannot be trusted, it could be

---

[82] The "lemon problem" was discussed in detail in Akerlof's 1970 paper. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

[83] Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSP. 145, 154 (2001).

difficult to make a financing contract with them.[84]

These problems are especially difficult in terms of a firm whose performance is extremely difficult to assess such as an early-stage high-technology company with a heavy reliance on R&D.[85] Entrepreneurs may invest in strategies or projects that have high personal returns yet low monetary payoffs to the shareholders. For example, an entrepreneur may invest in certain high-risk projects that receive great personal recognition in the scientific community but offer less monetary interest to the investors, or may still enjoy managing the firm even if the initial feedback of the product from the market is not particularly promising; moreover, he/she may rush a product to the market even if it requires further testing. All such activities result from the fact that the entrepreneurs can gain from personal success which is generated from others' money, without actually suffering from losses when there is a failure.

1.2.2 Venture Capital as the Intermediary

Since it is difficult for innovators to find direct finance in the market, specialized financial capital provided to early-stage and high-risk startup companies – namely venture capital – came into existence (Figure 5). Obtaining venture capital is different from raising money from loans. Instead of interest payment to the lenders irrespective of success or failure, the return of the venture capitalists, who provide capital (not necessarily their own money) to startup companies in exchange for an equity stake, depends on the growth and profitability of the invested companies. This return, also different from normal shareholder dividend, is generally earned when the venture capitalist makes an "exit" from the investment, by selling his or her share stakes when

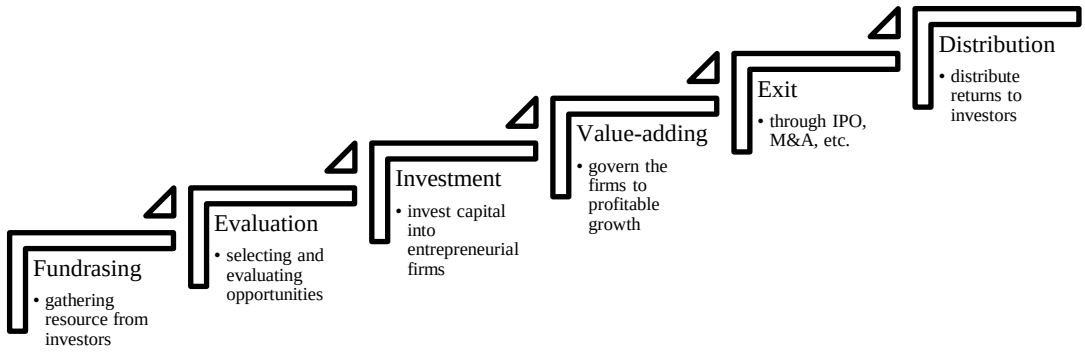
---

[84] See, e.g. Sanford J. Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691,717 (1986); Oliver Hart & John Moore, *Default and Renegotiation: A Dynamic Model of Debt*, 133 Q. J. ECON. 1, 2 (1998).

[85] Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSP. 145, 155 (2001).

the companies are sold to another owner. The exit strategy may be selling shares to another company through an acquisition, or to investors through an initial public offering (IPO).[86]

Figure 5 The Venture Capital Investment Process



Source: author

1.2.2.1 Screening Investments

Without the ability to screen out low-quality projects and entrepreneurs, investors are unable to make efficient decisions about where to invest. Venture capitalists spend a significant amount of time and effort evaluating investment opportunities. This screening process could help investors to evaluate an investment in a company, while it could also reduce the likelihood that an entrepreneur will seek financing despite having a low-quality project. The ability to screen prospective investments is crucial for venture capitalists' success.[87] Indeed, this superior ability to screen investment is the precise reason for the venture capitalist's existence.[88]

---

86 Other types of exit strategy include management buyout (the company's existing managers acquire a large part or all of the company), and even liquidation (when the performance of the invested company does not meet the predetermined milestones) of all the assets to limit further losses.
See http://www.investopedia.com/terms/e/exitstrategy.asp.

87 Steven N. Kaplan & Per Strömberg, *Venture Capitalist as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 427 (2001).

88 Models have been developed to illustrate the venture capitalist's superior ability in screening

In the screening process, venture capitalists explicitly consider the attractiveness of the proposed projects and describe the risks associate with different elements; for example, market size, technology, strategy, competition, management team and contract terms.[89] Screening criteria can also be categorized into classes of negative factors: in other words, the kinds of projects that should be screened out, such as those ventures that lack qualified management or experience, projects in which the viability is in doubt and those with high exposure to competition.[90]

In practice, the screening process may be held in the form of progressive phases, whereby each phase filters the proposed ventures according to different criteria.[91] Initial screening filters all ventures from a macro-level perspective and determines whether the venture should progress to the next level of screening. Subsequently, progressive screening determines which ventures are the most favorable to invest in, before final screening determines which venture shall be selected among the best ones.

The ability of venture capitalists to identify the most profitable projects can also influence the effectiveness of their future involvement in the firm, since the effort exerted by a venture capitalist is more valuable for higher quality projects. Furthermore, gathering information about the potential projects can be very costly. The venture capitalist could reduce such costs by forming a syndicate such as signing

---

venture projects. See, e.g. Masako Ueda, *Banks versus Venture Capital: Project Evaluation, Screening, and Expropriation*, 59 J. FIN. 601 (2004) (the venture capitalists can assess the projects better than the banks).

89 Steven N. Kaplan & Per Strömberg, *Venture Capitalist as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 428 (2001). This theoretical view is supported by empirical studies by Kaplan and Strömberg using data of 58 venture capital investments in 42 portfolio companies by 10 venture capital partnerships. See Steven N. Kaplan & Per Strömberg, *How Do Venture Capitalists Choose Investments?* (U. CHI. Working Paper, 2000).

90 Ian C. MacMillan et al, *Criteria Distinguishing Successful from Unsuccessful Ventures in the Venture Screening Process*, 2 J. Bus. Venturing 123, 124 (1987).

91 Properly developed models may be successful screening decision aides. See Andrew L. Zacharakis & G. Dale Meyer, *The Potential of Actuarial Decision Models: Can They Improve the Venture Capital Investment Decision?*, 15 J. BUS. VENTURING 323, 324 (2000). In practice, the screening methods see e.g. MARVIN LAI, ITM VENTURES INC., VENTURE CAPITALIST SCREENING CRITERIA AND ASSOCIATED TOOLS: PROGRESSIVE SCREENING MATRIX & MEAN-IRR INDEX (2006).

a co-investment or co-ownership contract between two or more venture capitalists.[92]

1.2.2.2 Value-adding Services

Research has shown that the venture capitalists not only inject money in the venture firm but also provide a non-financial contribution and value-adding services, helping to professionalize the company and establish it in the marketplace.

These ancillary services include helping the venture firm to build up its investor group, formulating the business strategies and filling the management team.[93] For example, the venture capitalists often sit on the board of directors, help to recruit and compensate key employees, introduce potential customers, suppliers and service providers such as lawyers and PR firms, help to structure mergers and acquisition transactions, play a major role in fund-raising processes and help the venture firm in strategic and operational planning. Indeed, they are sometimes even willing to take over the day-to-day operations.[94] With the successful help of a venture capitalist who has established credibility in terms of capital, contracts and range of projects, the venture-backed company can, in essence, more easily raise new capital and resources from the fund itself or from other sources.

Among these value-adding services, professionalizing the management of the firm attracts great attention.[95] The venture capitalist ties the quality of advice with the

---

92 Catherine Casamatta & Carole Haritchabalet, *Experience, Screening and Syndication in Venture Capital Investments*, 16 J. FIN. INTERMEDIATION 368, 369 (2007).

93 Michael Gorman & William A. Sahlman, *What Do Venture Capitalist Do?*, 4 J. BUS. VENTURING 231, 237 (1989).

94 William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 508 (1990). In the Gorman and Sahlman survey, they asked the venture capitalists to indicate whether they performed these services for their companies and the ranking of importance and frequency of providing such services. For example, help obtaining additional financing ranked first with a 75.0 frequency. See *Id.*

95 The value-adding role is empirically supported. Compared to non-venture-backed firms, venture-backed firms have fewer independent directors whose primary role is to provide management expertise. See, e.g. Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J.L. & ECON. 569 (2003); Thomas Hellmann & Manju Puri, *Venture Capital and*

venture-backed firm, meaning that experienced advice is recycled and continues to accumulate in value when investing in new firms.[96] Furthermore, entrepreneurs may be unwilling to share control with a hired outside professional manager, whereas the venture capitalist has no such hesitation. With a better reputation, the venture capitalist can hire higher quality managers.[97]

All such activities are considered designed to "increase the likelihood of success and improve return on investment"[98], although questions remain concerning whether venture capitalists play a positive role in financial markets and if firms appreciate their help. Some researchers have questioned the value of venture capital, claiming that venture capitalists cannot accurately assess the skill level of the entrepreneurs. Only less capable entrepreneurs will choose to attract venture capital investment, whereas the more capable ones will develop their projects without venture capitalists.[99] Furthermore, one problem with industrial data such as results from surveys is that venture capitalists can only be compared with one another, which cannot reveal effects common to all venture capitalists.[100] However, with better research methods,[101] scholars are able to identify the true positive value that venture

---

the Profeesionalization of Start-up Firms: Empirical Evidence, 57 J. FIN. 169 (2002); Steven N. Kaplan & Per Strömberg, *How Do Venture Capitalists Choose Investments?* (U. CHI. Working Paper, 2000).

96 Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 254-55 (1998).

97 Michael D. Klausner & Litvak, Kate, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY, 54 (Michael Whincop, ed., 2001).

98 William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 508 (1990).

99 Paphael Amit et al, *Entrepreneurial Ability, Venture Investments, and Risk Sharing*, 36 MGMT. SCI. 1232,1232 (1990). At the time, the market for venture capital appeared to be breaking down. However, the paper ignores certain aspects such as the contract, which could address the agency problem. See Christopher B. Barry, *New Directions in Research on Venture Capital Finance*, 23 FIN. MGMT. 3,11 (1994).

100 Thomas Hellmann & Manju Puri, *On the Fundamental Role of Venture Capital*, 4th Q. FED. RES. BANK OF ATLANTA ECON. REV. 19, 20 (2002).

101 For example, the Stanford Project on Emerging Companies (SPEC) – which aims at understanding the development of high technology start-ups in Silicon Valley – provides samples that generate variation between firms that do and do not obtain venture capital. See *Id*.

capitalists bring to the market. Research has shown that firms choose their investors based upon how much value the investor will add. Among all kinds of firms, innovators are particularly likely to benefit from venture capital investments.[102]

In conclusion, three elements should be taken into consideration in a national innovation system, namely the business environment, the regulatory environment, and the innovation policy environment.[103] Venture capital is an important component of the business financing system, for it provides not only money but also management know-how to a new innovative business with high risk. Consequently, it becomes an important part of the innovation business environment.

---

[102] Thomas Hellmann & Manju Puri, *On the Fundamental Role of Venture Capital*, 4th Q. FED. RES. BANK OF ATLANTA ECON. REV. 19, 21 (2002).

[103] Robert D. Atkinson, *Understanding the U.S. National Innovation System*, ITIF, 7 (June, 2014).

Chapter 2 Venture Capital Limited Partnership in Financing Innovation

An innovative entrepreneur in possession of innovative technology but short of money, would like to start a business. Venture capital organizations raise funds from individuals and institutions to invest in these early-stage businesses. These businesses usually have limited operating history and a novel technology or business model and thus are simultaneously associated with great risk and a potential high return. Venture capital is an attractive funding source to such new businesses because it is hard for them to obtain bank loans or raise capital in the public market.

Meanwhile, we observe that the limited partnership is the dominant business form for venture capital organizations in the U.S., given that it is "the single most important organizational innovation of the modern venture capital system"[104]. Moreover, the first major burst of VC activity in the U.S. was due to the pension fund entering as the limited partner. In this chapter, I will discuss the limited partnership form and its benefits for the purpose of innovation finance and at the same time its inherent flaws.

2.1 The Venture Capital Limited Partnership

2.1.1 The Limited Partnership Structure

Although other organizational forms are also possible,[105] venture capital organizations

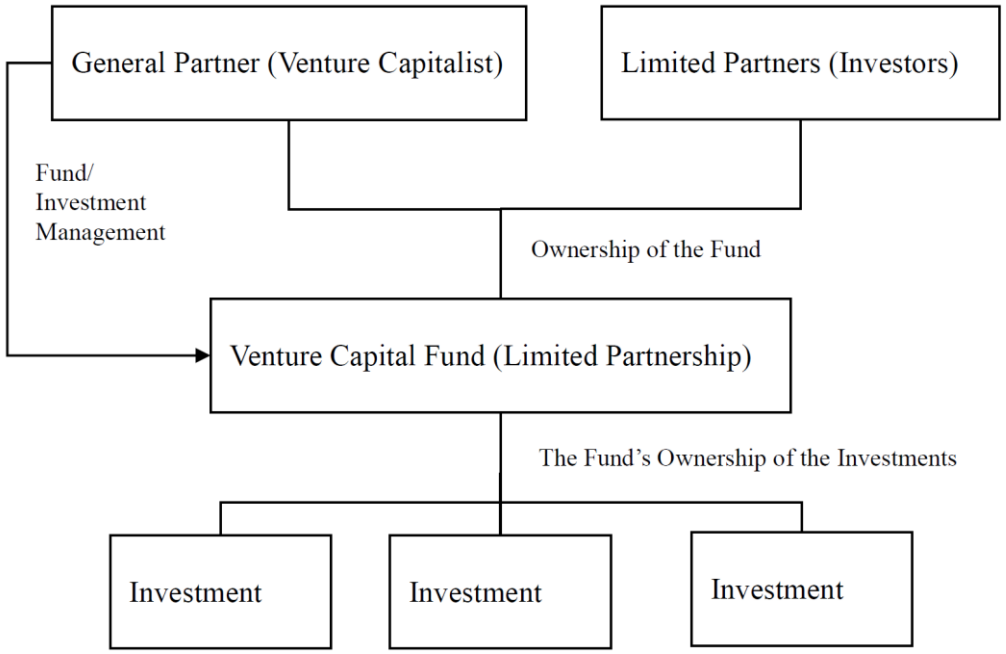
---

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

[105] For example, corporations may sponsor their own venture funds in the form of company subsidiaries. There is a series of literature on the topic of corporate venture capital. See, e.g. Paul Gompers & Josh Lerner, *The Determinants of Corporate Venture Capital Success: Organizational Structure, Incentives, and Complementarities*, *in* CONCENTRATED CORPORATE OWNERSHIP 17-54, (Randall K. Morck ed., 2000); Henry W. Chesbrough, *Making Sense of Corporate Venture Capital*, 80

in U.S. are typically formed as limited partnerships (Figure 6).[106] The venture capitalist serves as the general partner and the investors as the limited partners, often comprising institutional investors and pension funds, insurance companies, endowments and foundations.[107] In the United States, a limited partnership is governed under the Uniform Limited Partnership Act of 1916, with the most recent amendment in 2001. Customized versions of the law have been adopted by state legislatures throughout the country.

Figure 6 Structure of a Venture Capital Limited Partnership



The typical venture capital limited partnership has a finite lifespan, usually of around ten years, which is simply a matter of negotiation when drafting the limited

---

HARV. BUS. REV. 90 (2002).

106 See, e.g. William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 487 (1990); Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 252 (1998).

107 Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 248 (1998).

partnership agreement.[108] The key feature of the partnership is the prohibition of the limited partners from participating in management or control,[109] in exchange for the privilege of exemption from personal liability as to the debt of the partnership, only risking the funds they have invested.[110] The highlight of the limited partnership is the unique form of allocation of control, which makes "the limited partnership useful for firms, such as real estate and venture capital funds, where strong managers are vested with substantial discretion over funds of passive investors."[111]

In contrast to a general partnership, in which all members of the partnership act as principals acting on behalf of the partnership to make managerial decisions, only the general partner has the power to make daily management decisions in a limited partnership, and only the general partner bears the debts of the partnership. The limited partners are only passive investors who have very limited influence over the partnership; they have much less power than the shareholders of a close corporation.[112] They may serve as consultants and advisors to the general partners on committees for important issues regarding the conduct of the business or the partnership itself.[113] However, these powers are much weaker than those of the board of directors in a corporation.[114]

The decision-making power that the limited partners have given up brings with it full

---

108 See, e.g. Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 6 (1999); George W. Fenn et al., *The Economics of the Private Equity Market* 34 (Federal Reserve Board Staff Study, Working Paper No. 168, 1995).

109 Under Delaware Law, the limited partners can make some extraordinary decisions, such as replacing the general partner or terminating the partnership. See DEL. CODE. tit. 6, § 17-303(b)(8)(e) (2010). However, these rights are typically restricted by the partnership contract. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 249 (1998).

110 David Rosenberg, *Venture Capital Limited Partnerships: a Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 377 (2002).

111 Larry E. Ribstein, *Limited Partnership Revisited*, 67 U. CIN. L. REV. 953, 958 (1999).

112 *Id*., at 990.

113 See, e.g. DEL. CODE, tit. 6, §17-303(b)(2), (7) (2010).

114 David Rosenberg, *Venture Capital Limited Partnerships: a Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 380 (2002).

immunity from the debt of the partnership.[115] They are not responsible for the partnership debt and the only thing they are risking is their investments.

Since the majority investments in venture funds are from the investors, the general partner only invests a very limited amount of resources[116] but can gain almost complete control over the funds; indeed, this is a Berle-Means problem of separation of ownership and control.[117] Setting the scenario in public corporations, the Berle-Means theory states that the ownership and control of the corporation is separated, and the owners (shareholders) rely on the board of directors to represent their interest, and over time the boards become so dominated by the management that their supervisory role becomes ineffective, and the management gets the final say.[118] The venture capital limited partnership is not a public corporation, but it still faces such a problem, which will be discussed later this chapter.

2.1.2 The Venture Capital Cycle and the Reputation Mechanism

Venture capital investments have a curious cyclical nature. This cyclicality takes its form from "an implicit contract in which capital providers are expected to reinvest in future limited partnerships sponsored by successful venture capital funds."[119]

The venture capital cycle starts with raising capital from outside investors in a venture

---

115 This 'control rule' stated that the limited partners are not responsible for any debt of the partnership unless they behave like a general partner, participating in the control of the business. See DEL. CODE tit. 6, §17-303(a). However, it also provides several 'safe harbor' provisions for activities that are not exercising control of the business. See DEL. CODE tit. 6, §17-303(b).

116 If one treats the human capital contribution that the venture capitalists invest in the partnership, it is still less than 20 percent of the capital but receiving complete control. See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 249 (1998).

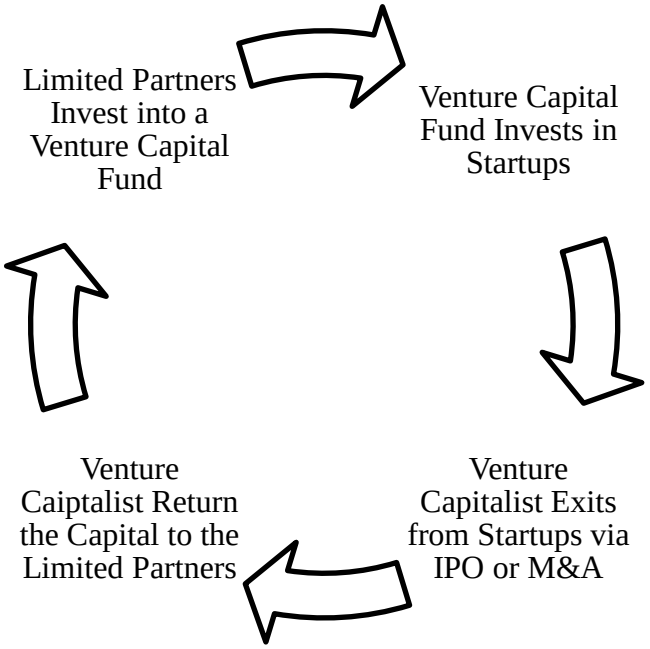
117 Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1071 (2003)

118 See ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

119 Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 256 (1998).

fund (the limited partnership), moves on through selecting, contracting, value-adding and monitoring of the portfolio companies, continues as the venture capitalist exits and returns capital to investors, and renews itself with the venture capitalist raising another round of funds (Figure 7).[120]

Figure 7 The Venture Capital Cycle



Source: author

For the entrepreneur seeking investment, a typical venture investment starts with screening and due diligence for potential investment projects and ends when the venture capital exits from the invested companies. However, for the venture capitalist, the venture activity starts with raising funds from outside investors. To complete the cycle, exits from successful deals are required to return capital to the investors; hence, the possibility exists for raising additional funds.

Furthermore, taking the venture capital organization structure into account, as

[120] Paul Gompers & Josh Lerner, *The Capital Revolution*, 15 J. ECON. PERSP. 145, 152; for a complete and detailed analysis of the venture capital cycle, see PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999).

previously discussed, most of the venture capital funds are organized as limited partnerships with a pre-defined lifetime, usually ten years. The venture capitalist must distribute returns to investors within that time.[121] If the venture capitalist wants to remain active in the business, he or she must periodically raise overlapping venture funds.[122] It is unlikely that the venture capitalist would engage in repeated deals with one particular entrepreneur, or the exact same set of investors, yet the reputation of his/her conduct will spread throughout the relatively concentrated venture investment community.[123] As limited partners, the investors do not participate in daily policy decisions. Therefore, it is difficult for them to evaluate the venture capitalist's ability through everyday performance. Accordingly, investors need other mechanisms to evaluate venture capitalists. The general partner's reputation, as revealed by a track record in terms of the performance of previous ventures, primarily the returns on investment, is the "principal tool for persuading investors to invest in successor funds."[124]

Theoretical and empirical research has shown the importance of reputation in raising capital.[125] For example, empirical evidence has shown that companies backed by more reputable venture capitalists are more likely to exit successfully.[126] Furthermore, the reputation of venture capitalists is positively related to the post-IPO performance

---

121 PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 240 (1999).

122 *Id.*

123 The community of venture capital funds is concentrated geographically. See, e.g. ANNALEE SAXENIAN, REGINAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 39-40 (1994) (significant percentage of U.S. venture capital funds are located in California); Josh Lerner, *The Syndication of Venture Capital Investments*, 23 FIN. MGMT. 16, 18 (1994) (venture capital funds concentrated their investments in portfolio companies geographically proximate to the fund's office). Should be mentioned earlier.

124 Ronald Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1090 (2003).

125 Research has also shown the importance of reputation in other types of funds. See Erik R. Sirri & Peter Rufano, *Competition in the Mutual Fund Industry*, 53 J. FIN. 1589 (1998) (by examining fundraising and investment patterns of various types of institutional fund managers, finding that past performance influences fundraising ability). Cite research on vc if possible.

126 Rajarishi Nahata, *Venture Capital Reputation and Investment Performance*, 90 J. FIN. ECON., 127 (2008).

of portfolio firms.[127]

Therefore, the reputation mechanism forms the whole venture capital investment process into an ever-revolving cycle. The venture capitalist's concern with maintaining a good reputation serves as a constraint mechanism to any possible opportunistic behavior, which may ultimately result in higher returns to the investors. Higher returns subsequently encourage the investors to reinvest in the general partner's successor funds. Therefore, the wheel turns and other innovative companies will receive funds from venture capital investments.

2.2 The Benefit of Limited Partnership Structure in Financing Innovation

2.2.1 The Direct Benefit and Cost of Personal Liability

When answering the question, "why is a limited partnership more suitable for innovation financing?" or rather, in a broader sense, "why are there so many forms of organization and what main purpose is served by alternative modes of economic organization?" transaction cost economic analysis seems appropriate. Based upon the idea that the transaction is the basic unit of activity for economic analysis,[128] transaction cost economics is concerned with the frictions that occur, whereby "the economic counterpart of friction is transaction cost".[129] Different transactions are assigned to various governance structures, which differ in their competencies in terms of economizing transaction costs.[130] Transaction cost economics adopts a contractual approach to the study of economic organizations, whereby any problem that can be posed as a contracting problem can be investigated in transaction cost economizing

---

127 C.N.V. Krishnan et al., *Venture Capital Reputation, Post-IPO Performance and Corporate Governance*, 46 J. FIN. QUANTITATIVE ANALYSIS 1295 (2011).
128 John R. Commons, *Institutional Economics*, 21 Am. Econ. Rev. 648, 652 (1931).
129 Oliver E. Williamson, Mechanisms of Governance 58 (1996).
130 *Id*., at 59.

terms. Thus, with a "nexus of contracts" view,[131] all institutional alternatives – from classical market contracting on one extreme to hierarchical organizations on the other, with mixtures of market and firm in between – can be assessed by adopting transaction cost economics theories.[132]

Thus, transaction cost theory can be applied in analyzing venture capital investments, which comprises two sets of contracts: the contract between the venture capital fund and the portfolio firms, as well as the contract between the venture fund and the investors. Moreover, the limited partnership is essentially the latter, with the venture fund manager acting as the general partner and the investors as the limited partners. Compared to other intra-partnership features that the limited partnership statutes provide, the parties would first consider the liability features. The reason is that the partners would have to enter into a separate agreement for each transaction to determine personal or limited liability, whereas if the liability feature is already chosen and fixed, other contractual terms among the partners will be easier to draft.[133]

The general partner's personal liability is the distinguishing feature of limited partnerships in comparison with corporations. It is therefore important to understand the benefits of personal liability when answering the question of why organizations choose a limited partnership over corporations as a business form.

One direct benefit of personal liability is that the general partner would have the incentive to avoid excessive risk-taking decisions by putting personal assets at risk. If the general partner is not personally liable for business debts, risky projects may be

---

131 Major contributions to the view in the far-too-extensive literature include Ronald Coase, *The Nature of the Firm*, 4 Economica 386 (1937); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 1 (1983); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & Econ.1 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 233 (1983); Oliver E. Williamson, The Economic Institutions of Capitalism (1985).

132 Oliver E. Williamson, The Economic Institutions of Capitalism 42 (1985).

133 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 840-41 (1988).

undertaken that are against the investors' interests. While monitoring of the manager by creditors may reduce such risk, it cannot duplicate the incentive effects of risk-taking induced by personal liability.[134] The investors would arguably have the incentive of monitoring the manager's decision, since they lose their investment first;[135] however, substantially reducing risk not only requires a fundamental review of each project, but also keeping track of the execution of the decision.[136]

Although the general partner's personal liability and guarantee of the partnership debt would reduce the risk of projects undertaken and the creditor's monitoring costs, other cost may incur due to personal liability.

From the limited partner's perspective, the personally liable general partner may be too risk-averse. Unlike a general partner, limited partners can diversify their risk. Thus, the risk avoidance nature of the general partner may cause a divergence of interests between the general and the limited partners. For example, the general partner may retain earnings even if it is optimal to distribute them to the investors, or may turn down projects that would be risky to the creditors but favorable to the limited partners.[137] Therefore, analyzing the direct benefit and cost of personal liability alone cannot reveal the true benefit of limited partnership in venture capital investing.

2.2.2 The Entrenchment of Management

Derived from the liability feature, another important aspect of the limited partnership is the relatively fixed position of the general partner. Compared to a corporate manager, the general partner of a limited partnership is more insulated from

---

134 *Id*., on 848.
135 Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 99 (1985).
136 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 848 (1988).
137 *Id*.

removal.[138]

Because the general partner guarantees the debts of the partnership, the removal of a general partner will result in the loss of this guarantee. This guarantee is a basic element of the limited partnership and the partnership must continue, as a legal requirement, to have at least one general partner. If the guarantee is lost, the limited partnership would either dissolve or replace the removed partner. Even if there is more than one general partner, the removal of one would have significant effects on those remaining. It would be a huge risk to the remaining general partners and consequently they may demand rights to block the removal of other general partners. The loss of the guarantee may also affect creditors, who may insist on covenants with penalties or acceleration of the debt. In any event, the removal of the general partner may result in an increase in the cost of debt.[139]

The entrenchment of the general partners results in the separation of ownership and control. The general partner is simultaneously the manager, and the power to manage includes the power to make decisions concerning the disposition of business assets.

This separation of ownership and control can be beneficial; for example, it can minimize the owner coordination problem and prevent the sale of the business for a lower price resulting from dispersed owners accepting offers lower than their own valuation. The reason is that each of the owners fears either being left with an illiquid investment and the fellow owner's tender at a lower price or facing a take-it-or-leave-it situation due to a lack of negotiating power.[140]

---

138 For a general discussion of removing the general partner, see Janet L. Eifert, *Removal of General Partners: A method of Intrapartnership Dispute Resolution for Limited Partnership*, 39 Vand. L. Rev. 1407 (1986); Kenneth Hooker, *The Power of Limited Partners to Remove and Replace the General Partner of a Limited Partnership*, 19 Tex. Tech. L. Rev. 1 (1988).

139 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 850 (1988).

140 *Id*., at 851.

The entrenchment of management can also prevent the sale of the asset at a price that does not fully reflect the information concerning the business. Costs would occur when an outsider tries to acquire information about the company, given that the cost of processing and verifying information may remain high even if basic information is voluntarily disclosed by the company. Accordingly, it is difficult for the owners to determine whether an offer reflects current information concerning the business. Given that the entrenchment detaches the power to change business assets from ownership interests, the bids addressed to owners will simply be refused, thus preventing the sale of assets that do not have a proper information value.[141]

2.2.3 The Net Benefit of Limited Partnership in Financing Innovation

Choosing the form of limited partnership can be a net benefit for some firms as compared with incorporation. Transaction cost analysis is used again in explaining the reason why venture capital funds would choose such a business form in the world of financing innovation projects.

2.2.3.1 Risky Investments

By its nature, innovation poses a conflict between generating usable results and massive blue-sky experimentations behind the scene. The most frequently encountered risks associated with innovation include project failure, excessive costs and time over-run. Consequently, as previously discussed, an obvious problem in the transformation process of an innovative idea into a realizable project is the lack of capital. While venture capital can somewhat mitigate this problem by raising capital from outside investors, the high asymmetry of information and uncertainty mean that the return of the investment will be earned upon the successful completion of the

---

141 *Id*., at 854.

investment rather than through ongoing dividends.[142]

Under such circumstances, the limited partnership approach may be a better option than the leveraged corporation form, in which the shareholders will require ongoing dividends. With the entrenchment of the management, managers have greater flexibility to hold on to the potential of projects, while the investors as the limited partners are more patient.[143] Therefore, businesses with high risk, potentially high reward and unpredictable earnings streams – features common to most innovative projects – would prefer the limited partnership form over incorporation.

Take the American Research and Development Corporation (ARD)[144] as a counter-example. ARD was structured as a publicly-traded closed-end investment fund, which is a mutual fund whose shares trade among investors on an exchange like an individual stock. The fund raised capital by selling its shares and investors could sell the shares to other investors if they no longer wanted to hold the investments. Such a structure encountered significant drawbacks when investors demanded high current income rather than long-term capital gain,[145] pressuring ARD's management to generate a steady stream of cash. Requiring dividends from early-stage firms would be difficult since they consume capital to fund the growth, and the risk of failure is increased if cash is immediately extracted from them. ARD had to deal with this dilemma by selecting investment types which could generate a steady stream of return, while venture capital limited partnerships did not face such a problem.[146]

---

142 Tereza Tykvova, *What Do Economists Tell Us About Venture Capital Contracts?*, 21 J. Econ. Surveys 65, 66 (2007).

143 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 858 (1988).

144 The first true venture capital firm of the U.S. – the American Research and Development Corporation (ARD) – began to operate in 1946, organized as a public corporation, unlike the modern VC funds.

145 Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. Econ. Persp. 145, 146-47 (2001).

146 David H. Hus & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946-1973*, 14 Indus. Corp. Change 579, 606-08 (2005).

3.2.3.2 Hostile Takeover Defense

Investors would prefer continuity of management if there are alternative mechanisms to deal with agency costs other than the market for control.[147] For less mature businesses like innovation ventures, a stable management would be particularly beneficial. As previously discussed, the venture capitalist as the manager also provides additional value-adding services for the healthy growth of the innovative firms. The entrepreneur who receives these services would be left in doubt if the contents of the services such as business strategies would change due to change of the management. In a limited partnership, the personal liability of the manager constrains the corporate raiders, because if the bidder wants to buy the partnership, besides the payment for the ownership interest, the bidder must also be personally liable for the debts incurred after the takeover. When investing in businesses that involve high risk, the bidder would less likely be willing to bear personal liability. Thus the partnership is protected from hostile takeovers.

Further, under a standard corporate form, it is commonly considered that the shareholders have a basic right to make fundamental corporate decisions. If the management prevents a takeover from happening, this could raise doubt in court if it came to litigation.[148] In a corporation, if it is a shareholder approved takeover defense scheme, it would be less subject to attack than a management approved one. In a limited partnership, limited partners have much less control than shareholders in corporations, given that they would otherwise lose the protection of limited liability.[149] Investors therefore might prefer to choose limited partnership as a means to seek takeover protection, because it is a safer way for the partnership management

---

147 Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. Chi. L. Rev. 119, 137 (1987). The alternatives to market of control will be discussed later.

148 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 860 (1988).

149 The market of control in limited partnership will be discussed later.

to resist a takeover. Therefore, the limited partnership form is less subjected to constraints of managerial control and more convenient for blocking hostile takeovers.

3.2.3.3 Firm-Specific Human Capital of Managers

Besides the lack of capital for entrepreneurs engaging in innovative activities, a lesser yet nonetheless essential problem is the lack of managerial expertise. Venture financing offers a joint provision of capital and managerial experience. Venture capitalists usually play an active role in offering advice, making decisions and providing managerial resources such as contacts to lawyers and consultants.[150] In the course of such engagement with the portfolio firms, the venture fund managers may develop skills and knowledge that hold specific value for the fund.

With entrenchment, the limited partnership form can protect the firm-specific human capital of the managers.[151] Firm-specific human capital is special and unique and has higher value within the firm than it would have if redeployed outside the firm.[152] If the firm is easily exposed to hostile takeovers or cannot provide sufficient compensating salary schemes, the managers would not have the incentive to make invest in human capital, given that the investment would be lost if they lost their jobs.[153]

Compared to limited partnership venture funds – which provide superior compensation possibilities for the professionals[154] – ARD's professionals were only

---

150 Tereza Tykvova, *What Do Economists Tell Us About Venture Capital Contracts?*, 21 J. Econ. Surveys 65, 66 (2007).

151 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835, 855 (1988).

152 For a general discussion of asset specificity, see Oliver E. Williamson, The Economic Institutions of Capitalism 52 (1985).

153 See, e.g. Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807, 812 (1987); Harry DeAngelo & Linda DeAngelo, *Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock*, 14 J. Fin. Econ. 33, 35 (1985).

154 Compensation of the venture capitalist will be discussed in the later chapters.

compensated with wages and bonuses. As a closed-end investment company, ARD was subject to SEC regulation under the Investment Company Act of 1940, which prohibited investment firm personnel from receiving equity or options from their portfolio companies.[155] Given that investment in innovative projects matures slowly, the salaries of ARD professionals were below market rates, which severely damaged the competitiveness of ARD.

The above analysis has shown that for firms engaged in high-growth and high-risk projects such as venture capital funds, the unique feature of management entrenchment that derives from personal liability has rendered the business form of limited partnership a particularly beneficial choice. However, the potential agency cost resulting from conflicts between the manager and investors cannot be overlooked.

2.3 The Cost of the Limited Partnership Structure

2.3.1 Agency Conflicts between the Venture Capitalist and the Investors

Given the unique structure of the limited partnership, investors cannot have significant control over the assets or management of the partnership. Furthermore, as discussed in previous sections, the general partners as management have a relatively fixed position, therefore venture capital partnerships potentially raise an agency problem between the venture capitalist and the passive investors.

An agency relationship can be seen as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform certain tasks on their behalf, delegating a certain level of decision-making power to the agent.[156] The

---

155 David H. Hus & Martin Kenney, *Organizing Venture Capital: the Rise and Demise of American Research & Development Corporation, 1946-1973*, 14 Indus. Corp. Change 579, 608-09 (2005).

156 Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. FIN ECON. 305, 308 (1976).

central problem in agency relationships is that the principals cannot monitor the agent's performance without any cost. The agent has better information about the nature of the assigned task compared with the principals, and due to this information asymmetry their interests may not be aligned. In a world without costless information, it is generally impossible for the principal to ensure that the agent will make optimal decisions, from the principal's viewpoint, at zero cost.[157]

By investing through the limited partnership rather than directly in entrepreneurial firms, investors as principals delegate powers to the general partner as the agent to perform a series of tasks throughout the venture investment process. The agency problem between the limited partners and the general partner in the venture capital industry can be particularly difficult due to a high degree of information asymmetry.[158] Some obvious ways in which general partner further their own interests at the expense of limited partners may include exerting insufficient effort in advising portfolio firms, charging excessive management fees and taking undue investment risks.[159]

2.3.2 The Market for Control

One possible mechanism for restraining the management from shirking and lower the agency cost is the market for control. Following the ground-breaking work of Henry Manne,[160] it is now commonly acknowledged that the market for corporate control is an important mechanism to constrain management's discretion against the interest of the shareholders. In fact, it may be the only potentially serious force other than the

---

157 *Id.*

158 William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 493 (1990).

159 George W. Fenn et al., *The Economics of the Private Equity Market*, Federal Reserve Board Staff Study No. 168, 35 (1995).

160 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

law for limiting management discretion.[161] In corporations, the shareholder management relationship is in fact a kind of principal agent relationship. It would be useful for the agency cost in limited partnerships if a market for control were also to exist.

The theory posits that the price of the company's stocks would decline if there were a reduction of the company's profitability. The poor performance of a company's securities in the capital market is a common indication of poor management.[162] Whether due to the management being inefficient or to it acting too divergently from the interest of shareholders, the lower the market price of the shares, the more attractive the firm is to outsiders for a takeover attempt. The potential purchasers believe that they can manage the target firm more effectively than the current management team after restructuring. On the other hand, fearing they would be replaced if control of the company changes, the management would perform more efficiently. Thus, with the threat of takeover, the market control mechanism can align the interests and goals of the management and the shareholders.

Two conditions are necessary for this constraint mechanism to function properly. First, the market price of the company's stock must accurately reflect the performance of the company's management. This condition accepts the efficient capital market hypothesis. While little debate remains concerning the market condition due to the formidable evidence supporting the theory,[163] it is the second condition that needs to be fulfilled, namely the possibility of removing the current under-performing management.

---

161 Ronald J. Gilson, *A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841 (1981).

162 Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5 (1978).

163 Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96 (1978) ("[T]here is no other proposition in economics which has more solid empirical evidence supporting it than the efficient market hypothesis.").

2.3.3 Shielding from the Market for Control

There are four general mechanisms for displacing incumbent management: a merger, a sale of assets, a proxy fight and a tender offer.[164] Both merger and sale of assets require shareholder approval, although if the incumbent management opposes the transaction, the shareholders would have no chance to consider it.[165] As the proxy fight is unattractive both economically and legally,[166] the tender offer remains the only mechanism that has an effective constraint on self-serving management behavior.

Directly addressed to the shareholders, a tender offer can be conditioned on receiving sufficient shares for control and other terms, such as the offer price, the opening time of the offer and withdrawal rights. For example, if the target company's stocks trade at $10 per share, the bidder might offer $11 per share to shareholders on the condition that 51% of the shareholders agree to sell. The tender offer is crucial because no other displacement mechanism is available without management cooperation.[167]

To avoid being displaced from tender offers and other takeover actions, in corporations, the managers need to employ all sorts of defensive tactics to make the takeover more difficult in order to shield themselves from the market for corporate control; for example, to adopt contractual provisions that depend on the continuation of the management or create supermajority approval requirements. However, these defensive tactics seem repugnant to the most basic principle of corporate democracy,

---

164 Ronald J. Gilson, *A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 842 (1981).

165 Peter Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105, 105 (1980); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1437 (1964).

166 Ronald J. Gilson, *A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 843 (1981); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 6-7 (1978).

167 Ronald J. Gilson, *A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 846 (1981).

as previously discussed: it is the power of the shareholders to decide a corporation's fate. In fact, courts may strike down management-approved takeover defenses.[168]

By contrast, these problems would not exist in a limited partnership. First of all, limited partnerships are closed entities that are not publicly traded in the market; second, as previously discussed, the structure of the organization has determined that the management is naturally shielded from the market for control. Given that the general partner is both the owner and manager, the personal liability that he or she bears prevents an outsider from taking over the company. In addition, in the world of financing innovation, it is beneficial to take limited partnership as an organizational form, and it is even harder to remove the management through takeovers. In fact, the absence of market for control exacerbates the principal agent problem between the venture capitalist and the investors, since the position of the venture capitalist (general partner) as the management is relatively fixed, and the threat of losing one's job for poor performance is much less pressing.

---

[168] *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984).

Chapter 3 Solutions to the Agency Problem in the US

Given the nature of venture capital investments, as previously discussed, limited partners (investors) in a venture capital limited partnership fund have a clear information disadvantage over the general partners. Further, the agency cost between these two parties is severe without the market for control. In this chapter, I discuss two legal solutions in the US which mitigate such problems. One possible legal solution would be for the conflicting parties to use the contract to arrange their rights and duties, set out covenants and obligations for conduct that breach, and compensation schemes that provide proper incentives. Another possible solution to such an agency problem is to impose duties by law on the acting agents not to deviate from the interests of the principal.

3.1 The Limited Partnership Agreement

3.1.1 Covenants in the Venture Capital Limited Partnership

Transactions that are subject to repeated bargaining problems can be governed by long-term contracts, and the terms and conditions of the contracts are critical to limiting opportunistic behaviors between the parties.[169] In venture partnerships, the limited partners have very limited recourse to the funds raised, while terms and conditions in the partnership contract could serve as remedies to limit the general partner's opportunistic behaviors.[170] The oversight mechanisms found in corporations – such as the market for corporate control – are not available in venture partnerships.

---

169 See, e.g. Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. ECON. 297 (1978); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. ECON. 233 (1979).

170 PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 30 (1999).

Consequently, the primary remedy for the limited partners consists of legal actions triggered by the violation of covenants.[171] The covenants can generally be grouped into three categories, each of which addresses a distinct agency issue.[172]

3.1.1.1 Covenants Relating to the Overall Fund Operation

Since the investors cannot interfere in monitoring the day-to-day operations of the fund, contractual restrictions regarding fund operation are very important. First, there are restrictions concerning the size of the investment in any one firm. This limitation is usually expressed as a maximum percentage of the fund capital that can be invested in any one firm. These provisions prevent the general partner from investing significant amounts of resources into one firm, thus increasing risk at the expense of diversification, because the fund manager might lower the effort cost associated with diversifying the investment portfolio and extend one investment disproportionately.[173]

Second, there are restrictions on the use of debt. The general partner may be tempted to increase the fund's return on capital by increasing leverage. Given that the venture capitalist's share of profits can be considered a call option,[174] borrowing money and leveraging the investment would increase its value while increasing the risks.

---

171 *Id*., at 29.

172 This part is developed from the works of Gompers and Lerner in 1999 and Cumming and Johan in 2009. The former is based upon data collected from 140 limited partnership agreements in the U.S., while the latter modifies it with a more up-to-date covenant reflecting the structure of the fund in other countries, through guidance from professionals and interviews with fund managers. See PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 37-41 (1999); DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 94-98 (2009). However, the analysis here tries to clarify some entanglements of the two works and provide a standard for later comparison.

173 Paul Gompers and Josh Lerner，*The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 29 J.L. ECON 463, 480 (1996).

174 The general partner's performance-based compensation can be viewed as a fraction of a call option with the strike price equal to the cost base and the time to maturity equal to the life of the fund. See, e.g. William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 496 (1990); George W. Fenn et al., *The Economics of the Private Equity Market*, Federal Reserve Board Staff Study No. 168, 40 (1995).

Third, many venture capital firms manage multiple funds, which formed simultaneously or several years apart. This can lead to opportunistic behavior because the fund manager may have an incentive to bail-out the poorly-performing investment at the expense of the newly-raised fund. Consequently, the co-investment by other funds that are managed by the fund manager would be restricted and the contract would require a majority/supermajority from the limited partners to approve these transactions.

Fourth, there are covenants related to the reinvestment of profits. The manager may reinvest the capital gains into new projects rather than distributing them to the investors for several reasons. Many venture partnership managers receive fees based upon the value of assets under their management; distributing profit would thus reduce these fees. The reinvestment of the profits into new projects that cannot be sufficiently mature to be liquidated may prolong the life of the partnership and thus continue to generate fees for the general partner. Moreover, the manager may want to achieve as many IPOs as possible to pursue fame rather than fortune. As a result, the reinvestment of profits would require approval from the limited partners.

Besides the aforementioned, there are also covenants designed to ensure the smooth operation of the funds. For example, there are covenants concerning the overall ability of the management, the disclosure of the fund activities to investors and the ability of the limited partners to vote to remove the manager without cause.

3.1.1.2 Restrictions on the General Partner's Activities

The first restriction limits the power of the general partner to invest his or her personal funds, because there would be a potential conflict of interest whereby the manager could devote excessive time to the firms in which he or she had personally invested, subjecting the entire portfolio to the risk of exerting less effort. Furthermore,

the manager may choose not to terminate funding if the firms in his or her own fund perform poorly. The size of the investment that the general partner can make in portfolio firms without seeking consent from the limited partners is usually restricted to a percentage of the fund's total capital.

The second area of restrictions addresses the problem of selling partnership interest by the general partner. Although not comparable to the limited partners' investments in the fund, the general partner's share could still be an attractive investment option. Outside investors may then acquire such a stake, making the general partner's stake in the partnership smaller. By bringing in additional investors, the interest of the current investors of the partnership might be compromised and the general partner's incentive to monitor the investments might be reduced. The partnership agreement may prohibit the sale of partnership interest or require consent from the limited partners.

Another restriction related to the aforementioned is that the partnership agreement limits the general partner's outside activities. Similarly, since outside activities are likely to reduce the attention that the general partner pays to the fund investments, he or she may be required manage the fund investments full-time and exclusively.

The fourth restriction concerns the general partner's power to raise new funds. It is possible that raising a new fund may reduce the attention paid by the general partner to existing funds. The general partner has an incentive to raise new funds because this would increase the management fee. The partnership agreement may prohibit new fund-raising until a certain percentage of the portfolio has been invested or the fund-raising may be restricted to a certain size or focus.

The fifth restriction is related to the personnel of the general partner and the management. The partnership agreement may ask for approval from the limited partners for the inclusion of new general partners, given that adding new general partners may reduce the burden on current ones while simultaneously reducing the

quality of the monitoring. There may also be key person provisions because the investors want their money to be managed by specific people with whom they have contracted.

3.1.1.3 Covenants Regarding the Type of Investments

It is often set out in the partnership agreement that the venture fund is only allowed to invest a certain percentage of the capital in a given investment class. These covenants restrict the types of investment made by the general partner. It is possible that without these restrictions, the fund manager may pursue investment strategies that are personally favorable. For example, the general partner may receive inappropriately large compensation by investing in a certain asset class, or may choose investments in which he or she has little expertise in the hope of gaining more experience. The general partner may engage in these activities regardless of the interest of the limited partners, and the covenants are designed to ensure that the investments are consistent with the limited partners' desired risk and return profile.

The aforementioned covenants are most frequently used in a limited partnership agreement. The purpose of these covenants is to mitigate the potential for agency problems associated with the venture fund manager's investing limited partners' capital. It is extremely important for the restrictive covenants to properly assign rights and obligations to the parties and to align their interests.

3.1.2 Compensation of the General Partner

3.1.2.1 Compensation Structure

The general partner's compensation structure is another important mechanism to respond to the potential agency costs resulting from the lack of market control of the general partner's behavior. The general partner is usually compensated with a two-

part fee, comprising a fixed management fee of around 1-3% of the committed capital and a performance fee typically set at 20% of the profits realized by the partnership.[175]

The management fee itself consists of two parts, namely the base (the base of management fees can be either the committed capital or the "managed capital" – measured as the cost basis of undistributed and unliquidated securities – or some combination of such) and the portion paid to the general partner.[176] The base and the portion can be constant or vary over time, although it does not depend on the profitability of business decisions of the general partner; therefore, the management fee can be seen as risk-free.[177] Since the venture investments are illiquid before exit events, the risk-free management fee should sufficiently meet operational needs prior to funding liquidity events before any profits are earned.[178]

The performance fee aligns the incentives of the general partner and the investors. This performance fee – also called a carried interest – is the primary return to the general partner. The carried interest is normally measured as a flat percentage of the fund's profits and is distributed to the general partner when realized profits are distributed to the limited partners.[179] The general partner's earnings are proportional to those of the investors and thus the compensation structure aligns the general

---

175 There is a uniformity in the financial interest of the general partner in the U.S. venture fund. See, e.g. William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON. 473, 491 (1990); Paul Gompers & Josh Lerner, *An analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON 3, 6 (1999); ANDREW METRICK & AYAKO YASUDA, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 30 (2nd ed., 2006); Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 169-75 (2009).

176 See a detailed description based upon analysis of partnership agreements of 68 venture capital funds in the U.S. by Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 169 (2009).

177 *Id.*

178 DOUGLAS CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING 131 (2009).

179 Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089 (2003)

partner's interest in the fund's success with that of the investors.

Unlike an incentive performance fee, the general partner also faces clawback provisions.[180] A clawback provision means that the performance fee paid to the fund manager may be delayed or retained in some portion, for the purpose of lowering the risk faced by the investors in the event of poor performance. If not held back, the performance fee might give the general partner an incentive to realize profitable investments prematurely before unprofitable ones.[181] For example, without clawback provision, the manager gets 20% of the profit of the first investment which is profitable, and the fund may lose money on the second investment. If the manager has kept the whole performance fee from the first investment, there would be an incentive to realize the first investment before it matures and then, regardless of the second investment, thus actually receive more than 20% of the total profit.

It is also important to consider the investors' compensation. Apart from the cash or share distribution after an exit, the limited partnership agreement may include provisions for mandatory distribution to the limited partners.[182] This is because the general partner's option-like interest may cause him or her to prefer riskier investments than the investors, especially for later investments when the earlier ones have performed poorly.[183] Moreover, since the general partner receives a fixed fee of a certain percentage of the committed capital, there would be an incentive to keep the capital within the fund or reinvest the profit realized by prior investments.[184] The

---

180 See, e.g. George W. Fenn et al., *The Economics of the Private Equity Market* 39 (Federal Reserve Board Staff Study Working Paper No. 168, (1995); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089 (2003); DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 131 (2009).

181 Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089 (2003).

182 *Id*.

183 See *supra* text accompany n.154.

184 Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1090 (2003).

limited partners' mandatory distribution ensures that profits must first be returned to the investors. Furthermore, the fixed term of the venture fund assures that the management's performance will be measured at some point, which can help the limited partners to assess the ability of the general partner and allow them to decide whether the general partner should be kept managing their fund.[185]

3.1.2.2 Compensation Variation

Although the typical fixed fee and the carried interest appear to be quite homogeneous in the industry, there remain distinct differences in compensation across funds.[186] These variations indicate that the compensation schemes reflect the agency concerns between the general partner and the investors.

Empirical evidence collected from different data sets suggest that fund managers with little relevant experience are more likely to have higher fixed fees and lower carried interest percentages, whereas more experienced ones have a larger carried interest, resulting in greater performance sensitivity.[187] These findings support the "learning model", in which the investors do not know the ability of the venture capitalist when raising the first fund. However, the investors would have better information about the general partner in the subsequent second fund since the information about general partner's ability is verifiable through the previous fund's performance.[188]

---

185 See Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, NBER working paper 9807 (2003) (explaining that better (worse) performing partnerships are more (less) likely to raise follow-on funds and larger funds).

186 E.g. in Gompers and Lerner's sample, the carried interest percentage ranges from 0.7% to 45%. See Paul Gompers & Josh Lerner, *An analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON 3, 14 (1999).

187 See, e.g. Paul Gompers & Josh Lerner, *An analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON 3 (1999); DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 131 (2009); David T. Robinson & Berk A. Sensoy, *Do Private Equity Managers Earn Their Fees? Compensation, Ownership and Cash Flow Performance*, NBER Working Paper No. 17942 (2012).

188 Paul Gompers & Josh Lerner, *An analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON 3,7 (1999).

The learning model implies that, from the time series difference perspective, the sensitivity of compensation to performance is higher in the second fund, since in the first fund the general partner has an incentive to work hard to establish a reputation and incentive for a potential for higher compensation. However, in the second fund, when the reputation is established, an explicit incentive in the form of high pay-for-performance sensitivity is needed to induce effort from the general partner.[189] With respect to cross-sectional differences, the pay-for-performance sensitivity of compensation schemes would be higher for the large and established venture organizations compared to the small and young ones.[190] Funds focused on investing in high-tech industries and the earlier stage of research and development projects are more likely to have higher performance fees to incentivize the general partner, since agency problems are more severe in the funds engaged in such investments.[191]

Overall, the empirical evidence can show that compensation is largely unrelated to the cash flow performance of the funds;[192] rather, the compensation schemes in the venture funds reflect agency concerns.[193]

In conclusion, the limited partnership agreement addresses areas of conflict between the venture capitalist and the non-managing limited partners through covenants, and the compensation system is structured to incentivize the venture capitalists to work hard. Therefore, the general partner's attitude can be aligned with the interest of the limited partner through both negative and positive stimuli.

---

189 *Id*., at 7-8.

190 *Id*., at 8.

191 DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 133 (2009).

192 David T. Robinson & Berk A. Sensoy, *Do Private Equity Managers Earn Their Fees? Compensation, Ownership and Cash Flow Performance*, NBER Working Paper No. 17942, 1 (2012).

193 See, e.g. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1087-89 (2003) (explaining that the limited partnership contract is designed to respond to agency costs); Ulf Axelson *et al*., *Why are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. FIN. 1549, 1570 (2009) (the financial structure minimizes agency conflicts between fund managers and investors).

3.2 Fiduciary Duties in the United States

In Anglo-American law, fiduciary duty is one of the core legal concepts to address the agency problem. Courts and case law play an important role in developing and refining the concept of fiduciary duty. According to case law, in limited partnerships, the general partner owes fiduciary duties to the limited partners.[194]

3.2.1 General Principles of Fiduciary Duties

The concept of a "fiduciary" originated in equity. It is derived from the term "use", which is the early term for today's trusts. The use came from the arrangement in thirteenth century medieval England whereby land was allowed to be held on behalf of religious orders who were to have no wealth at all.[195] Later, in the fourteenth century, the use was employed by landowners to avoid feudal inheritance rules by effectively willing the land to a group of joint tenants who would convey the land according to the landowner's direction after his death.[196] England's chancery courts began to formally enforce uses as they became popular and followed broad principles such as "the rules of equity and good conscience" with words such as "trust" and "confidence".[197] A breach of trust or confidence was used to describe various situations involving what are today considered to have features of trust/trustee relationships, such as agents, advisors and guardians.[198] Gradually, descriptive words like "confident" gave way to more precise terms and the term "trust" was recognized as a formal term with its technical meaning.[199]

Fiduciary is a rather vague term; indeed, it appears in many legal contexts, such as

---

194 E.g. Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981).
195 Frederic W. Maitland, EQUITY: A COURSE OF LECTURES ON EQUITY 24-25 (2nd ed., 1969).
196 *Id*., at 25-28, 30-31.
197 *Id*., at 7-8; L. S. Sealy, *Fiduciary Relationships*, 20 CAMBRIDGE L.J. 69, 70 (1962).
198 L. S. Sealy, *Fiduciary Relationships*, 20 CAMBRIDGE L.J. 69, 69 (1962).
199 *Id*., at 70-71.

contracts, agents, partners, trusts, wills, etc.[200] It means "one who must exercise a high standard of care in managing another's money or property".[201] One party, such as an asset manager, acts in a fiduciary capacity to the other, who entrusts funds to the fiduciary for safekeeping or investment, for example.

Courts create fiduciary duties with three elements: first, they define the functions that the fiduciaries are expected to serve; second, they determine the powers entrusted in the fiduciaries to perform these functions; and third, they define the regulatory regime for the particular case in light of these functions and powers.[202]

Fiduciary duty is a duty of utmost good faith, trust, confidence and candor owed by a fiduciary to the beneficiary, representing the highest degree of honesty and loyalty towards another person.[203] Fiduciary duties fall into two broad categories: the duty of loyalty and the duty of care.[204]

Fiduciaries may not create situations in which their interests conflict with those of their principals. This lies at the core of the duty of loyalty.[205] The duty is limited to the power entrusted in fiduciaries for performing their services, restraining them from converting the entrusted power for unauthorized uses.[206] For example, in the trust-

---

200 See D.W.M. WATERS, THE CONSTRUCTIVE TRUST: THE CASE FOR A NEW APPROACH IN ENGLISH LAW 4 (1964); Tamar Frankel, *Fiduciary Duties,* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW vol.2 127 (Peter Newman ed., 1998); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795 (1983).

201 BRYAN A. GARNER ED., BLACK'S LAW DICTIONARY, 640 (7th ed).

202 The Supreme Court of the U.S. stated that "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry: To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" See *SEC v Chenery Corp*., 318 U.S. 80, 85-6 (1943).

203 BRYAN A. GARNER ED., BLACK'S LAW DICTIONARY, 523 (7th ed).

204 See, e.g. Tamar Frankel, *Fiduciary Duties,* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW vol.2 127 (Peter Newman ed., 1998); Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605 (1987).

205 Duty of loyalty means a person's duty "not to engage in self-dealing or otherwise use his or her position to further personal interests rather than those of the beneficiary". See BRYAN A. GARNER ED., BLACK'S LAW DICTIONARY, 523 (7th ed); see also Boger A. Clapp, *A Fiduciary's Duty of Loyalty*, 3 MD. L. REV. 221, 221-222 (1938); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 809 (1983).

206 Tamar Frankel, *Fiduciary Duties,* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE

related case *Magruder v. Drury*, the courts stated that "it is a well settled rule that a trustee can make no profit out of his trust … The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity."[207] In the law of corporations, the directors have a duty of loyalty. In *Guth v. Loft*, the Delaware Supreme Court held that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their interests…[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest".[208] In general, the duty of loyalty requires the fiduciaries to segregate entrusted assets and provide their principals with information and accounting;, they must not compete with their principals.[209]

The duty of care requires fiduciaries to perform their services with the care and skill that can be reasonably expected in particular situations.[210] Like the duty of loyalty, the duty of care also emerges from the possibility that principals may choose not to enter into the fiduciary relationship for fear of a very high cost of monitoring the fiduciaries.[211] However, unlike the duty of loyalty, the duty of care is a negligence concept and the lesser fiduciary duty, which is imposed when there is a suspicion of conflicting interests yet without proof.[212] Agents are generally subject to liability for failure to exercise care under the law of agency and the law of malpractice.[213] For example, the Restatement of Agency provides that "an agent has a duty to the

---

LAW vol.2 127, 129 (Peter Newman ed., 1998).

207 Magruder v. Drury and Maddox, Trustees, 235 U.S. 106, 119 (1914).

208 Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

209 Tamar Frankel, *Fiduciary Duties,* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW vol.2 127, 129-130 (Peter Newman ed., 1998).

210 *Id*., at 130.

211 *Id.*

212 See *id*.; Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 945 (1990) (The duty of care is under the general heading of negligence); William A Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 183 (2005) (Argues that due care is not a fiduciary duty).

213 Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 948 (1990).

principal to act with the care, competence, and diligence".[214] Corporate directors owe a duty of care to their corporation and its stockholders; for instance, in *Briggs v. Spaulding*, the Supreme Court stated that directors should be held to the standard of action expected of "ordinary prudent and diligent men".[215] Generally, the duty of care relates to the fiduciaries' decision-making process, it requires them to gather and follow up information, pay attention before making a decision and make reasonable decisions, as well as using their skills in the decision-making process.[216]

3.2.2 Fiduciary Duties in a General Partnership

Partners have long been characterized as fiduciaries: as Judge Cardozo pronounced in *Meinhard v. Salmon*, "[j]oint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty."[217] Indeed, the law of partnership reflects the broader law of agency,[218] under which every agent is a fiduciary.[219]

A partnership is a "voluntary association of two or more persons who jointly own and carry on a business for profit".[220] The unique feature of a partnership relationship is that each partner is both a principal and an agent, "for he has the property, authority and confidence of his co-partners, as they do of him. He shares their profits and losses and is bound by their actions. Without the protection of fiduciary duties, each is at the others' mercy."[221] Partners must act fairly with loyalty and fidelity in their mutual

---

214 RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).
215 Briggs v. Spaulding, 141 U.S. 132, 152 (1891).
216 See Tamar Frankel, *Fiduciary Duties,* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW vol.2 127, 130 (Peter Newman ed., 1998); Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 948 (1990).
217 Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).
218 RUPA §404 cmt. n.1 (2007); see also Leona Beane, *The Fiduciary Relationship of a Partner*, 5 J. CORP. L. 483, 488 (1979).
219 RESTATEMENT (SECOND) OF AGENCY § 13 (1957) ("An agent is a fiduciary with respect to matters within the scope of his agency.")
220 BRYAN A. GARNER ED., BLACK'S LAW DICTIONARY, 1142 (7th ed).
221 J. CRAINE & A. BROMBERG, LAW OF PARTNERSHIP 389 (1968).

dealings,[222] whereby "[n]either partner can, in the business and affairs of the firm, clandestinely stipulate for a private advantage to himself … Every advantage which he can obtain in the business of the firm must endure to the benefit of the firm".[223]

When a partner acts as a manager or agent, the rigid standards of utmost loyalty and faith are more strictly imposed.[224] Although partners have a strong incentive to participate in management due to their personal liability for the partnership debt, if they delegate management powers, their personal liability increases the need for fiduciary duties.[225] For example, in *Meinhard v. Salmon*, Salmon managed the firm on behalf of Meinhard, whereby "[t]he heavier weight of duty rested … upon Salmon … He was much more than a coadventurer. He was a managing coadventurer … For him and for those like him, the rule of undivided loyalty is relentless and supreme …".[226] The managing partner's obligation to deal fairly and openly is heightened[227] and "the necessity for a full disclosure becomes even more acute and rests more heavily on him".[228]

The National Conference of Commissioners on Uniform State Laws (NCCU.S.L) first considered a uniform law of partnership in 1902, with the Uniform Partnership Act (UPA) approved by the Conference in 1914. After 80 years of little amendments, the American Bar Association issued a report in 1986 recommending revisions to the UPA.[229] After a series of meetings and readings, the Revised Uniform Partnership Act

---

222 See, e.g. Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928); Auld v. Estridge, 382 N.Y.S.2d 897 (N.Y. 1976); Bovy v. Granham, Cohen & Wampold, 564 P.2d 1175 (Wash. App., 1977).

223 Mitchell v. Reed, 61 N.Y. 123, 126 (N.Y. 1874).

224 Leona Beane, *The Fiduciary Relationship of a Partner*, 5 J. CORP. L. 483, 490 (1979); see also Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 238-40 (2005) (Arguing that partners acting solely as owners are not fiduciaries; rather, partners have fiduciary duties when they act as managers).

225 Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 240 (2005).

226 Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928).

227 Matter of Lester, 87 Misc.2d 717, 723, 386 N.Y.S.2d 509, 513 (N.Y. 1976).

228 Libby v. L. J. Corp., 247 F.2d 78, 82 (D.C. Cir. 1957).

229 See American Bar Association, *Should the Uniform Partnership Act be Revised?*, 43 BUS. L. 121 (1987).

(RUPA) was adopted by the Conference in 1992.[230] The latest version is the RUPA (1997).

The Revised Act includes an extensive treatment of the fiduciary duties of partners in Section 404, under the title "General Standards of Partner's Conduct". Compared to UPA, Section 404 is both comprehensive and exclusive.[231] Section 404 states that *the only* fiduciary duties that a partner owes to the partnership and the other partners are the duties of loyalty and care set forth in subsection (b) and (c). These duties may not be waived or eliminated in the partnership agreement, although the agreement may specify types of activities and set standards for measuring the performance of the duties if not manifestly unreasonable.[232]

Section 404(b) provides three specific rules that comprise a partner's duty of loyalty: subsection (b)(1) continues the rule that partnership property usurped by a partner is held in trust for the partnership;[233] subsection (b)(2) provides that a partner must refrain from dealing with the partnership as or on behalf of a party having an interest adverse to the partnership;[234] and subsection (b)(3) provides that a partner must refrain from competing with the partnership in the conduct of its business.[235] Subsection (c) is new, establishing the duty of care that partners owe to the partnership and the other partners.[236]

One interesting approach taken by RUPA is that, on the one hand, it denies courts the power to create new and different fiduciary duties by stating "the only fiduciary duties"

---

230 See RUPA Prefatory Note (1997).

231 UPA only touches upon a duty of loyalty and leaves further development of fiduciary duties to the law of agency. See UPA (1914) §4(3), §21; see also RUPA §404 cmt. n.1 (2007).

232 RUPA §103(b)(3)-(5) (1997).

233 This subsection is based upon UPA §21(1) (1914).

234 This rule is derived from the Restatement (Second) of Agency §389 & §391.

235 See Restatement (Second) of Agency §393.

236 There is no statutory duty of care under UPA (1914), although some courts have recognized common law duty of care in some cases. See, e.g. Rosenthal v. Rosenthal, 543 A.2d 348, 352 (Me. 1988) (duty of care limited to acting in a manner that does not constitute gross negligence or willful misconduct).

that a partner owes[237] and making the fiduciary duties "nonwaivable"[238]; on the other hand, RUPA allows drafting an agreement that tailors fiduciary duties to the partner's wishes.[239] This can be seen as a compromise between those who wanted to eliminate the language of fiduciary duties and those who insisted on preserving it.[240] RUPA has made an effort to distinguish between the mandatory aspects of fiduciary law, which cannot be contracted away, and the default aspects.[241] Some have argued that RUPA is too contractarian,[242] while others consider that it invites too much judicial intervention.[243]

One essential problem is the necessity of mandatory minima of fiduciary duties, given the contractual nature of the partnership. Why not allow the partners to contract away all fiduciary duties or enact a total waiver? One possible answer is that, given that the process of generating a partnership agreement involves dramatic information asymmetries, the existence of mandatory minima is likely to be efficient.[244] Due to information and behavior asymmetries, some bargainers are unlikely to bargain. Some bargainers may foresee situations more than others, while some are less likely to attend carefully to the language of the agreement and some may be in an inferior

---

237 RUPA §404(a) (1997).

238 See RUPA §103 title "nonwaivable provisions".

239 See RUPA §103(b)(3)-(5) (1997).

240 Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 LAW & CONTEMP. PROBS. 81, 86 (1995).

241 *Id.* Section 103 of RUPA does not use "mandatory" or "default" but they are mentioned in the comment. If a rule applies regardless of the agreement of the partners, it is mandatory, whereas if a rule can be eliminated by the parties, it is default. See RUPA §103 cmt.1.

242 See, e.g. Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993); Claire M. Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111 (1993).

243 See, e.g. Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1991); J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29 (1995).

244 See, e.g. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 113 (4th ed. 1992) ("The fiduciary principle is the law's answer to the problem of unequal costs of information … By imposing a duty of utmost good faith rather than the standard contractual duty … it minimizes the costs of self-protection to the fiduciary's principal.")

position in terms of ability to monitor the relationship.[245] Furthermore, a total waiver would be too easy: with a partial waiver, the bargainers would disclose the conflicts that are likely to happen and seek advance approval from the other partner; if all duties can be waived, it may fully deter bargains by allowing the partner who expects a conflict to simply demand a total waiver.[246] Therefore, the approach taken by RUPA reflects the drafters' best judgment concerning the role of mandatory minima in a world with asymmetries.

3.2.3 Fiduciary Duties in a Limited Partnership

Compared to the general partnership form, the distinctive aspect of the limited partnership form is the addition of limited partners who have limited liability, which means that the obligation to the firm's debts is limited to their investments in the firm. The limited partnership structure thus combines personally liable and actively managing general partners with passive limited partners.

When there is a divergence between the partners, there must be means of monitoring and control mechanisms that align the interests of the conflicting parties. The entrenchment nature means that the general managing partner is not exposed to the market power of control. When the disciplinary power of the market is absent from the scene, there must be substitutes: other sources of means of control to achieve an equivalent effect. Fiduciary duties would consequently function as an additional control mechanism for the imperfection regarding the market control of limited partnership form.

The application of fiduciary duties of loyalty and care is based upon the specific

---

[245] Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 LAW & CONTEMP. PROBS. 81, 100 (1995).

[246] Richard A. Booth, *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL & EMERGING BUS. L. 55, 64 (1997).

context of an agent managing the principal's property.[247] Arguably, it should follow that the limited partners – who have no default management responsibilities – should have no fiduciary duties.[248] The general partners in a limited partnership would have similar duties to those of partners in a general partnership. However, there is an important distinction here due to the passive role of the limited partners in the limited partnership. In a general partnership, the owners' personal liability encourages them to actively participate in partnership management; by contrast, in the context of constraining conflicts, since general partners in the limited partnership manage on behalf of the passive limited partners, the fiduciary duties may play a greater role than in the general partnership, in which the partners directly participate in management[249]

Together with the UPA (1914), the Uniform Limited Partnership Act (ULPA) – which was originally promulgated in 1916 – has been the basic law governing partnerships in the U.S. The revision of ULPA occurred in 1976 and further amendments followed in 1985 (Revised Uniform Limited Partnership Act, RULPA). Today, the NCCUSL (National Conference of Commissioners on Uniform State Laws) has adopted a new version of the Uniform Limited Partnership Act (ULPA 2001). The new act is a "stand alone" act, "de-linked" from both the UPA and the RUPA, and it does not rely on cross-references to the general partner law.[250] The new ULPA recognizes modern-day uses of the limited partnership form by "providing greater flexibility and protection to sophisticated groups seeking strongly entrenched, centralized management and persons requiring passive limited partners with little control over the

---

247 See Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 939 (2004).

248 However, the limited partners may take fiduciary duties if they take on the role of management, or in other situations by agreement. See, e.g. In re Kids Creek Partners, L.P., 212 B.R. 898 (1997) (limited partners do not per se owe a fiduciary duty to partnership or partners, but limited partners can owe fiduciary duty when so involved with a partnership to create fiduciary duties).

249 Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 939 (2004).

250 The immediate predecessor RULPA is not a stand-alone statute; rather, it was drafted to rest upon and link to UPA. See RULPA (1976) §1105 ("In any case not provided for in this [Act] the provisions of the Uniform Partnership Act govern"). See also, ULPA (2001) prefatory note.

partnership".[251]

ULPA 2001 clarifies that a limited partner – acting solely as such – does not have fiduciary duties.[252] A limited partner has an obligation of good faith and fair dealing,[253] although this is not a fiduciary duty and does not command altruism.[254] It is possible that a limited partner may be delegated with managerial power, although it is not a matter of status but rather a matter of contract. It is also possible that the partnership agreement expressly imposes fiduciary duties or creates a role that would give rise to fiduciary duties for a limited partner.[255] However, once again, it is a matter of contract.

Fiduciary duties of general partners in ULPA 2001 are closely based upon those in RUPA.[256] Therefore, concerns have been raised about the Act's restriction on waivers.[257] Due to the unique structure of the limited partnership form, the benefits of restricting waivers on fiduciary duties may be relatively low in limited partnerships. As previously discussed, the limited partnership form is particularly suitable for firms involving asset management such as venture capital funds rather than running an ongoing business. For ongoing businesses, owners can continuously monitor business decisions and replace poorly-performing managers. Given that the management is so entrenched, firms may be able to constrain managers through covenants that restrict particular types of behaviors that are known in advance. Investors are more likely to

---

251 Uniform Law Commission, Limited Partnership Act Summary, (last visited Sept. 23, 2013).

252 ULPA §305(a) (2001) ("A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.")

253 ULPA §305(b) (2001).

254 ULPA §305 cmt. (2001).

255 For example, if the partnership agreement makes a limited partner an agent for the partnership concerning particular matters, the law of agency will impose fiduciary duties on said limited partner with respect to the agent role.

256 ULPA §408 & §110(b)(5) (2001), RUPA §404 & §103(b)(3) (1997).

257 The restriction on waivers is the same in both Acts. For RUPA, see RUPA §103(b)(3)-(5) (1997); for ULPA, see ULPA §110(b)(5)-(7) (2001). See also, Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 962 (2004).

be able to protect themselves than in less specialized business forms such as general partnerships.[258] Choosing the limited partnership form itself can raise an alarm to the users of such a form to become more sophisticated and seek legal advice, thus mitigating some of the information and behavior asymmetry problems. Furthermore, a reputational incentive can mitigate the need for fiduciary duties, as the general partners may have the need to maintain a good reputation for new rounds of fund-raising. Covenants together with reputation incentives can serve as a complement to the absence of the market for control; therefore, it might not be necessary for limited partnership form to be subject to rigid rules of fiduciary duties.

Compared to the federal law, Delaware law has made an effort towards honoring contractual freedom on the issue of limited partnership fiduciary duties. The Delaware Code has explicitly provided for "maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements" and states that "the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement". [259] This strongly-worded provision has attracted the court's attention, focusing firstly on the language of the partnership agreement and thus discouraging courts from substituting default rules for contractual duties. [260] The aforementioned two sections were established in the 1990 amendments,[261] while in the 2002 case *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, the Delaware Supreme Court clarified that although Delaware law allows fiduciary duties to be *expanded* or *restricted* by the partnership agreement, "[t]here is no mention in §17-1101(d)(2), or elsewhere in DRULPA at 6 *Del. C.*, ch.

---

258 Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 962 (2004).

259 DEL. CODE ANN. tit. 6 § 17-1101(c)(d) (2013).

260 See, e.g. Wilmington Leasing, Inc. v. Parrish Leasing Co., L.P. 1996 WL 752364 (Del.Ch. 1996) (when addressing Parrish's argument of breaching fiduciary duties, the court stated that "any fiduciary duties that might be owed … is satisfied by compliance with the applicable provision of the partnership agreement.")

261 67 Del. Laws, c. 348, §27 (1990).

17, that a limited partnership agreement may *eliminate* the fiduciary duties or liabilities of a general partner."[262] Furthermore, the court noted a historic cautionary approach of the Delaware courts that "efforts by a fiduciary to escape a fiduciary duty … should be scrutinized searchingly".[263] However, the word "eliminated" was added in 2004 amendments of the law.[264] The ULPA as a federal law applies to the entire nation while the Delaware law is applicable in Delaware; since a firm can choose its seat, perhaps simply due to Delaware's general reputation for honoring contractual freedom and its legal sophistication, as is the case for corporations,[265] Delaware has become a major jurisdiction for limited partnership legislation.[266]

3.2.4 Fiduciary Duties in a Limited Partnership with a Corporate General Partner

3.2.4.1 Limited Partnerships with a Corporate General Partner

The corporate general partner of limited partnerships presumably appeared in the U.S. shortly before 1970.[267] The primary reason for the rise of corporate general partners relates to taxation.[268] However, besides tax reasons, the incorporation of the general partner is potentially efficient for some firms, given that it may be a better way to achieve special investment purpose than a natural person as general partner. A single manager has to commit a substantially large amount of wealth to gain control of the firm, thus losing the benefits of risk diversification. If control is obtained through a corporate general partner, this makes the manager less reluctant to undertake risky

---

262 Gotham Partners, L.P. v. Hallwood Realty Parters, L.P., 817 A.2d 160, 168 (Del. 2002).
263 Gotham Partners, L.P. v. Hallwood Realty Parters, L.P., 817 A.2d 160, 168 (Del. 2002).
264 74 Del. Laws, c. 265, §15 (2004).
265 See, e.g. Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 255 (1985) (discussing why Delaware has dominance in corporate law).
266 Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 952 (2004).
267 See the evidence in Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 77 (1997).
268 See *id*., at 80.

projects.[269] Firms that benefit from investment in risky businesses – like venture capital funds – may find that it is useful for businesses to have an incorporated general partner.

A corporate general partner differs from an individual general partner in several respects, thus complicating fiduciary duty scenarios. First, when an individual natural person serves as the general partner, this person's actions will be evaluated under principles of fiduciary duties. With a corporate general partner who would be subject to the control of someone else, possibly a panel of people (board of directors, or shareholders) in the corporation – the identity of the decision body may not be known to the limited partners, thus creating an information gap. Furthermore, the corporate general partner may be sold to a third party, whereby the control of the partnership may be shifted while not affecting the corporate general partner's continuous existence. It may be problematic for the limited partners, to whom the identity of those in control of the general partner is more important than the formal identity of the general partner.[270]

Second, potential conflicts of fiduciary duties exist when the general partner is a corporation. Obviously, the general partner owes fiduciary duties to the partnership and the limited partners. However, as a corporation, the corporate officers also owe fiduciary duties to the shareholders of the corporate general partner. These duties may conflict, especially when the shareholders of the corporate general partner have no interest in the limited partnership and when the gain of the shareholders from breaching fiduciary duties is greater than the loss of the limited partners. It is – at least theoretically – possible that the managers are required to breach fiduciary duties to the

---

269 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L. J. 835, 870 (1988).
270 Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 86 (1997).

limited partners to ensure the maximum gain of the corporate shareholders.[271]

Third, the potential risk of limited partners may be higher due to the asset status of the corporate partner. If the corporation is thinly capitalized, it is difficult to achieve recovery when there is a claim of breach of fiduciary duty against the corporate general partner, while the corporation may be still acceptable as a general partner even if it only has nominal assets. Furthermore, it may still be risky to the limited partners, even if the corporate general partner is well capitalized on the outside,[272] given that these assets may be reduced due to subsequent transactions of the corporation. If damage from the breach of fiduciary duty can be recovered, it must be held true that the parties that manage the corporation are liable for the general partner's breach of fiduciary duty.

3.2.4.2 Fiduciary Duties of Directors of the Corporate General Partner

Case law has broadened the scope of the fiduciary duties of directors of a corporate general partner to limited partners, against the traditional view of fiduciary relationships. The most significant and commonly cited case is the opinion from the Delaware Court of Chancery in *In re USACafes, L.P. Litigation*.[273]

USACafes involved a suit by the limited partners of USACafes, L.P., a Delaware limited partnership (the "Partnership"), against several defendants including USACafes General Partner, Inc. (the "General Partner"), a Delaware corporation that acted as the general partner of the Partnership, as well as several individuals who

---

271 Case law says otherwise. See, e.g. Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981), aff'd, 483 A.2d 633 (Del. 1984) (the court stated that the corporation as the general partner owes "the duty… to exercise the utmost good faith, fairness, and loyalty" for the benefit of the limited partnership. It seemed to require that directors of the corporate general partner favor their duties to the limited partnership above the duty to the shareholders.)

272 Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 87 (1997).

273 In re USACafes, L.P. Litigation, 600 A.2d 43 (Del. Ch. 1991).

served as directors of the general partner. The plaintiffs alleged that the directors of the General Partner received "side payments" of $15-$17 million, which induced them to approve a sale of the assets of the Partnership at a low price, constituting a breach of duty of loyalty by both the General Partner and the individual directors of the General Partner.[274]

The director defendants argued that while the General Partner owed fiduciary duties to the limited partners, the directors of the General Partner did not.[275] The court found "no corporation law precedents directly addressing the question whether directors of a corporate general partner owe fiduciary duties to the partnership and its limited partners."[276] Nevertheless, the court held that the director of a corporate general partner bears fiduciary duties towards the limited partnership based upon general principles and trust law.[277] As a general principle, the court stated that "one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner."[278] For trust law bases, the court found that "a large number of trust cases … stand for a principle that would extend a fiduciary duty" owed by directors of corporate general partners.[279] The court also cited cases holding a controlling stockholder of a corporate general partner personally liable for breach of fiduciary duty, supporting the recognition of such duty in "directors of the General Partner who, more directly than a controlling shareholder, are in control of the partnership's property."[280]

After *USACafes* was decided, the Delaware Court of Chancery applied its decision to

---

274 *Id*., at 46.
275 *Id*., at 47.
276 *Id*., at 48.
277 The court stated that the question of whether the director should bear the fiduciary duty "seems to be clearly indicated by general principles and by analogy to trust law." *Id*.
278 *Id*.
279 *Id*.
280 *Id*., at 49.

other cases.[281] However, *USACafes* was subject to criticism for relying on trust law principles, ignoring the difference between a trustee's fiduciary duty and the limited partnership's contractual nature; moreover, it is unclear under *USACafes* how the director is to balance fiduciary duties to the corporation and the partnership.[282] One way to circumvent the problem was suggested by the statute. In 1994, DRULPA was amended to permit the partners in a limited partnership to define the scope of the duties owed by directors of a corporate general partner.[283] The court enforced a partnership provision that limited the fiduciary duties of directors of corporate general partners in *Brickell Partners v. Wise*.[284]

When directly addressing the issue, the Court of Chancery applied *USACafes* in a hesitant but suggestive manner to mitigate the concerns. In *Gotham Partner*, the Court of Chancery referred to *USACafes* as a "less venerable but largely unquestioned precedent" and described the decision as "in some senses unorthodox."[285] The court stated that under a "more strictly traditional approach," the limited partner would "look to only the general partner in the first instance to seek redress for any breach of duty" and only upon "abuse of the corporate form by the owners of the corporate general partner that would justify veil piercing would the limited partners be able to look beyond the corporate partner to others for redress."[286] In a 2009 case, *Bay Center*, the court noted that *USACafes* "raises some difficult policy issues and disregards corporate formalities in a manner unusual for Delaware law."[287] Nevertheless, the

---

281 e.g. James River-Pennington Inc. v. CRSS Capital Inc., 1995 WL 106554 (Del. Ch. 1995); In re Boston Celtic Ltd. Partnership Shareholders Litigation, 1999 WL 641902 (Del. Ch. 1999); Wallace ex rel. Cencom Cable Income Partners II, Inc., L.P. v. Wood, 752 A.2d 1175 (Del. Ch. 1999).

282 Robert B. Robbins, *The Fiduciary Duties of Directors of Corporate General Partners; Ten Years after USACafes*, Mar. 14-16, ALI-ABA Course of Study (2002) (*available at* Westlaw).

283 DEL. CODE ANN. tit. 6 § 17-1101(d).

284 Brickell Partners v. Wise, 794 A.2d 1 (Del. Ch. 2001).

285 Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 2000 WL 1476663, 19-20 (Del. Ch. 2000).

286 *Id*., at 20.

287 Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, n.44 (Del. Ch. 2009).

court applied *USACafes*, albeit with the suggestions that the application of *USACafes* should be limited to "the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership."[288] Therefore, one possible way to reduce the conflicts between duties to the corporation and duties to the partnership would be to limit the director's *USACafes* duties to the circumstances under which the director acts at the partnership's expense to his or her own personal benefit, which is quite akin to one aspect of the veil piercing test, namely when the corporation is being used for personal dealings.[289]

3.2.5 Fiduciary Duties in a Venture Capital Fund

For venture capital funds – which frequently take the limited partnership as business form – it would appear that fiduciary duties should play an important role in regulating the relationship between the venture capitalist as the general partner and investors as limited partners. Since the investors have so much less control of the partnership than the general partners, the default fiduciary duty should be very strict.[290] However, it seems that fiduciary duties only play "a marginal role" under Delaware law[291] and it is rare in case law that investors have successfully sued venture capitalists for breach of fiduciary duties.[292]

DRULPA section 17-1101 plays a crucial role in understanding the minor role of fiduciary duties in venture capital litigation. By using 17-1101, venture capitalists are able to waive all fiduciary duties imposed by state law with explicit agreement.[293]

---

288 *Id*., at 10. (citing *USACafes*).

289 Russell C. Silberglied & Blake Rohrbacher, *TOU.S.A, U.S.ACafes, and the Fiduciary Duties of a Parent's Directors upon a Subsidiary's Insolvency*, 2011 NORTON ANN. SURV. OF BANKR. L. 2, n.104 (2011).

290 Allan W. Vestal, *A Comprehensive Uniform Limited Partnership Act? The Time Has Come*, 28 U.C. DAVIS L. REV. 1995, 1211 (1995).

291 David Rosenberg, *The Two "Cycles" of Venture Capital,* 28 J. CORP. L. 419, 430 (2003).

292 *Id*., at 431.

293 DEL. CODE ANN. tit. 6 § 17-1101(d) (2013). See also, David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 388-394 (2002).

Such waivers are frequently upheld by Delaware courts. In *Gale v. Bershad*, the court stated that to "allow a fiduciary duty claim to coexist in parallel with an implied contractual claim, would undermine the primacy of contract law over fiduciary law in matters involving the essentially contractual rights and obligations of preferred stockholders."[294] In *Sonet v. Plum Creek Timber Co.*, the court stated that it is "a correct statement of law that principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain."[295] In terms of the issue of the corporate directors, alike *Brickell Partners v. Wise*,[296] in the 2006 case *Blue Chip Capital Fund II Ltd. Partnership v. Tubergen*,[297] citing *Gale*,[298] the court held that it is contract rather than fiduciary principles that govern the claims against directors of the corporation (which is the general partner in the limited partnership). Thus, venture capitalists have extremely limited duties towards the investors, aside from those actions prohibited by the limited partnership agreement. Furthermore, as the statute adds more explicit terms,[299] the issue of fiduciary duties of a venture capital fund now seem "dead".[300]

Now, one might ask for the reason for the discussion of fiduciary duties in venture capital limited partnerships if it is not used in practice. While it is true that the primary remedy for the venture capital investors consists of legal actions triggered by breach of contract[301] when there is an absence of the market control, it is still worth discussing fiduciary duties when there is silence in the limited partnership agreement. The imposition of fiduciary duties in the absence of waiving such duties continues in

---

294 Gale v. Bershad, 1998 WL 118022, 5 (Del. Ch. 1998).
295 Sonet v. Timber Co., L.P., 722A.2d 319, 322 (Del. Ch. 1998).
296 Brickell Partners v. Wise, 794 A.2d 1 (Del. Ch. 2001).
297 Blue Chip Capital Fund II Ltd. Partnership v. Tubergen, 906 A.2d 827 (Del. Ch. 2006).
298 *Id*., at 833.
299 DRULPA explicitly states that the parties may "eliminate" fiduciary duties by the partnership agreement. DEL. CODE ANN. tit. 6 § 17-1101(d) (2013)
300 See Larry A. Ribstein, *Symposium on the Future of the Unincorporated Firm: Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 589-90 (1997) ("fiduciary duties are virtually a dead issue").
301 See PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 29 (1999).

Delaware courts.[302] Further, the DRULPA 2004 amendment emphasized that the principle of freedom of contract does not constitute a denial of the existence of default fiduciary duties. It even specified that, when in doubt, equity governs.[303] Ultimately, I do not believe that fiduciary duties can be totally replaced by contractual obligations, for each has a different "causative event"[304]: fiduciary duties come from the parties entering into a certain sort of relationship, while contractual obligations arise from the parties entering into an exchange agreement. It is dangerous to mix the problematic aspects of contractual relationship into the fiduciary relationship: for example, when the negotiating parties are not sufficiently sophisticated to tailor each contract term to what fits their best interest, or more specifically, when the limited partners who are not managing the partnership are not sophisticated enough to recognize all the rights and obligations set out in the agreement, they will face risky consequences if the fiduciary duties are absent.

3.3 The Role of Reputation

In a venture capital limited partnership, if all fiduciary duties are waived, and the partnership contracting is flawed, reputational constraints would be almost the last resort of protecting investments of the limited partners.[305] The incentive created by reputation for good behavior of the venture capitalists does not depend on duties generated by the law rules or obligations set out in the contract, it is embodied in the very nature of venture capital – the need to maintain a good relationship with

---

302 See, e.g. Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC, No. 5502-CS, 2011 WL 3505355 at 31 (Del. Ch. Aug. 8, 2011) (holding the general partner liable for breaching her fiduciary duties because no provision in the partnership agreement modified traditional fiduciary duties); For LLCs, see, e.g. Kelly v. Blum, No. 4516-VCP, 2010 WL 629850, at 1 (Del. Ch. Feb. 24, 2010) (the managers and controlling members owe Plaintiff duties of loyalty and care since the LLC agreement does not explicitly alter those default fiduciary duties); Feeley v. NHAOCG, LLC, 62 A.3d 649, 660 (Del. Ch. 2012) ("long line of Chancery precedents holding that default fiduciary duties apply").

303 Del. Code. Ann. tit. 6, § 17-1105.

304 See Peter Birks, The Content of Fiduciary Obligation, 34 Israel L. Rev. 3 (2000)

305 David Rosenberg, *Venture Capital Limited Partnerships: A study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 395.

investors in order to receive further rounds of funding.

3.3.1 The Benefit of Control to the Reputation Mechanism

As previously discussed, the cyclical nature of venture capital investments can increase the potency of the reputation mechanism.[306] The reputation mechanism plays an important role in preventing venture capital management from behaving opportunistically, as well as determining the competence of managers.[307] For the reputational constraint mechanism to function, there must exist (1) the possibility of repeat transactions with current parties, and (2) the potential development of new business relationships as a result of market participants exchanging information.[308] The fact that the venture capitalists need to raise successor funds is embedded in the cyclical nature of venture capital investments, which coincides with the first requirement of a proper functioning reputation mechanism, namely repeated transactions. It is necessary to consider the second requirement: the efficiency of information exchange.

It lies at the heart of limited partnership law that general partners are personally liable for the partnership debt while limited partners are not. Nonetheless, the limited partner liability shield is not impenetrable and is always under assault. The so-called "control rule" makes limited partners personally liable for the obligation of the partnership if they – like general partners – take part in the management and control of the partnership's affairs.[309] Thus, when a prospective investor evaluates the fund

---

306 David Rosenberg, *Venture Capital Limited Partnerships: A study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 395 (investment protection mechanism of venture capital partnership investors rely almost exclusively on reputational constraints).

307 William A. Sahlman, *The Structure and Governance of Venture-capital Organizations*, 27 J. FIN. ECON, 473, 502 (1990) ("if they engage in opportunistic acts or are incompetent, they will be denied access to funds.")

308 Elizabeth Cosenza, *Co-invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights of First Refusal in the Venture Capital Context*, 55 AM. U. L. REV. 87, 100.

309 See Uniformed Limited Partnership Act (ULPA) (1916). Section 7 of the act stated that "a limited partner shall not become liable as a general partner unless, in addition to the exercise of his

manager's competence through past fund performances and the fund is structured as a limited partnership, the investor can safely assume that the fund's successes were solely attributed to the fund manager, before subsequently making an investment based upon this assumption. In such a case, the fund manager efficiently signaled his or her competence to the market.

If the limited partners can play an active role in daily management of the fund business, the simple label of a "limited partnership" cannot then serve as a strong signal that the fund manager takes the full credit. In such a case, if the previous funds were successful, the prospective investor tends to allocate part of the credit to possible contributions made by the limited partners, whereas if the previous funds were failures, the managers tend to bear the full blame.[310] This means that if the fund manager could not signal to the market that he or her contributed solely to the success of earlier funds, he or she would share the upside rewards but bear all the downside reputational risk.[311]

Strong control by the general partner could benefit the venture capital market in several ways. With a clear message that the general partner assumes control, the prospective investor public can monitor the fund manager more efficiently through the reputation mechanism, thus creating a strong incentive for the managers to avoid opportunistic behaviors and invest their competence in the projects. When the managers exert their full efforts, the venture capital market as a whole can benefit from such an effort. Furthermore, if the fund manager can efficiently signal competence, frictions would be reduced when completing the venture capital cycle. The prospective investor public would have a clear perception that the previous

---

rights and powers as a limited partner, he takes part in the control of the business".

310 Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 267, 307 (2006).

311 *Id.*

successes or failures of the fund were solely attributed to the fund manager. Based upon such a perception, the investors can subsequently make investment decisions concerning whether to reward the manager with next-round funding or punish the manager with no further funding. It is less costly for the prospective investors to differentiate the fund manager's contribution from that of the limited partners; therefore, they are less hesitant about making the commitment of future funding. Strong control of the general partner discourages investor participation and helps to screen out weak fund managers who would rely on the limited partners to maintain better performance. Without the limited partners' help, less competent fund managers would eventually die out from the venture capital businesses.[312]

3.3.2 Loosening of Control

There was no definition of "control" in ULPA 1916.[313] Courts had generally developed two types of tests for deciding when to impose personal liability on a limited partner.[314] In most of the reported decisions, courts held a limited partner liable for the partnership obligation based upon the extensiveness of involvement in the partnership's business. Once a limited partner's activity has crossed some threshold, he or she is held liable.[315] In a few other cases, the courts explained that the limited partner should not be personally liable for partnership debt unless the creditor believed that the limited partner was in fact a general partner due to involvement in the control of the business.[316] Although the latter test corresponded with the

---

312 Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALB. L. REV. 267, 308 (2006).

313 Frank D. Jacobs, *Activities Making a Limited Partner Liable as a General Partner*, 56 MICH. L. REV. 285, 285 (1957).

314 Joseph J. Basile, Jr., *Limited Liability for Limited Partners: an Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1205-1210 (1985); See also Norman Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. L. REV 785 (1978) (comprehensive analysis and tests characterization of the reported decisions).

315 See, e.g. Holzman v. de Escamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (Cal. App. 4 Dist. 1948); Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (Cal. 1957).

316 See, e.g. Western Camps, Inc. v. Riverway Ranch Enter., 70 Cal. App. 3d 714, 138 Cal. Rptr. 918

implications of ULPA Section 7, it was not widely utilized.[317]

A statutory repair was needed to clarify the application of the control rule to a limited partner. Section 303 of the ULPA 1976 made an effort to set standards to determine when the "control" line has been crossed.[318]

ULPA 1976 Section 303(a) reiterated ULPA 1916 Section 7 by retaining the language, "takes part in the control of the business."[319] It did so to "insure that judicial decisions under the prior uniform law remain applicable to the extent not expressly changed."[320] The language that followed was new and was intended to address the ambiguity that existed in determining whether a limited partner was liable as a general partner. It set a test combining the control participation level of the limited partner with a specific reliance of the creditor. Therefore, a limited partner may be liable in two different ways. He or she may incur a full liability as a general partner, where the level of participation is "substantially the same as" that of a general partner and no specific creditor reliance was needed to justify the liability; and there is partial liability, where the participation is "not substantially the same as" that of a general partner, and here the knowledge of a specific creditor is needed to justify the liability. While clarifying the parameters of liability of a limited partner, some argued that this would only transfer the uncertainty from determining "participation in control" to "substantially

---

(Cal. App. 1977); Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244 (WASH 1977).

317 See Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667, 686-687 (2004).

318 ULPA §303, cmt. (1976).

319 ULPA Section 303 (a) stated that except as provided in subsection (d), "a limited partner is not liable for the obligation of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] takes part in the control of the business. However, if the Limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he [or she] is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control."

320 ULPA §303, cmt. (1976).

the same".[321]

Another important change was ULPA 1976 Section 303(b), providing a non-exclusive[322] list of safe-harbor activities in which a limited partner may engage without being deemed as participating in control. The safe-harbor rules allowed a limited partner to be a contractor, an agent or employee of the partnership or of a general partner (§303(b)(1)); to consult with and advise a general partner (§303(b)(2)); to act as surety for the partnership (§303(b)(3)); to approve or disapprove partnership agreement amendments (§303(b)(4)); and to vote on important matters concerning the partnership such as partnership dissolution, transfer of assets, change of business nature and removal of a general partner (§303(b)(5)). Concerning the last rule, it should be noted that exercise of certain voting powers by a limited partner can rise to the level of participating in control of business within the meaning of 303(a).[323]

The new section 303 of ULPA 1985 was designed to strengthen the limited partner liability shield. The second part of 303(a) was significantly changed[324] and the safe-harbor list was expanded.[325]

The new section 303(a) abandoned the confusing test of "substantially the same". It was designed to eliminate full personal liability when the third party had no

---

321 See, e.g. Robert A. Kessler, *The New Uniform Limited Partnership Act: A Critique*, 48 FORDHAM L. REV. 159, 164 (1979); Joseph J. Basile, Jr., *Limited Liability for Limited Partners: an Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1211 (1985).

322 The non-exclusiveness was provided by Subsection (c), which stated that: "The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him [or her] in the business of the limited partnership." ULPA §303(c) (1976).

323 ULPA Section 302 provided that "Subject to Section 303, the partnership agreement may grant to all or a specified group of the limited partners the right to vote (on a per capita or other basis) upon any matter." The comment to this section stated that "if such voting powers are granted to limited partners beyond the 'safe harbor' of Section 303(b)(5), a court may hold that, under the circumstances, the limited partners have participated in 'control of the business' within the meaning of Section 303(a)."

324 The second sentence of new section 303(a) stated that "However, if the limited partner participates in the control of the business, he is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." ULPA §303(a) (1985).

325 ULPA §303(b) (1985).

knowledge of the limited partner's conduct,[326] whereby a limited partner who participated in control was only liable to the person who had reasonable belief that the limited partner was a general partner. The Comments did not give a reason for changing "with actual knowledge" to "reasonably believing", although the language suggested that the standard for specific reliance had lowered, since the new rule only required reasonable belief rather than an actual knowledge.

The 1985 amendment to section 303(b) added a number of safe-harbor activities, including being an officer, director or shareholder of a general partner that is a corporation (303(b)(1)); guaranteeing or assuming obligations of the partnership (303(b)(3)); taking action to bring or pursue a derivative action (303(b)(4)); requesting or attending a meeting of partners (303(b)(5)); proposing, approving or disapproving matters such as the admission or removal of a general partner and a limited partner, a transaction involving conflict of interest between a general partner and the limited partnership or the limited partners, an amendment to the partnership agreement or certificate of limited partnership (303(b)(6)); and winding up the limited partnership (303(b)(7)). While there can never be a complete list of specific safe-harbor activities, even with the most carefully crafted expansion, this inexhaustibleness was recognized by the amendments to section 303(b). Accordingly, a limited partner can propose, approve or disapprove other matters "related to the partnership business not otherwise enumerated in this subsection (b), which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners."[327]

The 1985 amendment was to relax yet not abolish the control rule: even with the change of language and the expansion of the safe-harbor list, there were at least some

---

326 ULPA §303(a) cmt. (1985).
327 ULPA §303(b)(6)(ix) (1985).

circumstances under which a limited partner must sacrifice the benefit of limited liability if participating in the control of the business. The control rule long attracted critique due to the difficulty of defining "control",[328] as well as creating uncertainty for the limited partners.[329] Moreover, given the creation of new business vehicles such as LLLPs, ULPA 2001 simply eliminated any trace of the control rule and brought it to an extinction.[330] Section 303 of ULPA 2001 provides that a limited partner "is not personally liable…for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership."[331]

However in Delaware law, the control rule still exists.[332] The language of DRULPA has largely followed ULPA 1985, with some safe harbor activities listed that were not included in ULPA 1985. For example, proposing, approving or disapproving the sale of not substantially all partnership assets, and the incurrence of indebtedness by the partnership in the ordinary course of business.[333] Therefore, although diluted, the control rule's certain merits in promoting a more efficient reputation mechanism especially regarding venture capital limited partnership are still appreciated. Just as the 19th century scholar Clement Bates once put it:

"The public are entitled to have the business conducted under the uncontrolled judgment and skill of the general partner; for they may not have been willing to trust

---

328 Commentary had attempted to suggest appropriate standards for deciding whether a particular conduct should subject the limited partner for control of the business. See, e.g. Alan L. Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969); Norman Abrams, *Imposing Liability for "Control" Under Section 7 of the Uniform Limited Partnership Act*, 28 CASE W. RES. L. REV. 785 (1978).

329 See, e.g. Robert A. Kessler, *The New Uniform Limited Partnership Act: A Critique*, 48 FORDHAM L. REV. 159, 166 (1979); Frederick G. Kempin Jr., *The Problem of Control in Limited Partnership Law: an Analysis and Recommendation*, 22 AM. BUS. L.J. 433, 465 (1985); Joseph J. Basile, Jr., *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1217-1228 (1985).

330 ULPA §303 cmt. (2001).

331 ULPA §303 (2001).

332 See DEL. CODE. ANN. tit. 6, § 17-303 (2013).

333 DEL. CODE. ANN. tit. 6, § 17-303(b)(8)b-(8)c (2013).

the firm where the general partner or the business is governed by the special partner."[334]

3.3.3 The Reputation Constraint without Control

As previously mentioned, a strong control rule could enhance the efficiency of the reputation mechanism, although the control rule is quite diluted these days. What then would be the effect on the reputational constraint of not having a strong control rule? Meanwhile, the estoppel liability may come to mind, given that it has a similar concept to the control rule and is indeed connected. It is therefore worth discussing the effect of the reputation mechanism with a diluted control rule, taking into consideration this complimentary principle of estoppel liability.

3.3.3.1 Estoppel Liability

Estoppel is fundamentally a doctrine in the law of torts.[335] It is a "bar that prevents one from asserting a claim or right that contradicts what one has said or done before or what has been legally established as true."[336] In the law of agency, estoppel doctrine holds a person liable to other persons who "have changed their positions because of their belief that the transaction was entered into by or for him."[337] It may result from a misrepresentation or a failure to reveal facts.[338]

---

334 CLEMENT BATES, THE LAW OF LIMITED PARTNERSHIP 133 (1886).

335 See Restatement (First) of Torts § 872, 894 (1939). "A person who makes to another a definite misrepresentation of fact concerning the ownership of property or its disposition, knowing that the other intends to act in reliance thereon, and who thereafter does an act or makes a refusal which would be tortuous if the statement were true, is liable to the other as if the statement were true, provided that the other in reasonable reliance upon the statement has so changed his position that it would be inequitable to deny an action for the act or refusal." Restatement (First) of Torts § 872 (1939) (Tort Liability Based on Estoppel).

336 "estoppel", Black's Law Dictionary (9th ed. 2009).

337 Restatement (Second) of Agency § 8B (1958).

338 Restatement (Second) of Agency § 8B cmt. a (1958). Estoppel by misrepresentation, see, e.g. Minard v. ITC Deltacom Communications, Inc., 447 F.3d 352, 358 (C.A.5 (La.), 2006); estoppels by silence, see, e.g. Swiss Credit Bank v. Chemical Bank, 422 F.Supp. 1305, 1309 (D.C.N.Y. 1976).

In terms of limited partnerships, estoppel liability has always been applicable but has seldom been used because control liability has prevailed.[339] The partner estoppel rule in UPA 1914[340] applied to limited partnership through UPA 1914 Section 6(2), which stated that the act "shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith."[341] There is no provision in ULPA 1916 regarding the matter of application. RULPA 1976 and RULPA 1985 section 1105 provides that the general partnership law applies to limited partnerships in any case not separately provided for in the limited partnership law.[342] Even with the "de-linkage" of ULPA 2001 from general partnership law, estoppel liability remains a source of potential limited partner liability for a limited partnership.[343]

Estoppel liability theory would require a specific creditor reliance and thus is generally more difficult to prove.[344] Given the comparative ease of applying the control rule, estoppel liability has played a "minor judicial role"[345] in holding the limited partners personally liable for the partnership debts.

---

339 Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667, 678 (2004).

340 "Partner by Estoppel". UPA § 16 (1914). RUPA 1997 Section 308 continued the estoppel principle from UPA 1914, with a more accurate title "Liability of Purported Partner." RUPA § 308 cmt. (1997).

341 UPA § 6(2) (1914).

342 RULPA § 1105 (1976); RULPA § 1105 (1985).

343 Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667, 679 (2004) (ULPA section 107(a) provides that the principles of law and equity supplement the act, estoppel should be one of the principles).

344 See, e.g. Heckler v. Community Health Services of Crawford, 467 U.S. 51, 59 (U.S., 1984) (this court reversed the court of appeals, holding that plaintiff failed to prove detrimental reliance on agent's advice); Wells Fargo Business v. Ben Kozloff, Inc., 695 F.2d 940, 946 (C.A. Tex., 1982) (the court found no basis to apply the estoppel theory of agency, which would require a showing of the defendant's reliance); McCurnin v. Kohlmeyer & Company, 347 F. Supp. 573, 579 (D.C. La., 1972) (the defendant could not claim estoppel because plaintiff did not mislead defendant, and defendant did not change position in reliance on plaintiff's representations), aff'd, 477 F.2d 113 (5th Cir. 1973).

345 Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667, 678 (2004).

3.3.3.2 Analysis of Reputation Mechanism without Control Rule

As previously discussed, a strong control rule would benefit the reputation mechanism through an efficient information signaling mechanism. With a strong control rule, simply by recognizing the organizational form of a limited partnership, the prospective investors could effectively allocate credit for success to the fund manager. Accordingly, the fund manager's incentive for better performance would also increase; thus, the venture capital cycle would be complete. However, without a strong control rule, what effects would the estoppel liability and other law rules induce on the reputation mechanism?

Let us assume that P is a prospective investor and L is a limited partner, and L participates in the venture fund's business activities and exercises control. Based upon P's knowledge concerning the status of L, five possible scenarios might exist:[346]

(1) P knows that L is a limited partner and P also knows that L exercises control.

(2) P knows that L is a limited partner, but L conceals his participation in the business, so P is misled into believing that Ldoes not exercise control.

(3) P knows that L is a limited partner, but P is unaware of L's participation in the business; therefore, P believes that L does not exercise control.

(4) P knows that L exercises control and L intentionally misleads P into believing that L is a general partner.

(5) P knows that L exercises control; therefore, P believes that L is a general partner.

If a strong control rule applied,[347] the limited partner would be held liable for his

---

[346] Developed based on the category by R. Kurt Wilke, *Limited Partnership Control: A reexamination of Creditor Reliance*, 60 IND. L.J. 515, 529 (1984).

[347] E.g. if Section 7 of ULPA (1916) applies. It states that "[a] limited partner shall not become

exercising of control in the partnership business in each of the scenarios above. Without the control rule, the liability of the limited partners would be reconsidered in each scenario under the estoppel principle, since exercising control of the partnership business would no longer be the reason for inducing personal liability for limited partners. If the prospective investors have all the correct information, as scenario (1) suggests, there is no estoppel liability for the limited partner since there is no reliance or unreasonable reliance. Such a scenario resembles the market with perfect information.[348] When rational, profit-maximizing market participants have all the information, they will choose the best products and make the best decisions; thus, the existence of a market for reputation would not be necessary.

As in scenarios (2) and (4), the limited partner would lose his limited liability status under the estoppel principle, having made a misrepresentation. In (2), due to the misrepresentation, prospective investors would not have the actual knowledge of the quality of the managers; rather, the fact that the limited partners have credit in the success of previous projects would be concealed from them. In (4), with false information given to the prospective investors, the efficiency of the reputation mechanism would be in jeopardy due to identity confusion. Furthermore, if the limited partners present themselves as general partners to the public, creditor reliance would not be required to make the limited partners personally liable.[349] In such cases,

---

liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

[348] Perfect information is discussed in many economic textbooks. For example, "each firm and each customer is well informed about available products and prices. They know whether one supplier is selling at a lower price than another." See WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY156 (9th ed. 2005); "… buyers know what they are buying, whether it is stocks or bonds, a house, a used car, or a refrigerator. Firms know the productivity of each worker they hire, and when workers go to work for a firm, they know exactly what is expected of them in return for the promised pay." See JOSEPH EUGENE STIGLITZ & CARL E. WALSH, PRINCIPLES OF MICROECONOMICS 228 (3rd ed. 2002); "… households and firms possess all the information they need to make market choices." See KARL E. CASE & RAY C. FAIR, PRINCIPLES OF ECONOMICS 103 (7th ed. 2004).

[349] Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner*

the limited partner may refrain from making misrepresentation, owing to fear of losing limited liability status. Therefore, estoppel liability can to some extent compensate for the absence of the control right, as well as improving the efficiency of the reputation mechanism through a clarity of management signaling.

Scenario (3) has a similar impact on the market for reputation as (2). In both cases, the prospective investors failed to detect the involvement of the limited partner in the partnership business and thus miscalculate the management's competence regarding previous projects. The complication in (3) is that the limited partner did not intentionally conceal his participation in control. Therefore, it is unlikely that estoppel could be applied to such a situation because no representation has been made in such a case. However, the limited partner could be held liable under the agency concept of undisclosed principal.[350] In such a scenario, the manager/general partner becomes the actual agent of the limited partner, the limited partner becomes the undisclosed principal and the prospective investor thinks that he is dealing with the manager directly. This concept would require the limited partner to have exercised sufficient control to justify a finding that he is the actual principal and that the manager is his agent.[351] A similar requirement can be found in jurisdictions where the control rule still holds. In *In re Adelphia Communications Corp*., the court rejected the argument that a third party's actual knowledge of limited partner status automatically defeated a claim of de facto general partner liability under Delaware Code § 17-303(a), given that only the limited partner's conduct is relevant.[352] Therefore, under scenario (3), it is rather difficult to create a negative incentive that prevents the limited partners from

---

Liability?, 37 SUFFOLK U. L. REV. 667, 716 (2004) (refer to Antonic Rigging and Erecting of Missouri, Inc. v. Foundry East Ltd. Partnership, 773 F.Supp. 420 (S.D.Ga., 1991)).

350 Restatement (Third) of Agency § 2.06 (2006).

351 R. Kurt Wilke, *Limited Partnership Control: A reexamination of Creditor Reliance*, 60 IND. L.J. 515, 531 (1984).

352 In re Adelphia Communications Corp. 376 B.R. 87, 90 (Bankr. S.D.N.Y. 2007). "This Court holds that for the purposes of Section 17-303(a), only the limited partner's conduct is relevant because the statute specifically directs in determining a third party's reasonable belief, the analysis must be 'based upon the limited partner's conduct.'"

participating in the course of partnership business without a strong control rule.

It is also difficult to hold the limited partner liable under estoppel principle in scenario (5) since there is no representation. Similar to scenario (4), the prospective investor's belief that the limited partner is the general partner would diminish the actual general partner's contribution in the projects; therefore, managers would have a negative incentive to exert efforts. However, under real-life circumstances, the situation described in (5) is hardly regarded as problematic. When evaluating a venture fund through its prior successful projects, a sophisticated prospective investor would most likely examine the organizational documents of the fund. It would be rare for the prospective investor not to differentiate the limited partner from the general partner. In Shinko v. Guenther,[353] a law firm argued that it reasonably believed that the limited partner was a general partner. The appellate court held that the limited partner's conduct might have been sufficient to support the reasonable belief that the limited partner was a general partner for a different creditor; however, the law firm was not an ordinary creditor, but rather it was chargeable with knowledge of the organic documents that listed the defendant as a limited partner and thus it was not reasonable for it to believe that the limited partner was a general partner.[354]

In conclusion, with a strong control rule, the efficiency of the reputation mechanism would be improved because the venture fund's organizational structure – the limited partnership – could itself serve as a strong signal to the investment public about who is responsible for previous projects, and thus about the genuine quality of the fund managers. Without a strong control rule, other legal mechanisms such as estoppel liability might not reach the same level of effectiveness for the organizational structure alone to be a strong indicator.

---

353 Shinko v. Guenther, 505 F. 3d 987 (9th Cir. 2007).
354 *Id*., at 988.

Chapter 4 A Brief History of Venture Capital in China

To date, the development of venture capital investment in China has comprised three stages. The first stage took place from the 1980s to 1998, when the central government undertook a pilot trial to engineer a venture capital market in China, after which local governments began to play a role. In the second stage, from 1998 to 2003, the Chinese venture capital market underwent a dramatic era of boosting and cooling. The third stage features a venture market developing under regulation, covering the period from 2003 to present.

4.1 Stage 1: 1985-1998 The First Wave of Venture Capital Investments

4.1.1 The First Encounter (1985-1993)

There was virtually no venture capital investment in China before the mid-1980s and the impetus for the development of a Chinese venture capital industry came from government policies. In 1985, the Central Committee of the Chinese Communist Party issued the Decision on the Reform of the Science and Technology System ("the Decision"), which stated that "venture capital enterprises could be set up to support the development of high-tech business with ever-changing nature and high risks".[355] Pursuant to the Decision, the government-sponsored China New Technology Venture Investment Corporation (CNTVIC) – the first ever Chinese venture capital firm[356] –

---

355 Zhonggong Zhongyang Guanyu Kexue Jishu Tizhi Gaige de Jueding (中共中央关于科学技术体制改革的决定) [Decision on the Reform of Science and Technology System] (promulgated on Mar. 13, 1985).

356 Li Yining (厉以宁), *Zhongguo Chuangye Touziye Fazhan Yange, Xianzhuang yu Wenti* (中国创业投资业发展沿革、现状与问题) [*History, Present, and Problem of China's Venture Capital Investment*], 07 ZHONGGUO CHUANGYE TOUZI YU GAOKEJI (中国创业投资与高科技) [CHINA VENTURE CAPITAL & HIGH-TECH] 17, 17 (2004); Christopher M. Vaughn, *Venture Capital in China:*

was founded in the same year. After that, the State Council has issued a series of policies on establishing venture capital investment institutions.[357]

The emergence of venture capital investments was due to the desperate need for new capital within China's newly formed private enterprise sector after the 1978 economic reform.[358] To address this problem, China restructured its banking system by establishing commercial banks, which replaced budgetary grants with interest-bearing loans. In 1989, the Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC) started loan programs specialized in new technology. Securities trading recommenced first in several selected cities in 1986, before national exchanges in Shanghai and Shenzhen were subsequently opened in 1990. In addition, China's open-door policy encouraged foreign investments such as foreign direct investment and joint ventures.[359] These reforms expanded the financing options for the private sector.

These policies resulted in a large number of new innovative venture projects being funded in China without an institutionalized venture capital system.[360] Several features can be identified in this era. First, the funding methods were largely

---

Developing a Regulatory Framework, 16 COLUM. J. ASIAN L. 227, 228 (2002); Lu Haitian et al., *Venture Capital and the Law in China*, 37 HONG KONG L.J. 229, 237 (2007).

357 For example, Zhongguo Kexue Jishu Zhengce Zhinan (中国科学技术政策指南) [The Guidance on Science and Technology Policies] (promulgated by the St. Council in 1986) (mentioned setting up strategies on developing venture capital investment for the first time); Guojia Gaoxin Jishu Chanye Kaifaqu Ruogan Zhengce de Zanxing Guiding (国家高新技术产业开发区若干政策的暂行规定) [Interim Provisions on National Policy of High and New Technology Development Zone] (promulgated by St. Council, Mar. 6, 1991, effective Mar. 6, 1991) (venture capital investment companies can be established in the high and new technology development zones).

358 In 1978, in the third Plenary Session, the 11th Central Committee of the Chinese Communist Party decided to shift its ideological focus from class struggle to economic liberalization and development, turning the planned economy slowly into a market-oriented economy, and thus the economic reform in China began. Prior to the reform, 99% of the state revenues were generated by state-owned enterprises. Christopher M. Vaughn, *Venture Capital in China: Developing a Regulatory Framework*, 16 COLUM. J. ASIAN L. 227, 232 (2002).

359 About China's financial reforms, see e.g. Hassanali Mehran & Marc Quintyn, *Financial Sector Reforms in China*, 33 FIN. & DEV. 18 (1996); XU XIAOPING, CHINA'S FINANCIAL SYSTEM UNDER TRANSITION (1998).

360 Steven White et al, *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RES. POL'Y 894, 899 (2005).

dependent on government budget allocations, which had limited financial resources for supporting these new and highly risky ventures. Second, the immature system did not provide legal, regulatory or institutional support, resulting in a lack of legal definition and even protection of ownership over the new venture's assets. Third, both the infrastructure and the culture of a capital market were yet to be established. Given these characteristics, by the early-1990s, the current system for financing and promoting new ventures was far from mature. The CNTVIC was founded with the State Science and Technology Commission[361] holding 40% of the shares and the Ministry of Finance 23%, while other shareholders were the state-owned enterprises (SOE) in the mining and shipping sectors. Despite being intended to replicate the system by which new technology ventures were financed in Silicon Valley in the U.S., this was more a case of a government agency mandated to support national technology development policies rather than being a profit-earning enterprise.[362] Due to the lack of funding and the immature capital market, the CNTVIC's investment objectives gradually deviated from financing technology ventures to other businesses such as investment in trusts and securities; ultimately, it was ordered to liquidate by the People's Bank of China[363] due to illegal speculation in housing and future markets, and it eventually declared bankruptcy.

4.1.2 Exploring the Path (1993-1998)

The perception of innovation financing gradually changed during this period. Political authorities and policy makers began to view venture capital financing more as a commercial activity that supports the commercialization of technology than as distribution of government funds. Government-financed venture capital firms were

---

361 Later became the Ministry of Science and Technology (the MOST).

362 Steven White et al, *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RES. POL'Y 894, 900 (2005).

363 The central bank in China.

established with funding from provincial/municipal governments such as Jiangsu, Zhejiang and Shanghai. By the year 1996, the number of government-funded venture capital firms reached 24.[364] In the same year, the Law on Promoting the Transformation of Scientific and Technological Achievements was enacted, stating that "[t]he State encourages establishment of funds or risk funds for transformation of scientific and technological achievements, and such funds shall be raised by the State, local authorities, enterprises, institutions and other organizations and individuals".[365] It also provided the first legal basis for the rights and interests of scientific and technological achievements.[366]

During this period, foreign venture capital firms began to operate in China, with the leading firms including IDG Capital Partners and ChinaVest.[367] Despite the continuous participation of central and local government in the venture capital system as well as the entry of foreign funds, the involvement of the domestic private sector remained scarce.[368] Furthermore, due to a lack of fund management experience, the amount of domestic investment was minor compared to foreign investment.[369]

---

364 Li Yining (厉以宁), at 18.

365 Cujin Keji Chengguo Zhuanhua Fa (促进科技成果转化法) [Law on Promoting the Transformation of Scientific and Technological Achievements] (promulgated by the Standing Comm. Nat'l People's Cong., May 15, 1996, effective Oct. 1, 1996) (China), Art. 24. English version *available at*:
http://en.pkulaw.cn/display.aspx?cgid=14408&lib=law.

366 *Id*., Ch. 4.

367 As of 2001, the top ten (ranked by cumulative investment) foreign venture capital firms in China were IDG, ChinaVest Ltd., Intel Capital, Shenzhen Venture Capital Co. Ltd., H&Q Asia Pacific, WI Harper Group, Baring Private Equity Partners (Asia), Goldman Sachs (Asia) Ltd., Vertex Management and Walden International. Source: http://www.zero2ipo.com.cn.

368 Li Yining (厉以宁), at 18.

369 Between 1990 and 1999, only 10 out of 131 deals were made by Chinese domestic VC firms, accounting for U.S.$ 88 million out of a total $1,913 million. Anson Wong, *The Evolution of the Venture Capital Market in China: Current Trends in Venture Capital Financing Strategies and Investment Preferences*, 20 J. INVESTING 16, 18 (2011).

4.2 Stage 2: 1998-2003 When the Bubble Bursts

4.2.1 Building the Bubble (1998-2001)

Venture capital investment in China entered a stage of rapid development after 1998, prior to which the domestic venture investment system was still following the traditional style of government funding, essentially only with the terminology changing from "funding" to "investing". However, with the continuous efforts of central and local government exploring the development of the venture industry, Announcement No. 1[370] marked the beginning of a fast-developing venture-investing era. During the first session of the 9th National Committee of the Political Consultative Conference in March 1998, Announcement No. 1 was put forward and eventually led to a wave of venture capital investing enthusiasm.[371] There were 43 newly-established venture capital firms in the second half of 1998 alone, and by August 1999 the number of government-funded venture firms had exceeded 100.[372] Announcement No. 1 has provided useful guidelines to push forward the unregulated venture industry into a coherent institutional system. It suggested that "combined with China's reality, one should adopt the government-private cooperation model. The State shall inject certain amount of money as start and guarantee, then absorb investments from private sectors through issuing stock or bond, supporting the formation of venture capital enterprises that operate under market-based rules and the guidance of the State's planning."

During this period, China's economic environment became much more friendly

---

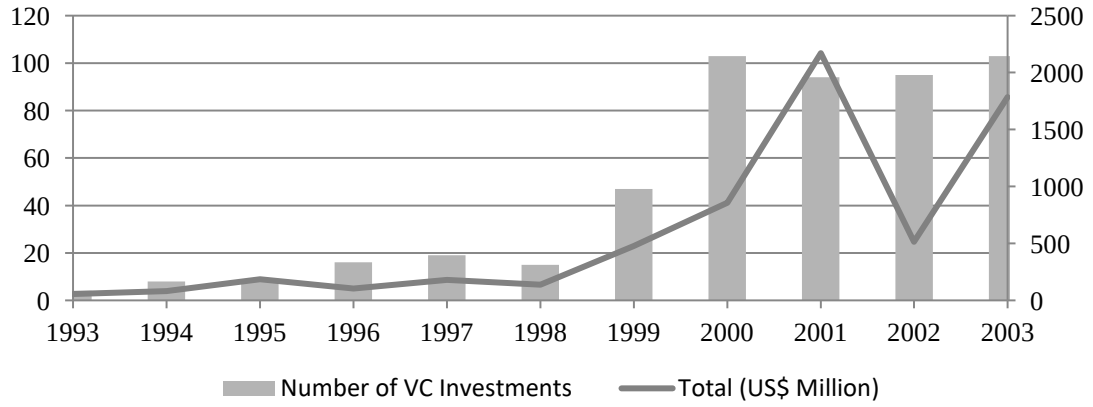
370 The full name of the Announcement No.1 is Guanyu Jiakuai Fazhan Woguo Fengxian Touzi Shiye (关于加快发展我国风险投资事业) [On Accelerating China Venture Capital Industry]; it was put forward by Cheng Siwei, member of the China National Democratic Construction Association.

371 Lu Haitian et al., *Venture Capital and the Law in China*, 37 HONG KONG L.J. 229, 238 (2007); White et al., *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RES. POL'Y 894, 900 (2005).

372 York Chen et al., Zhongguo Chuangtou 20 Nian (中国创投 20 年) [China Venture Capital 20 Years] 2011. Selected chapters *available at http://data.book.hexun.com/book-16981.shtml*.

towards the private sector. China's Constitution was amended in 1999 to promote the status of private ownership,[373] and private firms were allowed to be listed on the stock exchanges in the late-1990s. Consequently, private entrepreneurship began to thrive. Among other factors, the huge success of NASDAQ at that time played a critical role in venture investment in China.[374] Many overseas returnees who had worked in Silicon Valley and had experience of information technology on NASDAQ wanted to replicate Silicon Valley business models in China, which in turn attracted many international venture capitalists. Furthermore, NASDAQ provided an IPO exit channel for the venture-backed firms in China. 90% of venture-backed firms were private firms in the late-1990s.[375] The amount of venture capital investments experienced a huge jump (Figure 8) and by the end of the 1990s more than 70% of the venture-backed firms were conducting computer and internet-related business and services.[376]

Figure 8 Venture capital investments in China (1993-2003)



373 Xianfa (宪法) [Constitution] Amend. 16 (1999). English version *available at*:
. Before this amendment, the Constitution only stated that "the State permits the private sector of the economy to exist"; the 1999 Amendment changed to "the non-public sectors of the economy … constitute an important component of the socialist market economy". This amendment represented a supportive attitude toward the private sector in China.

374 FENG ZENG, VENTURE CAPITAL INVESTMENTS IN CHINA 98 (2004).

375 *Id*., at 100.

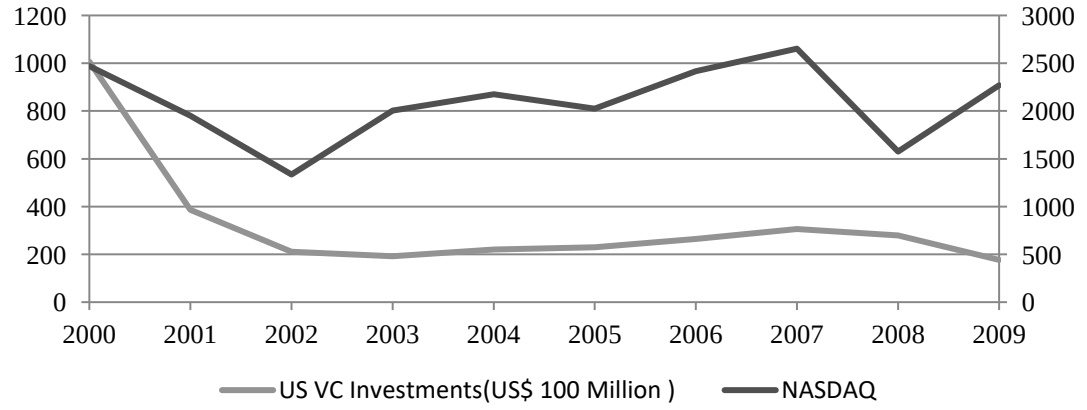
376 *Id*., at 103.

Source: AVCJ database

4.2.2 Cowering Down (2001-2003)

In light of the booming venture investment market and the huge success of NASDAQ, the State Council began to discuss the possibility of creating a new Growth Enterprise Market (GEM) panel at the Shenzhen Stock Exchange in 2000, which could provide a possible exit route for the venture backed firms. Presuming the launch of a GEM, domestic venture capitalists began to invest furiously in any firms that could have been related to the GEM.[377] However, what happened next postponed the launch of the GEM for almost a decade. From the beginning of the second half of 2000, the burst of the dotcom bubble devastated the NASDAQ, and the entire information industry and venture capital investments suffered severe losses (Figure 9). In 2001, the former Premier Zhu Rongji noted that it was necessary to first stabilize the main board of the stock exchange before considering launching the GEM, otherwise it would possibly possess the same weakness and repeat the same mistakes as the main board.[378] Accordingly, it was not until 2009 that the GEM was finally launched.

Figure 9 U.S. Venture Capital Investments and NASDAQ

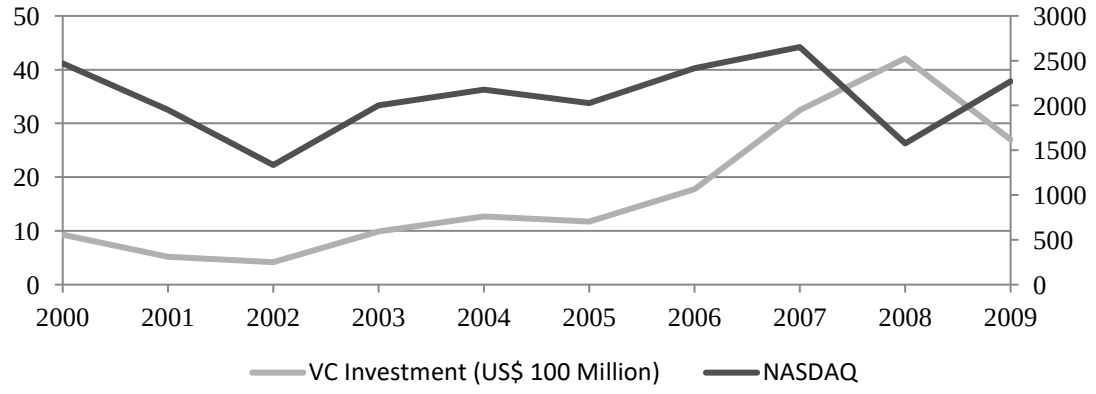


377 York Chen et al., Zhongguo Chuangtou 20 Nian (中国创投 20 年) [China Venture Capital 20 Years] 2011.
378 *Id.*

Source: www.zero2ipo.com.cn

Therefore, along with the crash of NASDAQ, the GEM being shelved also negatively affected the domestic venture capital industry (Figure 10). Lacking adequate venture investment experience, many of the newly-established venture capital organizations only focused on the concept of a growth market, while failing to distinguish the true quality of the invested entrepreneurial firms. When the GEM was postponed, there were no proper exit routes and thus a large number of domestic venture capital organizations had to either close down or diverge to other business areas.[379] Furthermore, during this period, domestic investors had not yet recognized and fully understood the business model of venture capital. They could not bear the long waiting period until the projects generated profit; instead, they were impatient to seek a steady stream of payback of their funds. Therefore, to meet the requirement of the investors, the domestic venture capitalists could only turn to other businesses.[380]

Figure 10 China Venture Capital Investments and NASDAQ



Source: www.zero2ipo.com.cn

[379] Haitian Lu et al., *Why do venture capital firms exist: An Institution-based rent-seeking perspective and Chinese evidence*, 30 ASIA PAC. J. MGMT. 921, 930 (2013).

[380] York Chen et al., Zhongguo Chuangtou 20 Nian (中国创投 20 年) [China Venture Capital 20 Years] 2011.

To illustrate the investment environment during this period, take Zhejiang Silicon Paradise Venture Capital (TTGG)[381] as an example. TTGG was established jointly by 18 listed and to-be-listed companies led by the Zhejiang Provincial Government in 2000. During the downturn of the market in the early years, after investing in several projects, the company began to invest in the stock market due to the lack of proper exit routes. As a result, it lost one-third of total assets by 2005.[382]

4.3. Stage 3: 2003-Present Development under Regulation

4.3.1 Breaking the Ice (2003-2005)

After the two-year market downturn, the successful listing of Ctrip[383] on NASDAQ on December 9, 2003 marked Wall Street's regained confidence in Chinese internet-related business, and some mainstream venture capitalists began to reconsider investing in China.[384] In the following two years, several Chinese internet-related companies were listed on NASDAQ, including Baidu, China's largest internet search engine.

In addition to foreign markets, new opportunities also presented themselves domestically. During this period, domestic venture capitalists benefited tremendously from a series of capital market reforms. First, rather than the GEM, a new board for small and medium-sized enterprises (SME) was launched at the Shenzhen Stock Exchange in 2004, providing an important exit route for the domestic venture-backed firms. From 2004 to 2009, among the newly listed companies, 8 (2004), 11 (2005), 21

---

381 The Chinese name of the company is Tiantang Guigu (天堂硅谷).

382 York Chen et al., Zhongguo Chuangtou 20 Nian (中国创投 20 年) [China Venture Capital 20 Years] 2011.

383 Ctrip is a company providing travel services including accommodation and ticket reservations, packaged tours and travel management, mainly through online services.

384 Li Na (李娜), VC Zhongguo Jinhuashi (VC 中国进化史) [VC China Revolution History], *available at*: http://www.ceocio.com.cn/e/action/ShowInfo.php?classid=245&id=125401.

(2006), 48 (2007), 72 (2008) and 87 (2009) companies with a venture capital background went public.[385] These successful exits generated a huge amount of return and an even greater incentive to the domestic venture capitalists. Second, the so-called "split share structure" reform was accelerated from 2005. In the late-1980s and early-1990s, China began to reorganize state-owned enterprises (SOE) into modern shareholding corporations. When the securities market was created, there were fears that if a SOE was listed on the stock exchange and the shares could be traded, the state may eventually lose its control over the enterprise. Therefore, when an SOE went public, it issued additional new stocks, which could be traded in the market, separated from the existing stocks, which could not be publicly traded. This split share structure reform was seen as the secondary privatization reform.[386] In 2004, the State Council issued Some Opinions on Promoting the Reform, Opening and Steady Growth of Capital Markets, stating that the "issue of split share structure must be settled in a positive and reliable manner."[387] On September 4, 2005, the China Securities Regulatory Commission (CSRC) issued the Measures for the Administration of the Share-trading Reform of Listed Companies. By the end of 2006, the reform had been completed. All non-tradable shares were converted into legitimate tradable shares with negotiated considerations to compensate holders of

---

385 York Chen et al., Zhongguo Chuangtou 20 Nian (中国创投 20 年) [China Venture Capital 20 Years] 2011.

386 Guquan Fenzhi Jiegou (股权分置结构), the split share structure, also translated as non-tradable shares structure. For a comprehensive introduction and analysis, see Li Liao et al., *China's Secondary Privatization: Perspectives from the Split-Share Structure Reform*, J. FIN. ECON. (forthcoming), *available at*: . Before the split-share reform, the Chinese government started corporatizing a selection of small SOEs in the mid-1980s. These SOEs went public to issue tradable shares to private agents. But these were only a small portion of the SOE ownership and had little decision-making power over the State's role. Hence the spit-share structure was formed. Corporatizing the SOEs was seen as a primary privatization reform, then split-share reform the secondary.

387 Guowuyuan Guanyu Tuijin Ziben Shichang Gaige Kaifang he Wending Fazhan de Ruogan Yijian (国务院关于推进资本市场改革开放和稳定发展的若干意见) [Some Opinions on Promoting the Reform, Opening and Steady Growth of Capital Markets] (promulgated by St. Council on Jan. 31, 2004, effective Jan. 31, 2004) Art. III. English version *available at*:
http://en.pkulaw.cn/display.aspx?cgid=51371&lib=law.

tradable shares.[388]

These capital market reforms not only created a new exit route for venture capital backed companies, but also significantly increased the efficiency of the capital market.[389] Now that the state shareholder's shares could be traded in the stock market, their wealth was more sensitive to the market value of the firms, which therefore increased the incentive for the shareholders to monitor the firm performance in order to maintain the share value; at the same time the tradable shares enabled the market of control to function properly. It was comparatiely easy for the venture capitalists, given that they could now bring their portfolio firms to IPO in the domestic market and achieve a better performance due to the improved investing environment of the whole market, consequently benefiting their follow-up fund-raising. The success of the venture capitalists in the domestic markets created a huge incentive for private investors, talents and researchers to participate in the venture-investing businesses.

4.3.2 The Second Wave (2005-2008)

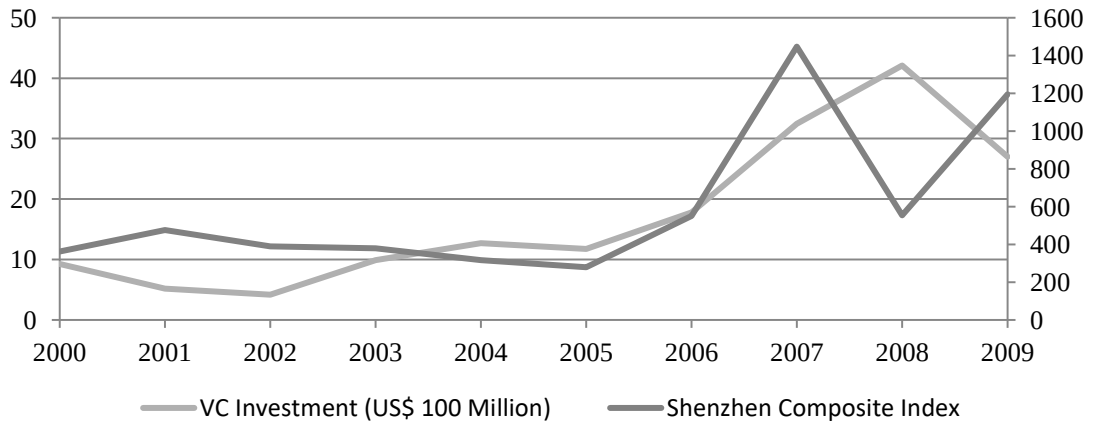
After a period of cooling and waiting, the venture market began to take a leap in the second half of the 2000s, a trend that even continued beyond the recent financial crisis (Figure 11). During this period, new laws and regulations concerning various aspects of venture capital investments were implemented. Together with further capital market reforms, these institutional changes had helped to expand the playground of venture capital investments.

Figure 11 Venture Capital Investment and Stock Market Index in China

---

388 Li Liao et al., *China's Secondary Privatization: Perspectives from the Split-Share Structure Reform*, J. FIN. ECON. (forthcoming), at 10.

389 See e.g. Douglas Cumming et al., *Impact of Split Share Structure Reform in China on CEO Accountability to Corporate Fraud*, (Working Paper Jan.1, 2012), *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2015287.



Source: www.zero2ipo.com.cn

These years were very busy in the development of China's legal system. First, the revised Company Law became effective on January 1, 2006, making several fundamental changes.[390] For example, for the first time it allows forming a single-member limited liability company.[391] It lowers the minimum registered capital requirement to form a limited liability company[392] and allows up to 70% of a limited liability company's registered capital to be in the form of non-cash contributions.[393] These provisions could promote the development of innovative entrepreneurial firms. Second, also effective as of January 1, 2006, the revised Securities Law defined "securities"[394] and "public offering"[395] for the first time and enhanced investor protection.[396] It also provided detailed rules for securities listing.[397] It encourages the securities market to adopt flexible approaches to attract innovative firms to become

---

390 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006). English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=60597&lib=law.

391 *Id*., art. 24.

392 *Id*., art. 26.

393 *Id*., art. 27.

394 Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 2. English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=60599&lib=law.

395 *Id*., art. 10.

396 *Id*., art. 134.

397 *Id*., ch. III.

listed. Third, the new Partnership Enterprise Law (PEL) came into force on June 1, 2007.[398] The most significant change from the 1997 version[399] is the introduction of Limited Partnerships.[400] In addition to individuals, an entity can become a general partner.[401] The most popular business form of venture capital funds was finally regulated by law.

Regarding regulations and reforms directly addressing venture capital businesses, the Interim Measures for the Administration of Venture Capital Investment Enterprises[402] (the Interim Measures) became effective on March 1, 2006. They define "venture capital investment enterprises"[403] as "any enterprise organization registered and established within the territory of the People's Republic of China for the purpose of mainly engaging in venture capital investment activities".[404] They clarified the definition of "venture capital" as "any stock right investments that are injected into a startup enterprise in expectation of capital gains mainly by the way of stock right transfer after the invested startup enterprise becomes mature or relatively mature." They also clarified that "startup enterprises" are those enterprises that have not been

---

398 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun.1,2007). English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=78896&lib=law.

399 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Feb. 23, 1997, effective Aug. 1, 1997). English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=16295&lib=law.

400 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun.1,2007) art. 2 & ch. 3.

401 *Id*., art. 2, 60.

402 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006). English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=60864&lib=law.

403 *Id*., art. 2.

404 The Interim Measures settled the long dispute over the issue of the Chinese translation of "venture capital", emphasizing the meaning of "venture" in the Chinese term. There have been two translations in Chinese when referring to "venture capital": 风险投资 literarily means "risk investment" and 创业投资 literarily means "invest in a newly started business". The Interim Measures chose the latter since the former only focuses on the risk feature of venture capital investment, which is not able to reveal the full nature of venture capital.

listed on the stock exchange.[405] Regarding the venture capital exit routes, the Interim Measures state that the venture capital investment enterprise "may withdraw its investments by transfer of listed equities, transfer of equities by agreement, repurchase by the invested enterprise or by other means."[406] They also state that those completing the filing procedure and complying with the supervision of the relevant regulatory body shall receive policy supports.[407] In February 2007, the Ministry of Finance (the MOF) and the State Administration of Taxation jointly issued the Notice on the Relevant Tax Policies on the Development of Venture Capital Investment Enterprises, providing significant tax benefits to venture-investing businesses.[408]

During this period, government-funded venture investment has begun to take the form of a "government guiding fund" rather than participating directly in project selection and investment; the guiding fund serves a role as "fund of funds", cooperates with other investors by contributing initial capital to a venture capital fund and thus guides the fund into high-growth businesses.[409]

By the end of 2008, the aggregate amount of venture capital investments exceeded US$ 4 billion[410] (Figure 12). The new funds raised by domestic and foreign venture capitalists that could be invested in mainland China in 2008 alone amounted to

---

405 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006), Art. 2, "any growing enterprises … that is during the course of establishment or reestablishment, excluding those enterprises that have go listed in the open market."

406 *Id*., art. 24.

407 *Id*., art. 3. See also Chapter IV of the Interim Measures, the support can be "holding their (government guiding funds) shares, providing financing guaranties, etc." "The state shall adopt tax preferential policies to support the development of venture capital investment enterprises."

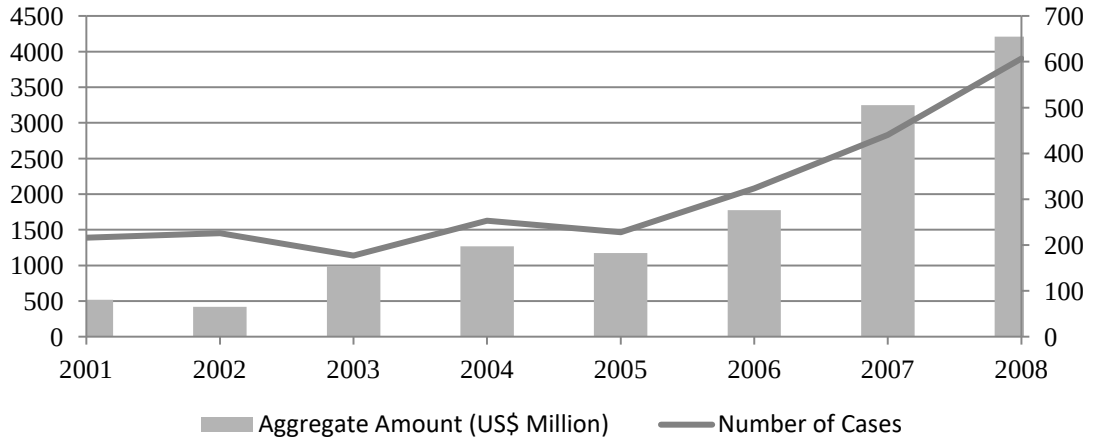
408 This Notice is ineffective since February 2, 2011. The taxation of venture capital funds in China will be discussed in later chapters.

409 In July 2007, the MOF and the MOST jointly issued the Interim Regulation on Managing the Venture Capital Guiding Fund for High-tech SMEs and in October 2008, the State Council issued the Guidance on Establishment and Operation of Venture Capital Guiding Funds, which provides the governing rules for the guiding funds. It will be discussed in detail in later chapters.

410 CHINA VENTURE CAPITAL ANNUAL REPORT 2008, *available at*: http://research.pedaily.cn/report/pay/368.shtml.

US$ 7.3 billion.[411]

Figure 12 Aggregate Amount of Venture Capital Investments in China



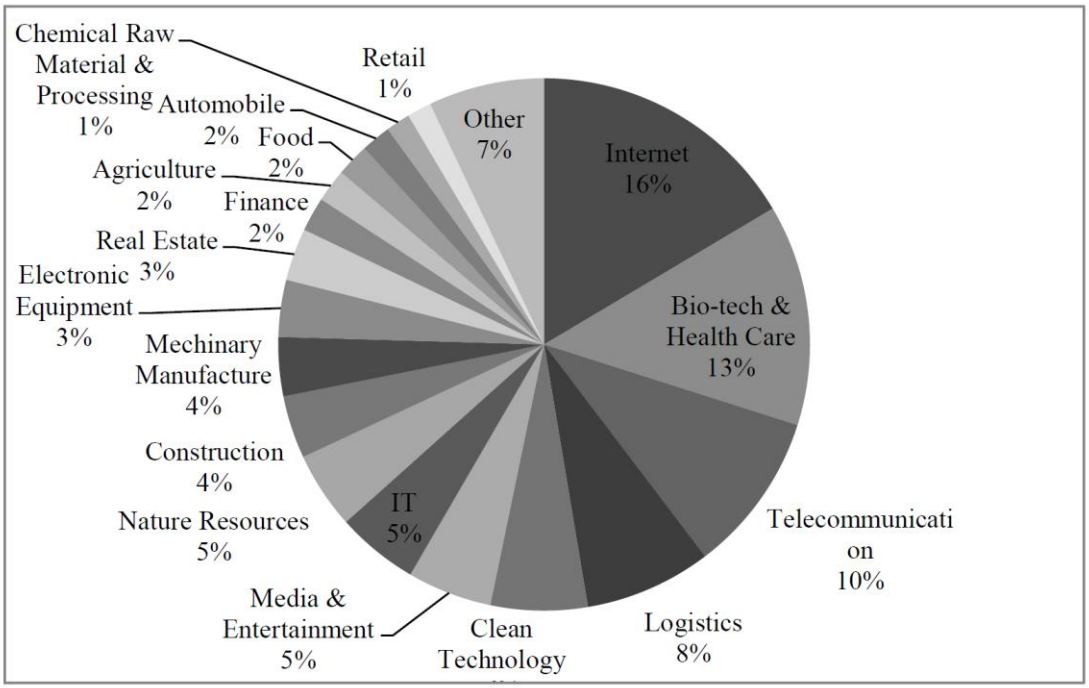
Source: www.zero2ipo.com.cn

4.3.3 A New Era (2008-Now)

In 2013, there were 1,148 venture capital investment events in China, with a total amount of around US$6.6 billion. By industry, internet-related business, telecommunications and biotechnology/heath care occupy the leading position (Figure 13).

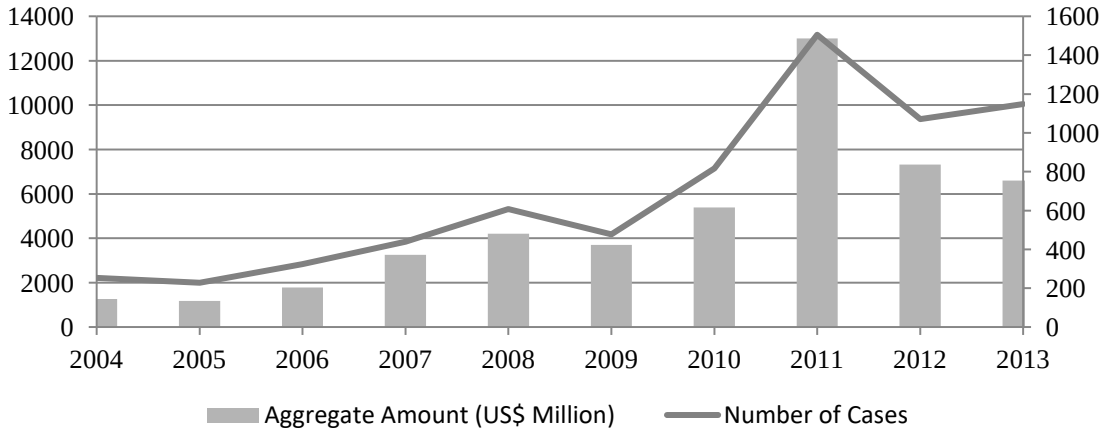
Figure 13 Venture Capital Investment by Industry in 2013 (by investment)

411 *Id.*



The recent financial crisis had a great impact on the Chinese venture capital market. The speed of investment increase already slowed down in 2008. In 2009, the aggregate amount of investments experienced a significant decrease for the first time since 2002. Although the investment growth quickly resumed its speed and peaked in 2011, due to various economic and policy reasons, the venture market is lingering in a low state (Figure 14).

Figure 14 Venture Capital Investment in China (2004-2013)



Source:

Several factors contributed to the fast growth of venture capital investments shortly after the crisis. First, the GEM was officially launched in late 2009. Structured as a sub-market inside the Shenzhen Stock Exchange, the GEM provides direct access to the capital market for companies that have demonstrated strong growth potential despite not meeting the criteria for the main board.[412] It provides a new exit route for both domestic and foreign venture capitalists. Second, in July 2010 the China Insurance Regulatory Commission (CIRC) issued the Interim Measures for Equity Investment with Insurance Funds.[413] These expand the funding sources of venture capital investment in China. Traditionally, domestic funds for venture investing in China were mainly from government, corporations and trust funds.[414] The funding pool is significantly enlarged with domestic insurance funds joining the family. Third, securities companies were officially permitted to participate in equity investment in 2011. Pilot projects of securities companies' equity investment had been launched since 2007 and after several years of experimentation, the Securities Association of China (SAC) issued the Guidance of Supervision for the Direct Investment Business of Securities Companies in November 2011.[415]

It has, however, been difficult for venture investing in the most recent years. One important reason is that, due to the slow recovery of the world economy from the 2008 financial crisis and the European debt crisis, the growth of exports from China

---

412 Adam Bobrow et al., *China*, 44 INT'L LAW. 631, 640 (2010).

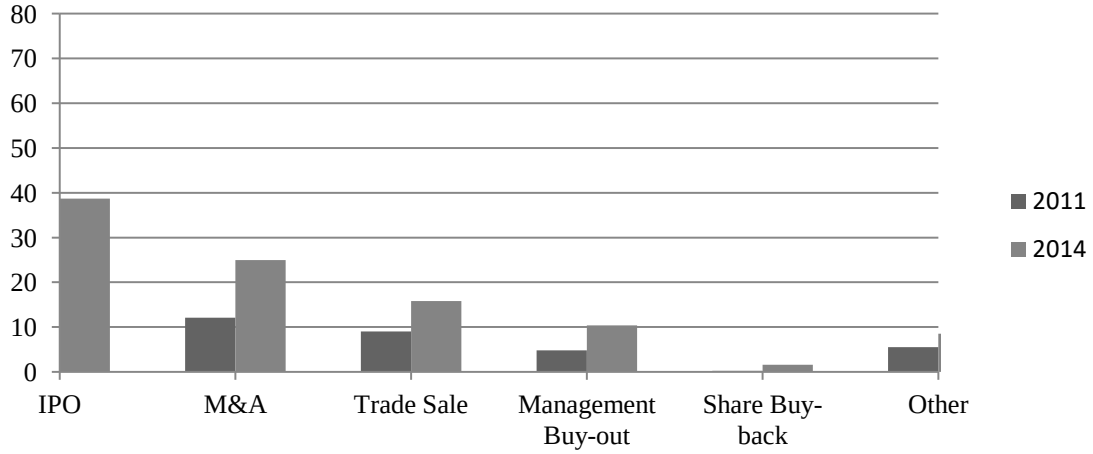
413 Baoxian Zijin Touzi Guquan Zanxing Banfa (保险资金投资股权暂行办法) [Interim Measures for Equity Investment with Insurance Funds] (promulgated by CIRC July 7, 2003, effective July 7, 2003). English version *available at*: http://en.pkulaw.cn/display.aspx?cgid=137434&lib=law.

414 CHINA VENTURE CAPITAL YEARBOOK 2011, at 75.

415 Zhengquan Gongsi Zhijie Touzi Yewu Jianguan Zhiyin (证券公司直接投资业务监管指引) [Guidance of Supervision for the Direct Investment Business of Securities Companies] (promulgated by SAC Nov. 22, 2011, effective Nov. 22, 2011); this guidance was amended in 2012 and 2013, the effective version today is Zhengquan Gongsi Zhijie Touzi Yewu Guifan (证券公司直接投资业务规范) [Rules for the Direct Investment Business of Securities Companies] (promulgated by SAC Jan. 3 2014, effective Jan. 3, 2014).

to developed countries has slowed down.[416] Given the circumstances of such uncertainty in the macroeconomic trend, foreign investors are hesitant about investing in China.[417] Domestically, the economic environment has placed downward pressure on the A-share market, while the CSRC has continuously increased the listing threshold, thereby severely hampering venture capital exits[418] (Figure 15).

Figure 15 Percentage of Venture Capital Exit Routes in 2011 and 2014



Venture capital investment plays an important role in driving economic growth though its ability to spur innovation in today's China. Compared to the United States, on the one hand, the agency problem still exists between the investors and the venture capitalist in both jurisdictions, and on the other hand, due to the uniqueness of the Chinese market, a quite different system was developed to respond to such problem through a curious mixture of all the traditional countermeasures such as contracts, legal rules, and the reputation mechanism.

---

416 CHINA VENTURE CAPITAL YEARBOOK 2012, at 92.

417 CHINA VENTURE CAPITAL ANNUAL REPORT 2013, *available at*: http://research.pedaily.cn/report/pay/898.shtml.

418 *Id*.

Chapter 5 Unique Features of Venture Capital Investments in China

One must face the agency problem between the investors and the general partner if one chooses the limited partnership as the organization form. For the U.S. investors, they choose to constrain the general partner's behavior through covenants and compensation provisions in the partnership agreement. At the same time, fiduciary duties and the reputation mechanism also prevent the management from shirking. However in China, facing the same agency problem, the Chinese investors tend to choose their strategies from a different angle: either they abandon the limited partnership form for good and are just content with shareholder rights in corporations, or they want to closely monitor the general partner's behavior in the limited partnership.

This chapter describes and explains these choices made by Chinese investors. Of course, similar countermeasures for the agency problem such as covenants also exist in China. However, these remedies may not be adequate to soothe the worries of the investors. Furthermore, cultural factors can be an explanation of the investors' choices, and even serve as a special form of constraint to deal with the agency problem.

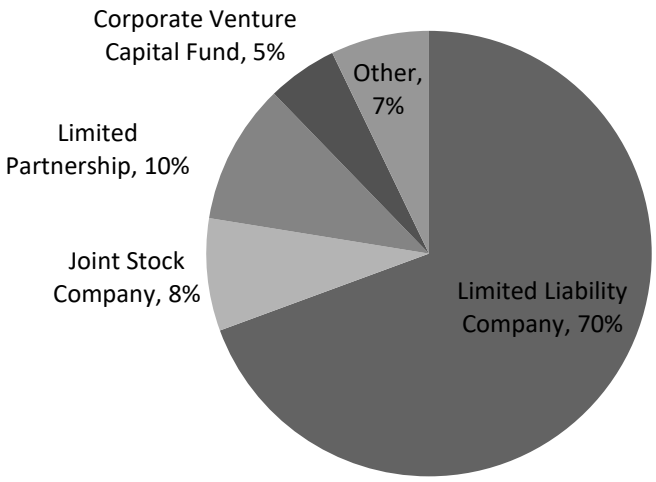
5.1 Investor Activism in China

5.1.1 The Choice of Business Form by Chinese Investors

Unlike in the U.S., most venture capital funds in China are organized as corporations. The current governing regulation – Interim Measures for the Administration of Venture Capital Investment Enterprises – states that "a venture capital investment enterprise may be established as a limited liability company, a joint stock company, or

other organization forms stipulated by law."[419] In 2012, 69.39% of the venture capital funds adopted the limited liability company as their business form, whereas other forms such as joint stock company, limited partnership and corporate venture capital fund accounted for 8.16%, 10.2% and 5.1%, respectively (Figure 16).[420]

Figure 16 Percentage of Business Forms of Venture Capital Funds in 2012



Source: Venture Capital Year Book

Meanwhile, the new Company Law of 2005 created a much more relaxed environment for venture capital enterprises. Such a trend has been extended in the latest amendment of the law in 2013.

---

419 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006), art.6. English version *available at*:
.

It is worth clarifying the terminology used here, given that the English translation of the respective organization forms cause a degree of confusion. In a limited liability company (Youxian Zeren Gongsi, 有限责任公司), the shareholders enjoy limited liability to the amount of their contribution, while in a joint stock company (Gufen Youxian Gongsi, 股份有限公司) the company's assets are divided into equal stocks and shareholders enjoy limited liability to the amount of the stocks they are holding. For the purpose of this paper, both company forms are considered as an incorporation to differentiate from the limited partnership, which does not have a legal person status and the general partners have unlimited liability.

420 VENTURE CAPITAL YEAR BOOK 2013, at 258.

First, the 2005 Company Law shortened the non-transferrable time period of the promoters' shares of a corporation from three years to one year.[421] It facilitates a more flexible timing choice for venture capital exits. Second, a joint stock company may be established by way of stock floatation[422] and in such case the shares subscribed by the promoters shall not be less than 35% of the total shares.[423] Compared to the old law, which allowed only promotion as the way of establishing a corporation, venture capital enterprises that choose the joint stock company as a business form enjoy a wider range of funding sources under the new law. Third, shareholders are allowed to make capital contributions in cash or other non-monetary properties. The newest amendment of Company Law cancelled the requirement of a minimum 30% cash contribution threshold,[424] which means that there is no upper limit to non-monetary contribution. It is a positive incentive for the investors who possess high-value intellectual property rights to invest in domestic venture capital companies,[425] while it shifts greater responsibility of due diligence to the venture capital enterprises for the valuation of these non-cash investments.[426]

It is worth mentioning that, although the tendency of relaxation in terms of setting up corporations is evident, the venture capital enterprises that choose corporation as their business forms may benefit less from the Interim Measures. The newest amendment

---

421 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec., 29, 1993, effective July 1, 1994), Art.147; Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), Art.142.

422 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), Art.77.

423 *Id*., at Art. 84.

424 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art.27 & 82.

425 Cheng Siwei (成思危), Xin Gongsifa Jiangdi Fengtou Jinru Menkan (新《公司法》降低风投进入门槛) [*New Company Law Lowers the Entry Requirements for Venture Capital*], available at: (last visited Sept. 15, 2014).

426 Qiu Jianxin (邱剑新), Xin Gongsi Fa, Xin Hehuo Qieye Fa Dui Chuangye Touzi Huodong Ruogan Fengxianxing Yingxiang Ji Duice (新《公司法》、新《合伙企业法》对创业投资活动若干风险性影响及对策) [*Several Points on the Risk for Venture Capital Investment under the New Company Law and the New Partnership Law*], VENTURE CAPITAL YEARBOOK 2007, 325.

of Company Law in 2013 has abolished the requirements of a minimum capital contribution[427] as well as a minimum actual capital contribution that must be paid for establishing a corporation,[428] yet the Interim Measures impose these requirements on venture capital enterprises.[429] Those that choose the corporation as their business form should nonetheless meet the capital contribution requirements.[430]

The percentage of funds that choose limited partnership as business form peaked in 2008 (Figure 17), since the 2007 enacted new Partnership Law contains a new chapter regulating limited partnership. For various reasons, limited partnership began to lose its popularity among venture funds in the following years. In 2012, the percentage of limited partnership was 10.2%, slightly higher than the previous year's 8.75%.[431]

Figure 17 Percentage of Business Forms of Venture Capital Funds in China

---

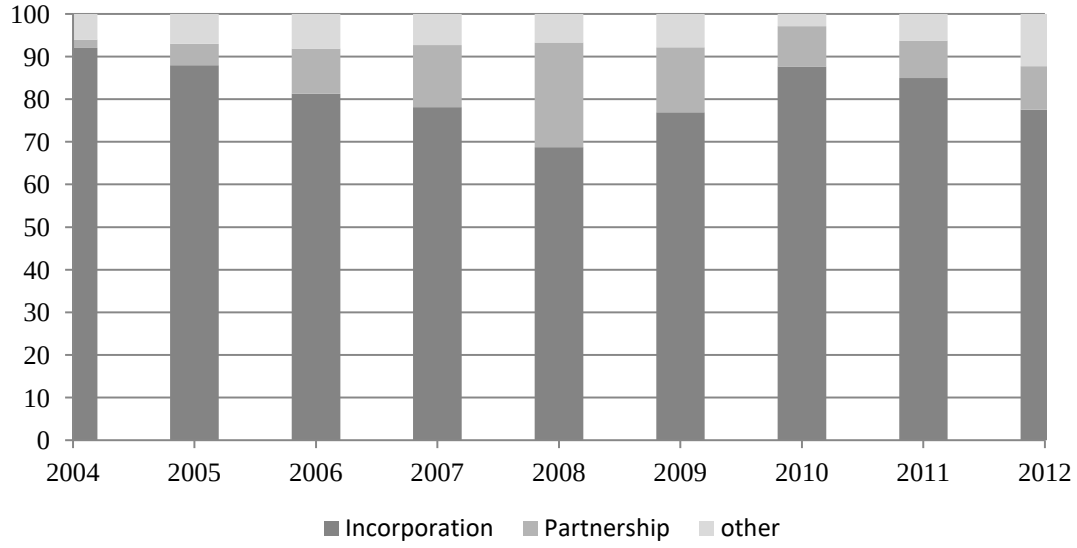
427 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art. 26 & 80.

428 *Id*., Art. 27 & 81.

429 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006), Art. 4.

430 The Company Law provides that "where any law or administrative regulation or any decision of the State Council provides otherwise for the paid-in registered capital or the minimum amount of registered capital…such provisions shall prevail." See e.g. Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art. 26.

431 VENTURE CAPITAL YEAR BOOK 2013, at 258.



Source: Venture Capital Year Book

Meanwhile, while the percentage of the limited partnership fund within as in the total number of venture funds remains small, the business form choice of the newly-established venture capital funds of each year – especially after the enactment of the new PEL – displayed an interesting trend (Figure 18). The number of *new* established venture funds every year that chose the limited partnership as their business form was very volatile, reflecting a mixed feeling of the investors towards such a "new" form.

It is worth noting that there are several limitations in PEL that may be seen as an adaption to the unique features of the Chinese market. One significant limitation is that PEL expressly prohibits wholly state-funded companies, state-owned companies, listed companies, public-welfare-oriented public institutions and social organizations from being general partners.[432] The purpose of the article is obvious, namely to protect state-owned property and the shareholders of listed companies from assuming unlimited liability. However, the statue contains no restriction about these entities being limited partners. Therefore, taking into consideration that the government had

[432] Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 3.

led the development of venture capital in China, companies with a government background are unable to manage limited partnership funds. It is, however, possible for them to bring government resources as investors in limited partnership funds. This provides the legal ground for the venture capital guiding funds, which will be discussed in the next chapter.

Another key difference is the number of partners permitted by law. In PEL, a limited partnership must have at least two partners, one of whom is a general partner and one of whom is a limited partner. Moreover, there may be no more than 50 partners unless otherwise provided by law.[433] By contrast, in either RULPA or ULPA, there is no limitation on the number of partners.[434] The purpose of the restriction in PEL is to prevent illegal fund collection,[435] although under such provision the venture capital fund would be unable to engage in large-scale fund-raising. Of course, the investors can first form several small limited partnerships that have fewer than 50 partners and subsequently form a large limited partnership out of these small partnerships. However, in such case it would significantly weaken the tax shielding function of the limited partnership due to excessive layers of the partnership.[436]

Figure 18 Percentage of limited partnership in newly-established venture funds

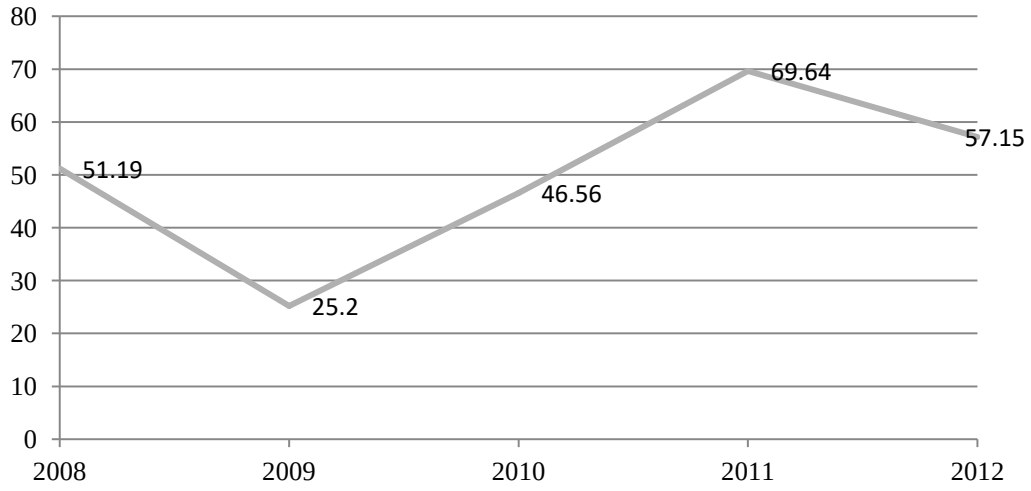
---

433 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 61.

434 RUPLA (1985) §101 (7); ULPA (2001) §102(11).

435 Qiu Jianxin (邱剑新), Xin Gongsi Fa, Xin Hehuo Qieye Fa Dui Chuangye Touzi Huodong Ruogan Fengxianxing Yingxiang Ji Duice (新《公司法》、新《合伙企业法》对创业投资活动若干风险性影响及对策) [*Several Points on the Risk for Venture Capital Investment under the New Company Law and the New Partnership Law*], VENTURE CAPITAL YEARBOOK 2007, 333.

436 *Id*.



Source: Venture Capital Year Book

From the figure above, one can tell that after the new PEL entered into effect in 2007, half of the venture funds tried out this new form in the next year. However, only a year later, the percentage had dropped by half. Subsequently, the number increased again and peaked in 2011, with almost 70% of newly-established venture funds taking the form of limited partnership. Before anyone could conclude that it has become a major choice of venture fund form in China, the number subsequently declined again.[437] This trend has shown an uncertain opinion among the public towards the limited partnership during a transition period. Recent sources have indicated that the limited partnership has already become the most popular choice of business form for venture capital investments.[438] However, there have always been concerns among the investing public about such a form. The following examples of China's limited partnership venture funds illustrate the major issues associated with such a business

---

[437] Data from the Venture Capital Yearbook before 2008 and 2013 are not available; however, according to interviewee A, venture funds in which he was involved, established before 2013, were all corporations and the four funds at hand (Mar. 2015) are all limited partnerships.

[438] Partial data from the online database "中投在线" (www.touzi.com) show that in 2014, among 38 newly established venture funds that had finished raising capital, 35 of them are organized as limited partnerships. See also, Yao Xiaomin (姚晓敏), Youxian Hehuo Jinjin Falv Jiufen Jiejue (有限合伙基金法律纠纷求解) [Disputes on Limited Partnership Funds], 1 Fa Ren (法人) [Legal Entity] 68, 68 (2015); Deng Xuehong (邓雪鸿), Youxian Hehuozhi Zai Zhongguo PE zhong de Yunyong (有限合伙制在中国 PE 中的运用) [Limited Partnership in Chinese PE], 30 Zhongguo Shichang (中国市场) [Chinese Market] 51, 51 (2015).

form while operating in a special investment environment in China.

The Zhejiang Donghai Venture Capital Fund (DHVC) was one of the first two venture capital funds that took limited partnership as an organization form after the new Partnership Law entered into effect in 2007.[439] DHVC had nine limited partners, eight of which were private manufacturing enterprises in Zhejiang Province, as well as one natural person. The general partner and manager of DHVC was James & Hina Capital Management Co., Ltd. (JH Capital). Despite being registered as a limited partnership, atypically, DHVC set up a joint committee of the partners as its decision-making body. According to the partnership agreement, a two-thirds majority vote was needed for passing investment decisions in the joint committee, and every RMB 5 million of the initial investment was counted as one vote. In fact, this joint committee was serving the function of a board in a corporation. Unfortunately, the partnership was dissolved after only a few months due to frequent disagreement among the partners.

On July 8, 2014, Jiang Tao, the CEO of Haicang Investment Management (HCIM), changed his social network signature into "this man has disappeared", revealing a huge scandal involving 9 venture capital/private equity funds which were managed by HCIM. The 31-year-old Jiang absconded with RMB 500 Million raised from near 300 investors. All the funds involved were organized as limited partnerships, with HCIM acting as the general partner.[440] This is only one of the cases in recent years that has raise the alarm for the investment public about the risk of the limited partnership funds as a tool of illegal fund raising.

---

439 See Hao Fengling (郝凤苓), Investigation on Limited Partnership: Vagueness of Chinese LP and GP (有限合伙制"实验"周年调查：中国 LPGP 角色模糊), 21st Century Business Herald (21 世纪经济报道), Sept. 1, 2008.

440 See *The Haicang Fraud: Investigation on Limited Partnership Investment*, (Last visit Dec. 9, 2016)

From the first example above, one can see that the Chinese limited partners are turning the general partner – who should offer managerial and investment expertise – into a mere executor of orders from the investors, therefore the merits of the limited partnership in venture capital financing cannot be fully exploited. The Chinese investors' attitudes toward the structure of limited partnership indicated that they do not trust their money to another party. In other words, they are afraid of the agency problems created by the entrenchment of the management in a limited partnership, which is shielded from the market for control. The second example illustrates the extreme case when the operating general partner uses the limited partnership form to engage in criminal activities, which could be the investor's deepest nightmare – lose all their money while they cannot be in charge of the funds they invest in.

5.1.2 Active Investors v. Passive Investors

As discussed above, the Chinese market has its unique features, which are fundamentally different from those of the United States. Chinese investors investing in limited partnership funds or other forms of investment organizations are generally more "active" in the business in which they are engaged compared to investors in the U.S. – who are generally described as "passive".[441]

When establishing a firm, the parties will need to decide whether the investors will be passive or active in the daily management of the business,[442] regardless of whether it

---

[441] See, e.g. Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. ECON. 463, 469 (1996) ("once the funds have been raised, the investors have very limited recourse to these funds."); Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 54 (Michael J. Whincop ed., 2001) ("[The investors] delegate all investment and monitoring decisions to the VC; and they have no control and few monitoring rights over the VC's actions."); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070 (2003) ("The typical transactional pattern in the U.S. venture capital market is for institutional investors . . . to invest through . . . 'venture capital funds,' in which the investors are passive limited partners.")

[442] See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 2-3 (1991).

is a venture capital fund or any other type of business organization. As the transaction cost analysis suggested, the parties will choose the strategy that provides a net benefit. Accordingly, if the net benefit of choosing one strategy is greater than for others, the parties will opt for such a strategy.

If the parties decided that the investors will be passive in the business and the manager will be in charge of operating the fund, the cost of such an arrangement would be agency costs.[443] Therefore, in the situation with a separation of ownership and control, there is a risk that the person in control will engage in opportunistic behavior. Therefore, investors will incur costs of *ex-ante* evaluations and *ex-post* monitoring of the manager and the manager will incur costs of signaling his loyalty to the investors. The fund would be benefited through lower capital cost saving from the irrelevance of the investor's quality and the investors can diversify their investment and reduce the overall risk of their portfolio since they can save the cost of attending to each of the investments.[444]

As previously discussed, limited partnership is suitable for innovation financing organizations such as venture capital funds. Essentially, taking a limited partnership as the organization form enables the manager to have greater power in daily management decisions involving high-risk and immature businesses, given that he or she has relevant expertise. Compared to the shareholders in a corporation, the investors in a limited partnership would not demand a steady stream of revenue payback for their investment, which is less likely to happen when investing in a high-risk innovative project. These merits of the limited partnership in financing innovation are precisely the results of the passivity of the limited partners: in other words, the fact that the limited partners have very little power over the daily management of the

---

443 Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON., 305, 308 (1976).

444 Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALBANY L. REV. 267, 278 (2006).

fund is the reason why the organization form of limited partnership is beneficial to the particular business of innovation financing.

However, as previously mentioned, passivity comes with costs. Therefore, if these agency costs can be minimized, the parties will choose a passive-investor strategy and thus the form of limited partnership. As previously discussed, in venture capital funds investors use covenants in the limited partnership agreement to prevent the management from shirking, fiduciary duties serve as a potential threat to ensure liability of the management, and the reputation mechanism ensures that the general partner performs in accordance with the interests of the funds. These conditions offset the agency cost from investor passivity, thus enabling the parties to exploit the merit of limited partnership to the best in innovation financing and investing.

Another important reason for the passivity of investors in U.S. venture capital funds is that institutional investors constitute the majority of venture capital providers.[445] For example, the 1979 ERISA "Prudent Man" Rule was revised allowing pension fund managers to engage in higher-risk investments including venture capital arrangements, after which money flooded to the venture capital market.[446] The Prudent Man Rule requires the manager to diversify the investments of the plan to minimize risk.[447] It is therefore understandable that, compared to corporate investors, institutional investors may be more conducive towards a passive-investor strategy since they operate large and diversified investment portfolios and it is impractical for them to participate in

---

445 Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 U.C.L.A. L. REV. 1737, 1753 ("In recent years, … a majority of the investment in start-ups has come from tax-exempt institutional investors, such as pensions and university endowments.); Victor Fleischer, *The* , 57 TAX. L. REV. 137, 158 (2003) ("… pension funds and university endowments, comprise the largest investor class in the venture capital industry.); Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1793 (2005) ("Private equity investing is typically carried out through a limited partnership structure in which the private equity firm serves as the general partner. The limited partners consist largely of institutional investors and wealthy individuals who provide the bulk of the capital.")

446 Paul A. Gompers, *The Rise and Fall of Venture Capital*, 23 BUS. ECON. HISTORY 1, 2 (1994).

447 29 U.S. Code §1104 (a) (1) (C).

each and every fund.[448]

The investors in China however are reluctant to be passive in the daily management of the fund. The investors would have to face severe agency problems and put their money at risk if they chose to be passive and let the management handle the entire fund business. They would rather choose an organization form that has been developed under more mature and systematic legal settings, namely the corporation.[449] Further, in China, a vast percentage of corporations are state-owned or family-owned and thus shareholder centrism has become the current mainstream theory of corporate governance, and the concept of viewing the company as an extension of the shareholder property is also widespread in judicial practice.[450] As the major player in the modern Chinese capital market, the corporation's governance activism has presented a strong influence on the Chinese investment culture and the investors.[451] As in the case of DHVC, the limited partners demanded a corporate-like decision body despite the fund being called a "limited partnership". Therefore, for the analysis of the newly-established limited partnership form, one must take such an influence into consideration.

5.1.3 The Worries of Chinese Limited Partners

Due to various reasons, compared to the U.S. venture investors' passivity, Chinese

---

448 Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALBANY L. REV. 267, 272 (2006).

449 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 40 (2012).

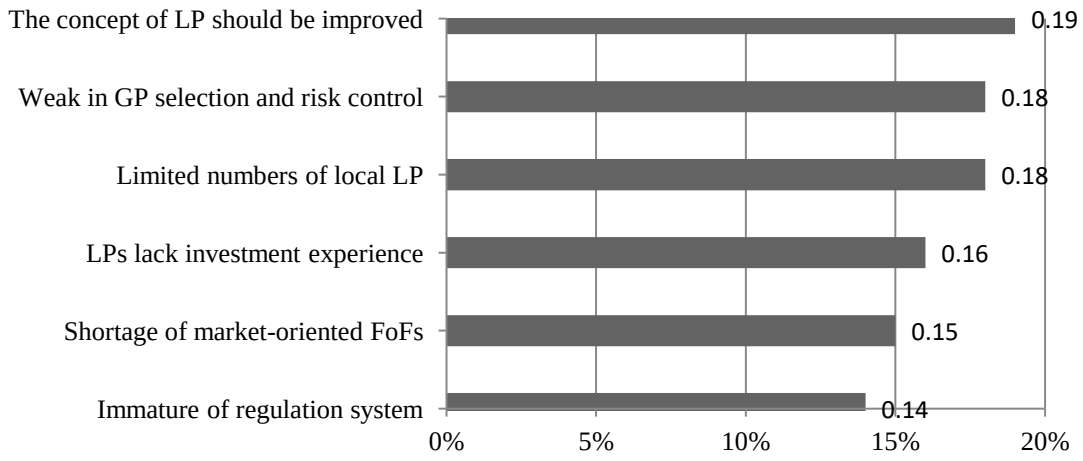
450 Deng Feng (邓峰) Dongshihui Zhidu de Qiyuan, Yanjin yu Zhongguo de Xuexi (董事会制度的起源、演进与中国的学习) [The System of Boards of Directors: its Origin and Evolution and China's Learning Experience], 1 Zhongguo Shehui Kexue (中国社会科学) [Social Science in China] 164,175 (2011).

451 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 41 (2012).

investors tend to be more active in the daily management of the fund. A survey conducted in 2015 on the limited partners in the Chinese private equity investment market[452] confirmed such activism: 44% of limited partners participating in the survey would want to join the decision body of the fund, compared to the 28% who would not. Only 16% of them stated that they would not participate in any fund management activities.[453]

Among the listed possible obstacles for a sound private equity market development in China (Figure 19), the "short-term profit-chasing investment concept" was chosen by 19% of the limited partners.[454] Chinese investors tend to demand a steady stream of returns rather than long-term patient investment and thus they may opt for a corporation as the business form, given that shareholders in a corporation would receive dividends.

Figure 19 Major problems identified by China's LPs



Source: 2015 LP Report, ChinaVenture

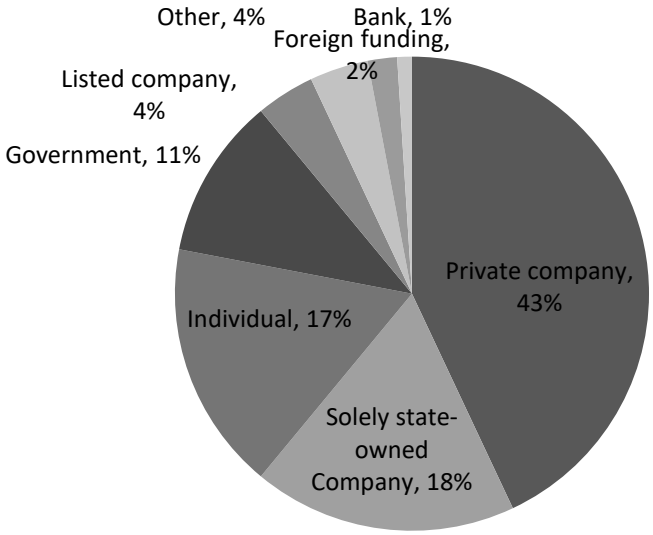
The general partner's expertise is an essential requirement for a limited partnership

452 2015 Private Equity Investment Fund LP Research Report, ChinaVenture Research, released on Oct. 12, 2015. Available at:
(last visited Oct. 28, 2015).
453 *Id*., at 13.
454 *Id*., at 17.

venture fund by virtue of the default rule that the general partner has managerial powers over the daily operation of the partnership. Limited partners in China are worried that there is a shortage of qualified and competent fund managers, which may be due to the short history of the venture capital/private equity market.[455]

Another important concern relates to the quantity of qualified limited partners in China. In the U.S., the major venture investments are from passive institutional investors such as pension funds. The scenario is different in China: traditionally, the government provided the majority of funds to the venture capital market. In recent years, the percentage of government funding has decreased, with industrial enterprises and wealthy individuals having become important funding sources (Figure 20).[456]

Figure 20 Funding sources of venture capital investment in 2013



Source: Survey conducted by MOST, MOC & China Development Bank in 2014

455 Lin Lin, *Private Equity Limited Partnership in China: a Critical Evaluation of Active Limited Partners*, 13 J. CORP. L. STUDIES 185, 200 (2013).

456 Yang Kui (杨葵), Fengxian Touzi de Chouzi Yanjiu (风险投资的筹资研究) [Venture Capital Investment Fund Raising] 141 (2007); Feng Zhongsheng (冯中圣), 2011 Zhongguo Chuangye Touzi Hangye Fazhan Baogao (2011 中国创业投资行业发展报告) [2011 China Venture Capital Report] 33 (2011).

The domination of individual investors could contribute to the reluctance for choosing limited partnerships as a business form for venture funds. Economists have argued that, on average, individual investors perform poorly compared to institutional investors.[457] The reasons may be that individual investors are at an information disadvantage[458] or their investments are driven by liquidity or psychological considerations rather than information about the assets,[459] or that they tend to over-invest when the investment is familiar to them because they are better informed. Although safe, this investment characteristic may lead to under-diversification and an average or low return.[460] In the special scenario of venture capital investment with great information asymmetry, uncertainty and risk, individual investors with less information would be even more reluctant to entrust their money to a third party to invest in those areas with which they are not familiar. Therefore, individual investors tend to choose the form of corporation, given that they can have more control over the fate of their money.

On the other hand, institutional investors had never played a significant role in the Chinese venture capital market.[461] One possible reason would be that under the

---

457 See e.g. Marshall E. Blume & Irwin Friend, *The Asset Structure of Individual Portfolios and Some Implications for Utility Functions*, 30 J. FIN 585 (1975); David Hirshleifer, *Investor Psychology and Asset Pricing*, 54 J. FIN. 1533 (2001); Randolph B. Cohen et al., *Who Underreacts to Cash-Flow News? Evidence from Trading Between Individuals and Institutions*, 66 J. FIN. ECON. 409 (2002).

458 See generally Joshua D. Coval et al., Can Individual Investors Beat the Market?, Harvard NOM Working Paper No. 02-45 (2005).

459 See e.g. Fisher Black, *Noise*, 41 J. FIN. 529 (1986); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POLITICAL ECON. 703 (1990); Charles Lee et al., *Investor Sentiment and the Closed-end Mutual Funds*, 46 J. FIN. 75 (1991).

460 Massimo Massa & Andrei Simonov, *Hedging, Familiarity and Portfolio Choice*, 19 REV. FIN. STU. 633 (2006) (investors tend to concentrate holding in stocks to which the investors is geographically or professionally close); Mark S. Seasholes & Ming Zhu, *Individual Investors and Local Bias*, 65 J. FIN. 1987 (2010) (portfolios of local holdings do not generate abnormal performance); Trond Doskeland & Hans K. Hvide, *Do Individual Investors Have Asymmetric Information Based on Work Experience*? 66 J. FIN. 1011 (2011) (individual investors make negative returns on familiar investments possibly due to over-confidence).

461 China Venture Capital & Private Equity Association (中国投资协会股权和创业投资专业委员会), Zhongguo Chuangye Touzi Hangye Fazhan Baogao 2014 (中国创业投资行业发展报告 2014) [China Venture Capital Report 2014], preface. *Available at*:
http://www.vcpe.org.cn/news/2014-11-21/vcpe0000011768.shtml.

current legal regime of Commercial Bank Law, Insurance Law and pension regulations, it is difficult for institutional investors such as pension funds and insurance companies to participate in venture capital investment.[462] The Commercial Bank Law of China states that commercial banks shall not invest in non-bank financial institutions and enterprises.[463] The usage of insurance funds is limited to banking deposit, securities and real estate, while leaving space for the future regulation of other investments.[464] Pension funds shall be put into deposit accounts, and can only investment in state bonds, and it is prohibited from investing into financial or operational businesses.[465] Compared to institutional investors, corporate investors are more conducive to an active investor strategy.[466]

These concerns raised by Chinese LPs reflects different aspects of their distrust toward general partners and hence the hesitation in choosing limited partnerships as an organization form.

5.2 Remedies for Chinese Limited Partners

5.2.1 Limited Partnership Contracting in China

5.2.1.1 Covenants

The limited partnership agreement is the fundamental tool to set out rights and obligations of the parties, and PEL has given partners considerable freedom to

---

462 Yang Kui (杨葵), Fengxian Touzi de Chouzi Yanjiu (风险投资的筹资研究) [Venture Capital Investment Fund Raising] 141 (2007).

463 Shangye Yinhang Fa (商业银行法) [Commercial Bank Law] (promulgated by the Standing Comm. Nat'l People's Cong., May 10 1995, amended Dec. 27, 2003) Art. 43.

464 Baoxian Fa (保险法) [Insurance Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, amended Oct. 28, 2002, 2nd amendment Aug. 31, 2014) Art.106.

465 Guowuyuan Guanyu Jianli Tongyi de Qiye Zhigong Jiben Yanglao Baoxian Zhidu de Jueding (国务院关于建立统一的企业职工基本养老保险制度的决定) [Decision of the State Council on the Basic Pension Insurance for Employees] (promulgated by the State Council July 16, 1997, effective July 16, 1997), Art. 7.

466 Christopher Gulinello, *Venture Capital Funds, Organizational Law, and Passive Investors*, 70 ALBANY L. REV. 267, 315 (2006).

rearrange partnership governance through contracting.[467] Research based on extensive interviews has shown that covenants relating to the general partners are widely used in the Chinese limited partnership agreements.[468] Several features of the covenants are worth mentioning.[469]

First, on the one hand, covenants about the size of the fund, the type and scope of investments are common in Chinese limited partnership agreements. Also covered in the agreements is the changing of partners as well as the requirements on the managers. There are detailed provisions on the issues of adding/reducing partners, identity exchanging of general partners and limited partners, as well as general partner's selling partnership interests. On the other hand, regarding the covenants on the operation of the fund, few of the investigated agreements have specified terms on using of debt or reinvesting of profit.

Second, contrasting to the detailed covenants found in U.S. partnership agreements on the general partner's investment decisions and activities, such as the power to co-invest by other fundswith the same manager, raise new funds, or engage in outside activities, the Chinese limited partnership agreements are quite general on such matters. Most of them only have a simple section on the issue of the general partner's engaging in businesses which may compete with the fund.

The third significant feature of Chinese limited partnership funds is the permission for co-investment of the general partner's own fund. As previously discussed, if the general partner invests in particular firms, he or she may devote excessive time to these firms while paying less attention to the entire portfolio, and may not terminate a

---

467 Lin Lin, *Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners*, 13 J. CORP. L. STUDIES 185, 205 (2013).

468 *Id*., at 206.

469 The author examined eight limited partnership agreements that are available online, although the details of the deals are concealed. See Appendix III.

project properly if it encounters difficulties.[470] Therefore, most of the foreign funds that operate in China would not allow co-investment of the general partner.[471] By contrast, many of the domestic limited partnership funds allow such co-investment.[472] The rationale behind such a phenomenon could be first, through co-investment, the interests of the general partner and the limited partners are aligned since the former has his or her own stake in the portfolio; second, the co-investment could serve as an incentive to the competent managers, for there is a huge compensation gap between domestic and foreign fund managers.[473] However, concerns have been raised that such co-investment would lead to biased judgments of the managers, thus damaging the partnership's interests.[474]

In 2012, Chen Shuiqing, CEO of Fuxing Venture Capital, was arrested under the criminal charge of "accepting bribes by a non-state functionary". Chen himself bought shares of the target companies which Fuxing was investing in at prices significantly lower than the market price, then sold them at higher prices to gain a huge margin. In 2014, the appeal court held Chen guilty and stated that "in order to obtain benefits such as funding, branding, and listing counseling from the Fuxing fund", the invested companies "agreed to transfer shares at a low price to Chen", and "knowing Fuxing's company bylaws [on co-investments, which must be made at the same price as the fund], Chen lied to the fund on the share price".[475] Chen was sentenced to 14 years of

---

470 PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 40 (1999); DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 96 (2009).

471 ZERO2IPO RESEARCH, REPORT OF VC/PE MANAGEMENT AND COMPENSATION SYSTEM IN CHINA 28 (2011).

472 See *id*. Half of the partnership agreements examined by the author contain specified provisions on the co-investment of the general partner using his or her own funds.

473 Zhang Qianlin & Bai Lituan (张黔林&柏立团), *First PE Bribery Case: the Doble-edged Sword of Co-investment* (争议"PE 受贿第一案"), Directors & Boards (董事会) 72, 72 (Dec., 2013). Available at: http://www.chinaventure.com.cn/cmsmodel/news/detail/249084.shtml.

474 *Id*.

475 Chen Shuiqing Fei Guojia Gongzuo Renyuan Shouhui An (陈水清非国家工作人员受贿案), [Chen Shuiqing Accepting Bribes by a Non-State Functionary Case] (Shanghai 2nd Interm. People's Ct., June 19, 2014). Available at: http://www.shezfy.com/view/cpws.html?id=352069.

imprisonment.

The above case triggered intensive debate on the supervision of VC/PE investments.[476] The Chinese criminal law does not have any provisions on such co-investment behavior, and PEL only has general provisions on the prohibition of general partners from participating in any business which is in competition with the partnership,[477] and a requirement that the proceeds to be returned to the partnership and losses be compensated by the violating partner.[478] However, the statute does not specify how to calculate such proceeds and losses. Therefore, there is a danger that the co-investment practice that is allowed in many limited partnership funds is not in line with the law.

5.2.1.2 Compensation

The compensation of Chinese general partners usually consists of two parts, the management fee which ranges average from 1.5 to 3% of the total committed capital contribution, and the carried interest.[479] This is basically the same as the U.S. practice.

There was evidence indicating that without strict covenants, the risk-free management fee might create problems. The general partner may only seek to select bigger projects or increase the fund size to earn more management fee if there is no covenant in the partnership contract regarding the fund size;[480] if one general partner is allowed to

---

476 See e.g. Zhang Qianlin & Bai Lituan (张黔林&柏立团), *First PE Bribery Case: the Double-edged Sword of Co-investment* (争议"PE 受贿第一案"), Directors & Boards (董事会) 72, 72 (Dec., 2013); Liu Dong (刘冬), *First Case on PE Bribery: PE Industry Supervision under Test*, China Business News, Dec. 6, 2012; Zhao Jing & Dai Xiaohe (赵静&戴小河), *Debate on the PE Bribery Case*, Capital Week, Dec. 17, 2012.

477 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 32.

478 *Id*., Art. 99.

479 ZERO2IPO RESEARCH, REPORT OF VC/PE MANAGEMENT AND COMPENSATION SYSTEM IN CHINA 3 (2011).

480 Shi Yubin (石育斌), Zhongguo Simu Guquan Touziren Quanyi Baohu Zhinan (中国私募股权投资人权益保护指南) [China PE Investor Protection] 168-170 (2011).

manage several funds at the same time, the management fee could reach a substantial level.[481] Under such circumstances, it is possible that the general partner only chases huge management fees rather than the performance fee, and from the carried interest would not have an incentive for good performance. On the other hand, there also exists the situation that the general partner receives zero management fee.[482] Limited partners who are afraid of the above problem are unwilling to pay a management fee. Arguably, if the general partner accepted such arrangement, it could indicate a poorer position in the negotiation process, with a possible poorer ability to manage the fund.

There are two ways of calculating the carried interest in China: the fixed rate, usually 20% of the fund net profit; and the threshold rate, whereby the manager would receive a certain percentage (usually 20%) of the profit only if the fund achieves a minimum rate of return.[483] The threshold is normally set at 8 to 10%.[484]

The performance-based carried interest is considered to play a central role in general partner compensation mechanisms. However, evidence suggests that, in China, the fund management fee makes up a substantial part of the income of the venture capitalists, while the carried interest only makes up a small part.[485] Especially for funds that have government background or a state-owned company as parent, the carried interest could be as low as 5%.[486] It is doubtful whether such low carried interest can effectively align the interests between the general partner and limited partners.

---

481 *Id*., at 168.
482 *Id*., at 170-171.
483 REPORT OF VC/PE MANAGEMENT AND COMPENSATION SYSTEM IN CHINA, ZERO2IPO RESEARCH 2011, p.3.
484 REPORT OF VC/PE LIMITED PARTNER IN CHINA, ZERO2IPO RESEARCH 2012, p. 57.
485 Zero2IPO Research, *Management Fee Takes Large Part of Domestic VC/PE Income*, Sept. 28, 2015. Available at: (last visited Feb. 25, 2016).
486 Yao Xuanjie (姚轩杰), *PE Remuneration: 10 Times Gap*, China Securities Journal (May 18, 2013). Available at: (last visited Feb. 25, 2016).

Many Chinese limited partnership agreements include claw back provisions. However, there is concern that it is hard to retain payments from the general partner when necessary.[487] The general partner usually has a very limited asset stake in the partnership, therefore it is hard to enforce the claw back provision, and investors rely to a very great extent on personal guarantees from the general partner. It is argued that there could be better arrangements in the partnership agreement to address the problem, such as setting up separate accounts for the general partner to deposit a certain portion of the carried interest which would be distributed, to ensure the claw back payment. Others argue that the claw back provisions were commonly used only because such practice was introduced in the early stage of Chinese venture capital fund development,[488] without recognizing the true meaning of such provision.

5.2.2 Fiduciary Duties in China

Fiduciary duties can be imposed on partners to address the issue of agency cost between them. However, there are virtually no fiduciary duty rules for the general partner in a limited partnership in Chinese partnership law, and it is difficult for the court to hold the general partner liable under fiduciary duty principles.[489] Regarding the general duties of the partners, PEL only has two rather vague articles setting out general principles: Art. 5 refers to "the principle of willingness, equality, fairness and good faith in the conclusion of a partnership agreement and in the establishment of a partnership enterprise." Art. 7 states that "a partnership enterprise and its partners shall abide by the laws, administrative regulations, social morals, commercial morals and bear social liabilities."

---

487 Shi Yubin (石育斌), Zhongguo Simu Guquan Touziren Quanyi Baohu Zhinan (中国私募股权投资人权益保护指南) [China PE Investor Protection] 181 (2011).

488 *Id.*

489 There is no limited partnership fiduciary duty case found using the largest Chinese case database pkulaw.cn (北大法宝) (last visited Feb. 2, 2016). (last visited Feb. 2, 2016). See Appendix I.

All eleven cases found in the database in which the courts had quoted Art. 5 and Art. 7 of PEL were general partnership cases, none of which, however, was decided solely based upon "the principle of willingness, equality, fairness and good faith".[490] The court decision generally used articles from other laws to back up its reasoning. For example, in the *Pan Zeyu v. Ma Guang & Ma Ke* case,[491] Pan and the Ma brothers started a partnership to run a gas station. After opening, the gas station did not open a settlement account of its own but rather the daily revenue was deposited in Ma Guang's (one of the Ma brothers) own personal bank account and his brother was running all the financials of the gas station. Pan sued the Ma brothers, claiming that he lost supervision and control of the gas station's account and thus that the partnership should terminate. The Wugang Basic People's court ruled in favor of the plaintiff based upon Art. 5 of PEL and Art. 6 of the Contract Law[492]. The Ma brothers appealed to the Shaoyang Intermediate People's Court. However, the appeal court revoked the original ruling, stating that, according to the partnership agreement that the parties signed, the Ma brothers were responsible for running the financial accounts for the gas station, although the agreement did not mention any specifics about setting up a separate bank account. During the partnership, although the Ma brothers managed the financials of the gas station through their own account, the financials were settled regularly and the profit was split evenly. Therefore, one could not hold Ma liable for breaching the partnership agreement. The appeal court ruled solely based upon contract terms rather than fiduciary duty reasoning.

For venture capital enterprises that choose the corporate form, the fiduciary duties

---

490 See Appendix I. Cases from pkulaw.cn, last visited Feb. 2, 2016.

491 Ma Guang deng yu Pan Zeyu Hehuo Xieyi Jiufen Shangsu An (马光等与潘泽玉合伙协议纠纷上诉案) [Ma & Pan Partnership Agreement Dispute Appeal Case], (2010) No. 444 Shaoyang Interm. People's Crt., Hunan Province (邵中民一终字第 444 号), decided Oct. 18, 2010.

492 Hetong Fa (合同法) [Contract Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), Art.6. "The parties shall observe the principle of honesty and good faith in exercising their rights and performing their obligations." English version available at: http://www.lawinfochina.com/display.aspx?lib=law&id=6145&CGid=.

have more clarity. Fiduciary duty rules are established in Article 147 to 149 in Chapter 6 "Qualifications and Obligations of the Directors, Supervisors and Senior Managers" of the Company Law. Article 147 states that the directors, supervisors and senior managers "shall comply with the laws, administrative regulations, and company bylaws. They shall bear the obligations of fidelity and diligence to the company."[493] Article 148 sets out a list of unlawful conducts of directors and managers.[494] These two articles are about the duty of loyalty, whereas the duty of care is regulated in Article 149, although it does not contain such detailed rules as the previous article.[495]

Fiduciary duties in China are under-developed compared to in the U.S., where fiduciary duty principles have been well constructed and refined in court decisions over a century. The norm of fiduciary duty did not exist in the Chinese legal system until the 2006 revision of the Company Law.[496] Some may argue that fiduciary principles can be found in the 2001 Trust Law.[497] Article 25 of the Trust Law states that a trustee "shall abide by the provisions of the trust documents and handle the trust affairs for the utmost interests of the beneficiary. The trustee shall fulfill his duties and perform the obligation of being honest, trustworthy and cautious and managing effectively."[498] However, the obligation of a trustee is more of a fiduciary duty in a

---

493 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art.147.

494 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art.148.

495 Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art.149. "Where any director, supervisor or senior manager violates any law, administrative regulation, or the bylaws during the course of performing his duties, if any loss is caused to the company, he shall be liable for compensation."

496 Han Shen, *A Comparative Study of Insider Trading Regulation Enforcement in The U.S. and China*, 9 J. BUS. & SEC. L. 41, 52 (2008).

497 Wang Leyu (王乐宇), Lun Woguo Youxian Hehuo Qiye Putong Hehuoren de Xinyi Yiwu (论我国有限合伙企业普通合伙人的信义义务) [*Limited Partnership General Partner's Fiduciary Duty in China*], 511 ECONOMIC FORUM (经济论坛) 173, 174 (2013).

498 Xintuo Fa (信托法) [Trust Law] (promulgated by Standing Comm. Nat'l People's Cong., Apr. 28, 2001, effective Oct. 1, 2001), Art. 25.

narrower sense. Unlike a trustee, a corporation's directors do not have legal ownership interests in transferable property owned by others;[499] consequently, the fiduciary role of a corporation director is different from that of a trustee. In fact, the term "fiduciary" itself was adopted to apply to situations falling short of "trusts".[500]

Since 2006, fiduciary duty principles have been applied by Chinese courts in company law cases. One empirical study showed that from 2006 to 2012, among the 68 final court decisions categorized as "damage company's interest",[501] 58.32% (40 out of 68) of the decisions applied fiduciary duty principles, while 51.47% (35 out of 68) of the decisions cited the fiduciary duty provisions in the new Company Law.

To further analyze the judicial application of fiduciary duty principles, 99 final court decisions were accounted for under "damage company's interest"[502] in 2013 and 2014.[503] Of the 99 cases, three of them were jurisdiction disputes, two cases were remanded for retrial, one case was withdrawn by the parties and another three were dismissed by the court due to procedural matters, such as the time limitation of action. In the remaining 90 cases, 24 involved shareholders damaging the company's interests, which was governed by Article 20 of the Company Law.[504] Among the 66

---

499 Deborah A. DeMott, *An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880 (1988).

500 *Id*.

501 Zhou Linbin & Wen Yajing (周林彬，文雅靖), Gongsi Gaoguan Feifan Yinyi Yiwu Zeren de Sifa Shiyong Xianzhuang yu Wanshan (公司高管违反信义义务责任的司法适用现状与完善) [*Judicial Application Status Quo of Senior Executive Violating Fiduciary Duties and Its Perfection*], 41 SEEKING TRUTH (求是学刊) 71, (2014). The case database used in the study is pkulaw.cn, the largest Chinese legal database.

502 "Damage company's interest" is one of the legal causes of actions in the Company Law in China. See Minshi Anjian Anyou Guiding (民事案件案由规定) [Provisions on the Cause of Action of Civil Cases] (promulgated by Supreme People's Court Oct. 29, 2007, amended Feb. 18, 2011, effective Apr. 1, 2011) Art. 21.

503 See Appendix II. Cases from pkulaw.cn.

504 "The shareholders of a company shall abide by the laws, administrative regulations and bylaw and shall exercise the shareholder's rights under the law. None of them may injure any of the interests of the company or of other shareholders by abusing the shareholder's rights, or injure the interests of any creditor of the company by abusing the independent status of legal person or the shareholder's limited liabilities." Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art. 20(1). The above empirical study did not differentiate the cases involving shareholders from cases involving the management.

cases that fall into the jurisdiction of Art. 147-149 involving "directors, supervisors and senior managers" of the company, 56.06% (37 out of 66) of the judgments cited the relevant provisions. Among the cases that did not cite fiduciary duty provisions, the main legal basis for the decisions included corporation bylaws,[505] employment contract terms[506] and general principles of civil law.[507]

While it seems that fiduciary principles have been applied in judicial practice in China, Chinese civil law does not have a similar law-equity system to that seen in common law jurisdictions and Chinese legislation tends to be general and rigid.[508] The doctrine of supremacy of the legislature prevails in China and the judges are not trained to interpret legislation; rather, they play a more passive role in the development of the law, whereby the legislation "starts and ends with civil codes".[509] In a 2014 case *Meifu Co. Ltd. v. Hu Jingke*,[510] Meifu was suing Hu for breaching the fiduciary duty of not competing with the company as laid down in the Company Law.[511] The defendant Hu was assigned to Meifu company by another company and despite taking the job as sales supervisor in Meifu, he did not have an employment contract directly

---

505 E.g. Shanghai Guangmaodaguangyi Keji Gufen Youxian Gongsi yu Wang Liping Sunhai Gongsi Liyi Zeren Jiufen Shangsu An(上海广茂达光艺科技股份有限公司与王丽萍损害公司利益责任纠纷上诉案) [Shanghai Guangmaodaguangyi Sci. & Tech. Co. Ltd. v. Wang Liping] (Shanghai 1st Interm. People's Ct. Mar. 20, 2014).

506 E.g. Guangzhoushi Weitong Maoyi Fazhan Youxian Gongsi yu Xu Zhaoyin Deng Gongsi Liyi Zeren Jiuren Shangsu An (广州市威通贸易发展有限公司与许昭银等公司利益责任纠纷上诉案) [Guangzhou Weitong Co. Ltd. v. Xu Zhaoyin] (Guangzhou Interm. People's Ct. June 17, 2014).

507 E.g. Shanghai Rongzhi Zidonghua Xitong Youxian Gongsi yu Li Huaijun Sunhai Gongsi Liyi Zeren Jiufen Shangsu An (上海容之自动化系统有限公司与李怀军损害公司利益责任纠纷上诉案) [Shanghai Rongzhi Co. Ltd. v. Li Huaijun] (Shanghai 1st Interm. People's Ct. Jan. 24, 2014).

508 Rebecca Lee, *Fiduciary Duty Without Equity: "Fiduciary Duties" of Directors under the Revised Company Law of the PRC*, 47 VA. J. INT'L L. 897, 909 (2007).

509 Peter Joseph Loughlin, *The Domestication of the Trust Bridging the Gap between Common Law and Civil Law*, available at (last visited Feb. 2, 2015).

510 Shanghai Meifu Wangluo Keji Youxian Gongsi yu Hu Jingke Sunhai Gongsi Liyi Zeren Jiufen Shangsu An (上海美福集网络科技有限公司与胡经科损害公司利益责任纠纷上诉案) [Shanghai Mefu Internet Tech. Co. Ltd. v. Hu Jingke] (Shanghai 1st Interm. People's Ct., Jan. 22, 2014).

511 "No director or senior management person may commit any of the following acts: … (5) without consent of the shareholders' meeting or shareholders' assembly, seeking business opportunities that belong to the company for himself or any other persons … or operating similar business of the company for which he works for himself or for any other persons." Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art. 148(5).

with Meifu. The appeal court decided that "sales supervisor" was not one of the four kinds of "senior management persons" mentioned in the Company Law, nor did the company bylaws of Meifu have any articles on such persons[512] and he did not have any non-competition contract with Meifu; therefore, he did not bear any duty towards Meifu.

This rigidness of China's legislature and judiciary suggests that the fiduciary principles introduced by the revised Company Law could be a "fiduciary duty without equity".[513] The fiduciary provisions in the law are merely a "generic description"[514] of director's duties rather than profound and well-developed equity principles. Of course, one may simply perceive that fiduciary duty principles are incompatible with the civil law tradition, although this does not mean that introducing fiduciary duties without an equity regime is completely unnecessary or naïve. Fiduciary duty principles have already been applied in judicial practice and they have become an important part of Chinese law, only requiring more substance and effect, as well as the courts' more proactive attitude.[515]

Fiduciary principles have been established in the Company Law in China. For the venture capital enterprises that take the corporate form, the shareholders would have adequate legal ground to bring law suits against the management for treacherous behavior. However, for a venture capital limited partnership, there is no fiduciary duty provision in the applicable legislation to hold the general partner/management liable under the legislation in such a situation.

---

512 "The 'senior management persons' refer to the manager, vice managers, chief financial officers, the secretary of the board of directors of a listed company, or any other persons provided in the bylaw." Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006, amended Dec., 28, 2013, effective Jan. 1, 2014), Art. 162(1).

513 Rebecca Lee, *Fiduciary Duty Without Equity: "Fiduciary Duties" of Directors under the Revised Company Law of the PRC*, 47 VA. J. INT'L L. 897, 909 (2007).

514 *Id*., at 925.

515 *Id*., at 926.

5.2.3 The Control Rule in China

As mentioned in the previous chapter, a strong control from the general partner can be beneficial to the efficiency of the reputation mechanism. It is necessary and interesting to consider this so-called control rule in the Chinese partnership law to examine its effects in a market with active investors who want to participate in the partnership control.

Article 68 of PEL states that "a limited partner may not execute the partnership affairs, nor may he represent the limited partnership enterprise before outsiders."[516] Similar to RULPA, the article sets out a safe-harbor list of conduct that the limited partners may undertake without bearing unlimited liability: (1) to participate in making a decision about the admission or withdraw of a general partner; (2) to put forward a proposal on the business management of the enterprise; (3) to participate in choosing an accounting firm to handle the audit business of the limited partnership enterprise; (4) to obtain a financial report of the limited partnership enterprise upon audit; (5) to consult the account books of the limited partnership enterprise and other financial materials that concern the limited partner's own interests; (6) to file claims or lodge a lawsuit against the liable partner(s) when this limited partner's interests in the limited partnership enterprise are impaired; (7) when the partner(s) responsible for executing the partnership affairs is (are) fails to exercise his (their) rights, to urge them to exercise their rights or initiate a lawsuit for protecting the interests of this enterprise; and (8) to offer a guarantee for this enterprise in accordance with the law.[517]

Although the limited partnership law rules in PEL were transplanted from the U.S.,[518]

---

516 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 68, para. 1.

517 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 68, para. 2.

518 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之

it does not necessarily mean that PEL has to follow the step and trend of the U.S. legislation. However, for different reasons, it remains necessary to give the limited partners more power in participating partnership businesses in China compared to the U.S.

Even compared to RULPA 1985, the control rule in PEL is more conservative and harsh on limited partners taking control of the partnership business. When the control rule takes the form of listed items, it is important to address one prime problem, namely whether it is an exhaustive list of safe-harbor actions or merely a list of examples. It was clearly stated in the RULPA 1985 that its safe-harbor list was not an exhaustive list.[519] However, in the U.S. the case law tradition gives the judges more freedom to interpret the text of a statute independently and thus the safe-harbor list cannot be and does not necessarily have to be an exhaustive list of limited partner behaviors. As a civil law country, the courts in China have very little authority to interpret statutes and there is no legislative or judicial interpretation of such an article. Further, in China, if a law provision in the form of a list is inexhaustive, it always has a so-called "miscellaneous provision", to include other scenarios that cannot be exhaustively listed.[520] Art. 68 of PEL does not have such miscellaneous provision. Therefore, the activities in which the limited partners may engage are limited to the eight safe-harbor behaviors listed in the provision.

When taking a closer look at the safe-harbor list of PEL, (2) relates to the advisory power of the limited partners. However, it is not very clear whether "put forward a proposal" is equal to participating partnership business. Moreover, strictly speaking,

---

边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 40 (2012).

519 RULPA (1985) §303 (c).

520 For example, Art. 14 of the PEL on the establishment of the partnership: "the following conditions shall be satisfied: (1) having 2 or more partners…; (2) having a written partnership agreement; (3) having a name…; (4) *other conditions* as provided for by laws and administrative regulations." Miscellaneous provisions in Chinese is "兜底条款".

(3), (4) and (5) reflect the limited partner's right to information,[521] which cannot be categorized as behaviors that take control of the partnership, while much the same applies to (6) and (7), which are about the right of limited partners to bring up law suits. Therefore, the control rule in PEL is much harsher than in RULPA 1985, let alone ULPA 2001, which has abolished the control rule.

Therefore, it is necessary to relax the control rule in PEL given the market conditions in China. An extremely strict control rule requires the limited partners not participating in the fund business, which is opposite to the need of the Chinese investors. The Chinese investors may opt for the corporation as the choice of business form to gain access in terms of being part of the business decisions, especially when there are no fiduciary duties in PEL, whereby the investors can hold the management liable when there is misconduct. By loosening the control rule and giving the investors more power in fund management, the investors may be more willing to choose a limited partnership as the fund form, thus exploiting the special merits that the limited partnership possesses in financing innovation.

Given the current PEL, it would be at least necessary to add an article about the right to vote of the limited partners on certain important fund matters. Chapter 3 of PEL – which governs the limited partnership – does not specify whether the limited partners have the right to vote. Clearly defining the limited partner's voting rights in important partnership business decisions such as buying and selling major partnership interests, investment above a certain threshold, etc., could be beneficial to the specific ways of the limited partners participating in the fund management.[522]

It is also worth mentioning the estoppel liability applied in limited partnerships in

---

521 See RULPA (1985) §305.

522 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 42 (2012).

China. Article 76 of PEL states that "where it is reasonable for a third person to believe a limited partner as a general partner and make a transaction with him, this limited partner shall bear the same liabilities for this transaction as a general partner shall do."[523] The problem is thus how to interpret this "reasonable belief".

Article 68 has clearly stated that the limited partners may not represent the limited partnership, meaning that it is much more complicated when applying estoppel principle in the limited partnership law compared to company law. In China, a company is naturally represented by the "legal representative" of the company, although the law does not exclude other persons – such as directors and senior executives – from representing the company when duly authorized. In practice, it is also common that an authorized personnel other than the legal representative acts on behalf of the company. Therefore, the agent's oral indication of representation, authorized blank contract, company contract seal can all give rise to reasonable belief on the part of the third person.[524] The limited partnership law excludes the right of the limited partner to be the partnership's representative; it is more complex to conclude that certain acts of the agent (the limited partner) are authorized and the creditors would have greater difficulty in evaluating whether the agent is an authorized representative, while the limited partner is generally prohibited from representing the partnership. Again, in contrast to the legal system in the U.S., Chinese courts do not have previous cases as a reference, meaning that it is necessary for them to find legal ground in law codes. At present, there is no relevant provision of a detailed description on such matter. It has been proposed by scholars that the principle of estoppel shall apply and several acts shall be counted as a clear sign of limited

---

523 Hehuo Qiye Fa (合伙企业法) [Partnership Enterprise Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), Art. 76, para. 1.

524 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 43 (2012).

partners acting as general partners.[525]

In conclusion, to promote the development of venture capital investment, China added the part of limited partnership law to PEL in 2006. It is understandable that as a legislative choice, PEL does not give extensive rights to the limited partners in managing partnership affairs, as transplanted from early U.S. legislations. However, as a legal transplant recipient country, the unique circumstances of the Chinese investment culture have made it necessary to give the limited partners certain power in partnership businesses to adapt to the special environment as well as monitoring the general partner's behavior.

5.3 The Chinese Culture and Venture Capital Investment

One problem associated with all legal comparative works between the Western World and China is a huge cultural difference behind the scenes. These cultural differences have great influence as well as explanatory powers on the arrangement of business relationships. By examining these culture reasons, one may acquire a different angle of viewing the features of the Chinese venture capital market.

5.3.1 Less Sophisticated Contracting Culture

Cultural differences have a direct impact on the formation and performance of business contracts. "Chinese interactions are governed by patterns laid down and developed through the experience of thousands of years."[526]

---

525 See Yao Xuexia (姚学侠), Jeidu Xin Hehuo Qiye Fa Youxian Hehuo Zhidu (解读新《合伙企业法》有限合伙制度) [Interpreting the Limited Partnership Law in the New PEL], 340 Hezuo Jingji yu Keji (合作经济与科技) [Co-operating Economics and Science Technology] 115, 116 (2008). The article proposed four conducts of misrepresentation: 1) the limited partner signs contract with a third person in behalf of the partnership; 2) clear statement on the limited partner's business card that the limited partner is the person in charge of the partnership; 3) the partnership takes the name of the limited partner as its name; and 4) the limited partner does not deny with the knowledge that he is recognized as the general partner.

526 SCOTT D. SELIGMAN, CHINESE BUSINESS ETIQUETTE 5 (1999).

Although the usage of written contract in business transactions in China can be dated back to even before 200 B.C.,[527] prior to the economic reforms in 1978, contract law did not exist in China.[528] After twenty years of development and continuous efforts to join the WTO, the Uniform Contract Law came in to effect on October 1, 1999.[529] However, modern contracting theory runs contrary to the political and legal traditions in China. Chinese law provides an example of "law without law", a normative order that falls short of the "rule of law".[530] China's cultural tradition does not support the growth of the contract; on the contrary, the internal mechanisms of the Chinese culture have an inhibitory and offsetting effect on contract law, let alone creating the spirit of contract.

The philosophy of Confucius has been the official state philosophy of China since the second century, and it has a great influence upon the contracting culture and interpersonal relationships even today. Hierarchy and individual roles within society are key to Confucian thinking. In the Confucian society, the individual does not belong to himself, but belongs to a particular hierarchy and has a specific identity. "Let the ruler be a ruler, the minister a minister, the father a father, and the son a son."[531] According to the teachings of Confucius, when everyone acts exactly in accordance with their assigned roles, rule of men prevails, and there is no need for the rule of law.[532] Therefore, there is no equality concept in Confucian culture. "The

---

527 Li Zhongsheng (李钟声), Zhonghua Faxi (中华法系) [Chinese Law] 349, (1985).

528 More detailed historical development of contract law in modern China, see e.g. John H. Matheson, *Convergence, Culture and Contract Law in China*, 15 MINN. J. INT'L L. 329 (2006); Patricia Pattison & Daniel Herron, *The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China*, 40 AM. BUS. L.J. 459 (2003). In fact, the whole law and regulation system was abandoned in the Cultural Revolution, when they were viewed as a form of capitalism.

529 Hetong Fa (合同法) [Contract Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999). English version *available at* http://en.pkulaw.cn/display.aspx?cgid=21651&lib=law.

530 Teema Ruskola, *Law Without Law, or is "Chinese Law" an Oxymoron?*, 11 WM. & MANY BILL OF RTS. J. 655, 655 (2003).

531 THE ANALECTS OF CONFUCIUS 12:11. Translated by A. Charles Muller. *Available at*: visited Mar. 04, 2015).

532 Patricia Pattison & Daniel Herron, *The Mountains are High and the Emperor is Far Away:*

entire Chinese social system is based on existential inequality."[533] To maintain a hierarchy-oriented order of society, factors essential and fundamental to contracting, such as the natural rights of human being, human self-awareness and free will, were ruled out as negative factors in Confucian culture.[534] Further, the Confucian teaching does not support the profit-chasing nature of humanity, which forms the basis of exchange and an important reason for contract forming. "The mind of the superior man is conversant with righteousness; the mind of the mean man is conversant with gain."[535] Following the Confucian thinking, stressing agriculture while restraining commerce had always been the state policy in the two thousand years of the Chinese empire.[536] After three decades of economic reform, nowadays China has gradually formed a system of modern business as well as contract legislations. However, without a history of encouraging profit-seeking and commerce, one cannot expect a sophisticated contracting culture even in today's China. Chinese commercial tradition is accustomed to using simple contracts; the parties lack the ability to negotiate and conclude a complex agreement.[537] It is therefore understandable that Chinese investors would hesitate when facing difficult contracting issues when concluding a partnership agreement if they decide to invest in a limited partnership fund. By contrast, choosing the corporation form would require much less of such efforts.

Sanctity of Contract in China, 40 AM. BUS. L.J. 459, 479 (2003).

533 YUAN WANG ET AL, BUSINESS CULTURE IN CHINA 22 (1998).

534 Yang Xiejun (杨解君), Qiyue Wenhua de Bianqian Jiqi Qishi (Xia) (契约文化的变迁及其启示(下)) [The Change and Enlightenment of the Contract Culture (second)], 129 Faxue Pinglun (法学评论) [Law Review] 28, 30 (2005).

535 THE ANALECTS OF CONFUCIUS 4:16. MIT Classics, available at (last visit Mar. 4, 2015).

536 Yang Xiejun (杨解君), Qiyue Wenhua de Bianqian Jiqi Qishi (Xia) (契约文化的变迁及其启示(下)) [The Change and Enlightenment of the Contract Culture (second)], 129 Faxue Pinglun (法学评论) [Law Review] 28, 31 (2005).

537 Gan Peizhong & Li Kezhen (甘培忠 李科珍), Lun Fengxian Touzi Youxian Hehuoren "Zhixing Hehuo Shiwu" Xingwei ji Quanli zhi Bianjie (论风险投资有限合伙人"执行合伙事务"行为暨权力之边界) [The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners], 172 Faxue Pinglun (法学评论) [Law Review] 33, 41 (2012).

5.3.2 The Reputation Mechanism in a Guanxi Society

As previously mentioned, venture capital limited partnership fund investors strongly rely on the reputational constraints set for the general partners and a strong control rule may have a positive influence on the efficiency of the reputation mechanism. The situation may be different in China. Research has indicated that reputation as a monitoring device might not be used extensively by the Chinese limited partners.[538] There might be deeper reasons in the Chinese culture to explain such a phenomenon.

It was suggested that besides a general partner's reputation, investors have other motivations influencing their investment decisions, such as local tax and policy preferences, local development plan and political pressures, and these motivations might be more influential among Chinese investors.[539] Furthermore, the lack of a credit reporting system and personal bankruptcy law in China have downgraded the reputational constraint.[540] While it might be true that factors such as policies and politics would influence the decision of the investors, when all of these other things are equal, investors would possibly still not choose projects according to the general partner's reputation, for reasons lying within the Chinese culture.

5.3.2.1 A Guanxi Society

As a Confucian state does not comprise individuals but rather interconnected people with respective roles, *guanxi* (关系) holds utmost importance to Chinese economic exchanges.[541] Social connections and networking are perhaps the closest English

---

538 Lin Lin, *Private Equity Limited Partnership in China: a Critical Evaluation of Active Limited Partners*, 13 J. CORP. L. STUDIES 185, 213-214 (2013).

539 *Id*., at 213.

540 *Id*., at 214.

541 About *guanxi*, see e.g. Xiaoping Chen & Chao C. Chen, *On the Intricacies of the Chinese Guanxi: A Process Model of Guanxi Development*, 21 ASIA PACIFIC J. MGMT 305 (2004); Ho Park & Yadong Luo, *Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms*, 22 STRATEGIC MGMT. J. 455 (2001); Luo Yangdong & Chen Min, *Managerial Implications of Guanxi-based Business Strategies*, 2 J. INT'L MGMT 293 (1996); Lucian W. Pye, *Factions and the Politics of*

synonyms to *guanxi*. However, *guanxi* is fundamentally embedded in the relationship between two individuals, reflecting the cultivation of long-term personal relationships, whereas networking is only one important aspect of *guanxi*-based business practices.[542] To establish *guanxi*, the two individuals must first have something in common or share a common understanding, such as the same birthplace, school, work or a mutually-known intermediary, or even an expectation of future exchange.[543] After these commonalities have been identified, the process of building a long-term relationship begins, mainly through creating reciprocal obligations toward one another through gift and favor exchanges.[544]

Therefore, in a *guanxi*-dominated society, the advantages brought by an effective and efficient reputation market are less significant. *Guanxi* and reputation are similar in the sense of reducing the possibility of opportunistic behavior of an exchange partner. *Guanxi* serves as a lubricant for exchange, whereas the loss of *guanxi* may result in the loss of exchange opportunities.[545] A reputable person will continue to act reputably for the fear of loss resulting from a damaged reputation.[546] However, there is a fundamental difference between *guanxi* and reputation, given that the latter is determined by the collective assessment of others.[547] Of course, one particular individual can bring a negative impact on the overall assessment of another individual's reputation, and the magnitude of this impact depends on the nature of the

---

Guanxi: *Paradoxes in Chinese administrative and political behavior*, 34 CHINA J. 35 (1995).

542 Stephen S. Standifird, *Using Guanxi to Establish Corporate Reputation in China*, 9 CORP. REPUTATION REV. 171, 173 (2006).

543 *Id*., at 172.

544 *Id*., at 174.

545 *Id*., at 173.

546 See e.g. Robert Wilson, *Reputations in Games and Markets*, in GAME-THEORETIC MODELS OF BARGAINING 27 (Alvin E. Roth ed., 1985); Jay B. Barney & Mark H. Hansen, *Trustworthiness as a source of Competitive Advantage*, 15 STRATEGIC MGMT J. 175 (1994); Charles J. Fombrun & Violina Rindova, *Reputation Management in Global 1000 Firms: a Benchmarking Study*, 1 CORP. REPUTATION REV. 205 (1998).

547 See e.g. Charles Fombrun & Mark Shanley, *What's in a Name? Reputation Building and Corporate Strategy*, 33 ACAD. MGMT. J. 233 (1990); Andrea M. Sjovall & Andrew C. Talk, *From Actions to Impressions: Cognitive Attribution Theory and the Formation of Corporate Reputation*, 7 CORP. REPUTATION REV. 269 (2004).

violation involved.[548] Furthermore, if the individual has a very strong positive reputation, the impact of a singular relationship is likely to be weak.[549] As previously discussed, *guanxi* is fundamentally between individuals and thus individual violation of *guanxi* can result in a complete expulsion of the entire *guanxi* network.[550]

For a simplified scenario, person A wants to do business with C, but A does not have *guanxi* with C. However, A has *guanxi* with B, who has *guanxi* with C. B can introduce A to C, then A may have business opportunities with C and C's other *guanxi* connections, thus forming a network. If A has violated his relationship with his point of entry B, A may be expelled from the network, while if A violated his relationship with any member of the network, A may also be expelled, for B would feel disgraced or "lose face" towards other members of the network. Therefore, discrete relationships between individuals have a much greater impact on the efficacy of a *guanxi* network than that of reputation.[551]

The reputation mechanism in China may be more subjective in the sense that the likeliness of doing business with one individual depends more on his personal *guanxi* rather than his ability that is known to others. In fact, *guanxi* itself can be extremely useful and powerful as an information network and connections which can provide one individual with people who are willing and able to help, but are unable to reach him.[552] While an established reputation could be ruined due to disagreement among individuals, an investor may choose a fund more based upon his *guanxi*, as the venture capitalist can also use *guanxi* to find the right resources. In the strongest sense,

---

548 See e.g. Stelios Zyglidopouls & Nelson Phillips, *Responding to Reputational Crises: a Stakeholder Perspective*, 2 CORP. REPUTATION REV. 333 (1999); Gary H. Jones et al., *Reputation as Rservoir: Buffering Against Loss in Times of Economic Crisis*, 3 CORP. REPUTATION REV. 21 (2000).

549 Stephen S. Standifird, *Using Guanxi to Establish Corporate Reputation in China*, 9 CORP. REPUTATION REV. 171, 174 (2006).

550 *Id.*

551 *Id.*

552 Andrew Hupert, *Americans Negotiating in China: Guanxi relationships and foreigners – doorbell or skeleton key?*. Available at:
(last visited Dec. 11, 2016).

it may be true that the venture capitalist would care less about his business reputation, allocate more of his time trying to maintain his *guanxi* with the investors rather than focusing on the projects; and one may even say that in a *guanxi*-centered society, the investors could not rely on the reputation mechanism for it could not fully and impartially signal one's true quality. However, given that the central government in China has devoted great effort to building a relatively transparent regulatory framework, and a growing community of internationally experienced experts who do not want to go back to a lawless China, where personal influence came before law and regulation, the traditional *guanxi* culture can serve as a base for a vast network of connections and a lubricant for negotiation, and a much quicker mechanism to brand and establish use of one's ability, where it may otherwise take a long time to build, and to be recognized for, one's reputation.

5.3.2.2 The Circle in the Venture Capital World

In a *guanxi*-based society, Chinese people often form circle structures in their workplace. The circle is a kind of *guanxi* network based on an "order pattern" and exchange of favors.[553] The circle centers on a "talented person", aggregating a group of acquaintances who are engaged in long-term favor exchange. According to their *guanxi* distance, loyalty and exchange capacity, concentric circles are formed around the core person. The "order pattern" means that people at different inside and outside levels have different rules of social exchange with the core person: the innermost are "cronies" with stress on the greatest loyalty and sharing with others; the further out the circle, the less sharing, and the shallower the depth of exchange.[554] A work place often has different core people forming different circles; these circles may compete

---

553 Luo Jiade et al. (罗家德,秦朗,周伶) Zhongguo Fengxian Touzi Chanye de Quanzi Xianxiang (中国风险投资产业的圈子现象) [Circle in Chinese Venture Capital Industry], 11 Chinese Journal of Management (管理学报) 469, 470 (2014).

554 *Id.*

with one another, and sometimes may also need cooperation which requires a "bridge person" to form overlapping parts.

The people working in the venture capital industry in China also form circles. The innermost tier 1 players consist of only a few of the most well-known venture capitalists; tier 2 are individuals and firm investors who possess a great amount of capital, they follow closely the steps of the central giants; tier 3 are venture capitalists who are specialized in investing in one area or in one region, they have relatively shallow connection with the inner circles and usually have connection with other circles at the same time.[555]

Forming circles in the venture capital industry has two significant advantages. First, forming a circle could help its members to combat risks with collective action and in a mutual supportive way. It is suggested that during the 2000s, when there was a lack of supervision of the venture capital industry, venture capitalists encountered the situation where the authorities failed to act and they had to utilize the connections and reputation of allies in their circle to settle disputes.[556] Therefore, the informal circle networks can be complementary to policies when the formal system has failed to work. Second, circles can provide resources for reputation accumulation. If a lesser-known venture capitalist wants to build up his reputation in the venture capital industry, he could try to join circles with the well-known and reputable venture capitalists at the core. It is possible the newly joined ones are only doing follow-up investment with the core, however, the market would not care for investment methods, but only focus on performance and return. Those at the core possess abilities to identify good projects and resources to nurture them to success, and consequently, the lesser-known venture capitalist can accumulate reputation using the network in the

---

555 *Id*., at 473.

556 Luo Jiade et al. (罗家德,秦朗,周伶) Zhongguo Fengxian Touzi Chanye de Quanzi Xianxiang (中国风险投资产业的圈子现象) [Circle in Chinese Venture Capital Industry], 11 Chinese Journal of Management (管理学报) 469, 474 (2014).

circle, slowly work his way up (or in), ultimately possibly forming his own circle and being the core. Compared to the reputation mechanism, which focuses on an individual's ability to show his success to the public, the circle has a half-closed feature: the circle's resources are only provided to those who are members in the circle, and at the same time there are chances for new entrants to the ring.[557]

The phenomenon of *guanxi* and the circle reveals that, in China, culture can play an important role in business exchanges. Compared to the mechanisms aimed at mitigating agency problem in the U.S., the Chinese venture capital industry and investors have their own ways of reaching the same goal.

[557] *Id*., at 476.

Chapter 6 The Role of Government in Venture Capital Investment

The Chinese government has been playing an important role in the evolution of the domestic venture capital market, as well as trying to steer national innovation through venture investing. The venture capital guiding fund is the new form of government involvement: rather than directly injecting funding to innovative projects or forming government-funded venture capital enterprises, the government began to seek new ways as an investor in private venture funds. The changed role of the government could have some significance in answering the doubts from other venture investors.

When explaining the Chinese venture investors' choice of business form, tax reasons should not be overlooked. The tax policies in China regarding venture capital investments will be examined in this chapter, showing that tax disadvantages might be another reason why Chinese investors less commonly choose the limited partnership form.

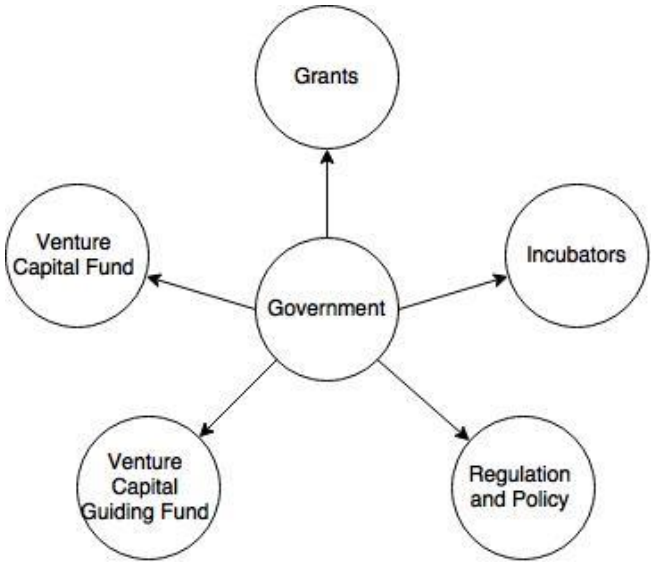
6.1 The Government's Involvement in Venture Capital Financing

The central government started its pilot trial to engineer a venture market in the 1980s. After years of evolution, the government may have served other important functions besides injecting money into the venture market.

The government plays an important role in the whole process of venture capital investment activities. There are several ways for the government to participate in the venture capital industry (Figure 21). Externally, the government can provide legal support and policy guidance to the venture capital market to ensure a good business environment, such as setting out new legislations (for example the new part of PEL and the Interim Measures) and provide tax relief to certain innovative projects; at the

same time, as one of the capital providers, the government could participate in the operation of the capital market, influencing investment behavior either directly or indirectly. Particularly, the government could directly set up government venture capital funds or build policy-favored incubators for innovative companies. Regarding the matter of funding, the government could either provide money directly to the venture capital funds or set up venture capital guiding funds.

Figure 21 Government Involvement in Venture Capital



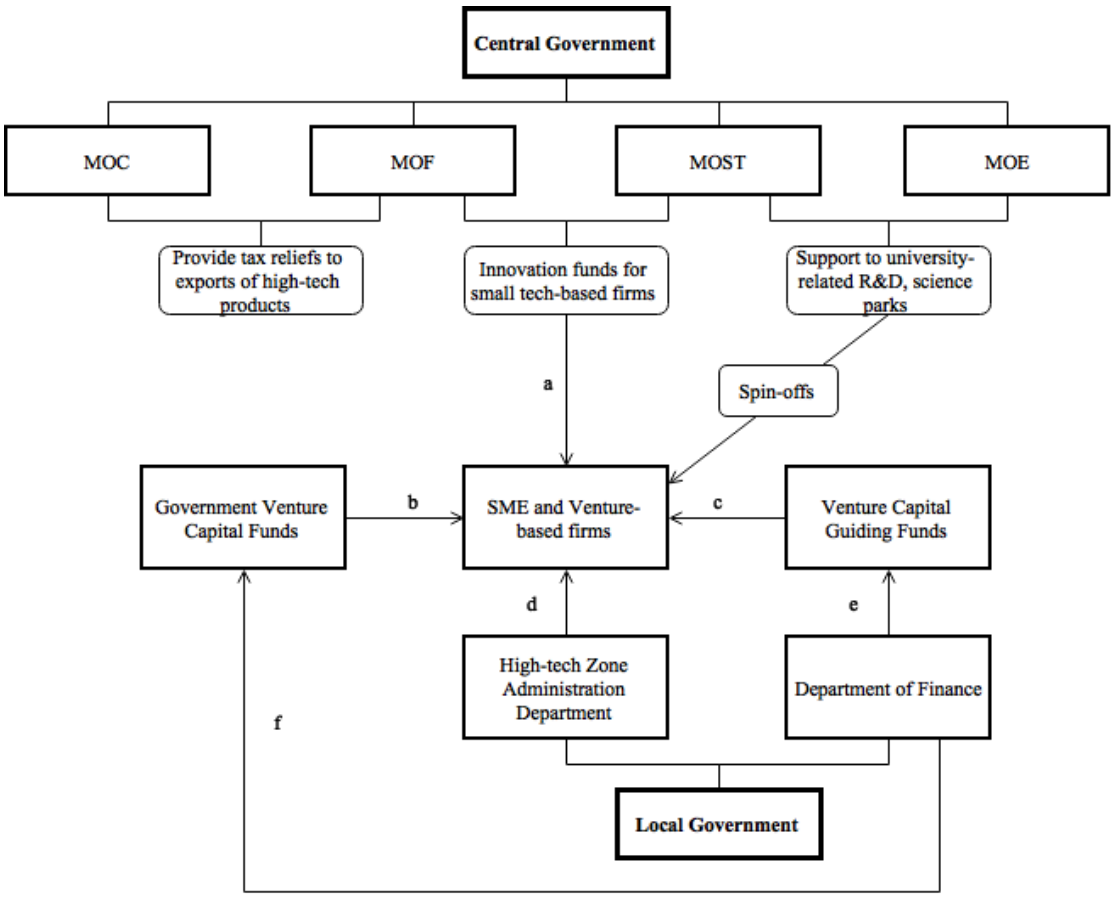
Source: China Venture Capital Research, 2013 VCGF Report

The government's role in defining China's venture capital system could be related to the innovation system (Figure 22). The central government has taken a more indirect approach towards the venture capital system, and the responsibility and authority are decentralized to create a playground for actors from the lower level (local governments, research institutes, universities, etc.) to act entrepreneurially.[558] With a small portion of direct funding, the ministries are collaborating more in providing favorable policy support and legitimizing venture capital and private entrepreneurship, allowing new organizational forms to become legal entities. This has allowed a

[558] Steven White et al., *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RESEARCH POLICY 894, 901 (2005).

broader basis for new venture firms such as spin-offs from research institutes and universities and even new firms established by individuals. The central government has made a great effort to align the financial and legal system more closely to establish a market-oriented venture capital business system.[559] The key elements include organization laws such as corporate law and partnership law, governing contract, investment and intellectual property, establishing various panels at the stock exchange and other elements in the capital market.

Figure 22 Government and the Venture Capital System in China



a, b, c: money, business opportunities, reputation

d: money, infrastructure support

e, f: money

Source: OECD Report, White (2005), and author

---

559 *Id.*

In recent years, the role of the government in the venture capital industry has been gradually shifting from a direct investor to an indirect one, and it is no longer establishing venture capital firms but rather venture capital guiding funds (VCGF). The VCGF aims to channel and guide more private capital into the venture capital industry to support the development of innovative SMEs.

6.2 The Venture Capital Guiding Fund

6.2.1 The Development of the Venture Capital Guiding Fund

After 1998, as venture capital investment in China entered a stage of rapid development, government-backed venture capital investment entities were established across the country. Although these entities were not named as "government guiding fund", they essentially played the role of channeling government funds and policies into the innovation market.

In the Interim Measures issued in 2005, Article 22 states that "the state and local governments may establish startup investment guiding funds so as to support the establishment and development of startup investment enterprise by way of holding their shares, providing financing guarantees, etc." [560] This article is the legal foundation of the government guiding fund, which also provided the means of investments of the guiding fund.

In the National Outline for Medium and Long Term Science and Technology Development (2006-2020), as "an attempt to attract more capital into venture capital investment market", it is highly encouraged to establish government guiding funds.[561] Corresponding with the second wave of venture capital investment in China, the

---

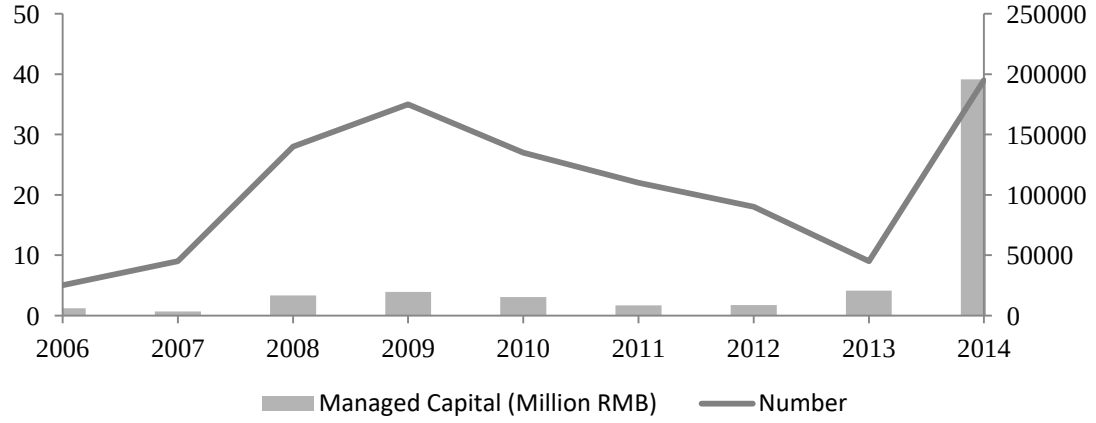
560 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006), Art. 22.

561 National Outline for Medium and Long Term S&T Development (2006-2020), VIII (5).

establishment of government guiding funds entered a period of fast development. Thirty-three new guiding funds were established during 2007 and 2008, compared with only six funds before 2006.[562] However, many problems remained to be solved due to the lack of detailed rules; for example, the daily management of the guiding fund, the functioning model of the fund, the risk control measures and regulation and inspection of the fund, etc. These problems resulted in many of the guiding funds being established without actual investing activities.[563]

As an answer to this question, in 2008 the NDRC, MOF and MOC jointly issued the Guidance on Establishment and Operation of Venture Capital Guiding Funds (hereinafter the Guidance). Following this detailed government guiding fund guidance, a new wave of establishing government guiding funds emerged in the country and local government also responded quickly to issue implementing measures. During this time, the revitalization of the domestic capital market, the strengthening of the SME board and the establishment of the Growth Enterprises Market Board in 2009 created a positive environment for venture capital investments by providing them with a better chance of exit.

Figure 23 2006-2014 Venture Capital Guiding Fund

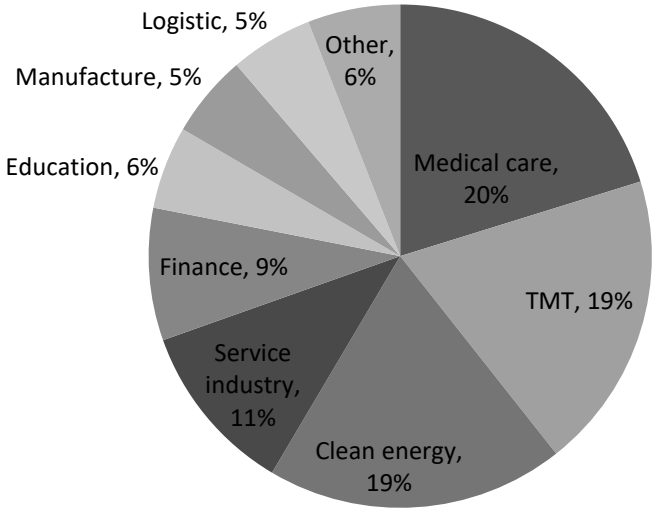


562 2013 Government Guiding Fund Report, China Venture Research, Feb., 2014.
563 *Id*.

Source: www.zero2ipo.com.cn

The state has pushed the development of government guiding funds ever since. In the Executive Meeting of the State Council on May 21 2014, Premier Li Keqiang stated that the state aims towards "expanding exponentially on the scale of the guiding fund", and "to improve the market operation mechanism".[564] Moreover, again in the Executive Meeting on January 14 2015, it was decided to establish the National Venture Capital Guiding Fund of New Industries to boost entrepreneurship, innovation and industrial upgrading. The goal is to exploit the leverage effect of the government funding to attract large enterprises, financial institutions and private capital to participate in the formation of the new industry venture capital guiding fund totaling RMB 40 billion.[565] These meetings reflect the attitude of the state government towards furthering the development and perfection of the venture capital guiding fund.

Figure 24 The Focus of the VCGF



Source: China Venture VCGF Report 2014.

564 (last visited Nov. 23, 2015).
565 (last visited Nov. 23, 2015).

6.2.2 Guidance on the Establishment and Operation of Venture Capital Guiding Funds

The first article of the Guidance states that "the guiding fund refers to the policy fund established by the government and operated in accordance with the mode of the market principle.[566] The guiding fund itself does not participate in venture capital investment businesses."[567] The purpose of the guiding fund is to "primarily give play to the leverage effect of government funds, increase the supply of venture capital investment, [and to] overcome market failures of the venture capital investment."[568] The guiding fund particularly encourages venture capital enterprises to invest in early-stage entrepreneurial companies.[569]

The main funding sources of the guiding fund are: (1) government funding specialized in supporting venture capital investment enterprises; (2) investment income and guarantee income of the guiding fund; (3) interest income of idle funds deposited in banks or government bonds; and (4) donations from individuals, enterprises or institutions.[570] At present, in China, the major funding sources are government funding, as well as joint financing from the government and the policy/non-commercial banks. The majority of the guiding funds are solely government funded, whereby only several early guiding funds are funded jointly by the local government and policy banks. For example, Suzhou Industrial Park Venture Capital Guiding Fund and Tianjin Binhai Xinqu Venture Capital Guiding Fund are funded by the local government and China Development Bank, while Chengdu Yindu Venture Capital Guiding Fund and Chongqing Science and Technology Venture Capital Guiding Fund

---

566 Market principle means that the funds will be operating according to the market's demand and supply, not by government plan or order.

567 Guanyu Chuanye Touzi Yindao Jijin Guifan Sheli yu Yunzuo de Zhidao Yijian (关于创业投资引导基金规范设立与运作的指导意见) [Guidance on Establishment and Operation of Venture Capital Guiding Funds] (promulgated by SDRC, MOF & MOC, Oct. 18, 2008), Art. 1, para. 1.

568 *Id*., Art.1, para. 2.

569 *Id.*

570 *Id*., Art.2, para. 3.

are funded by the local government and the Export-Import Bank of China.[571]

Table 2 Funding Sources of VCGF in 2010

	VCGF	Capital	
	number	RMB Billion	%
Government funds	51	34.30	63.49
State-owned investment companies	2	5.9	10.92
Other companies	6	0.33	0.6
Banks	4	8.5	15.73
Other	1	5	9.26

Source: 2011 survey conducted by MOST

According to the Guidance, the venture capital guiding fund shall be an independent public institution (事业法人).[572] The decision-making body of the guiding fund shall be a council composed of personnel appointed by relevant authorities. The council exercises the rights of the guiding fund and undertakes corresponding obligations and responsibilities.[573] In terms of the daily management and operation, it can be a dedicated management body from the fund or an entrusted qualified management agency.[574]

In reality, the local government normally establishes a guiding fund management council or fund committee as the highest decision-making body of the guiding fund. The members of the committee are from the local government and relevant government departments. However, this fund committee does not participate in the daily operation of the fund. Take the Venture Capital Guiding Fund of Shanghai (VCGFSH) as an example: the Shanghai municipal leader assigned to take the charge of task shall be appointed as the chairman and assistant chairman of the Fund Council

571 2013 Government Guiding Fund Report, 12 China Venture Research, Feb., 2014.

572 Guanyu Chuanye Touzi Yindao Jijin Guifan Sheli yu Yunzuo de Zhidao Yijian (关于创业投资引导基金规范设立与运作的指导意见) [Guidance on Establishment and Operation of Venture Capital Guiding Funds] (promulgated by SDRC, MOF & MOC, Oct. 18, 2008), Art. 2, para. 2.

573 Id.

574 Id., art. 4, para. 1.

and a leader from the Municipal Development and Reform Commission, the Municipal Economical Informatization Commission, the Municipal Business Affairs Commission, the Municipal Science and Technology Commission, the Municipal State-owned Assets Supervision and Administration Commission, the General Office of Municipal Finance and the Municipal Finance Bureau shall respectively be appointed as the members of the Fund Council. The Fund Council shall make decisions on the investment scheme of the VCGFSH.[575]

In terms of daily operation, several possibilities exist. First, the fund can set up its own management organ taking the form of a public institution. For example, Shenzhen Venture Capital Guiding Fund (VCGFSZ) set up the Management Committee Office of VCGFSZ as the managing body, whereby the Development Center of the Nanjing Venture Capital Guiding Fund (VCGFNJ) is responsible for the daily business routine of VCGFNJ. Second, the fund can entrust the management to the local state-owned asset management company or government-backed investment enterprises. For example, Shijingshan VCGF entrusts the Shijingshan District State-owned Asset Management Company as its management, whereby Shijiazhuang VCGF hired Shijiazhuang Development and Investment Company to manage the daily operation. Third, local government-backed venture capital investment enterprises can become the managers. Examples are Shanghai Venture Capital Investment Company managing the VCGFSH, Guangzhou S&T Venture Capital Investment Company for the Guangzhou VCGF. Fourth, daily operations are entrusted to external private professional management institutions, such as the SVB Capital managed a RMB 300 Million VCGF set up by Yangpu District, Shanghai in 2012.

---

575 Shanghaishi Chuangye Touzi Yindao Jijin Guanli Zanxing Banfa (上海市创业投资基金管理暂行办法) [Interim Procedures on Administration of Venture Capital Guiding Fund of Shanghai] (promulgated by Shanghai Municipal Development and Reform Commission and Shanghai Municipal Finance Bureau, Oct. 26, 2010).

The government guiding fund follows the principle of "government guiding, market operation, scientific policy-making and risk precaution" to participate in the capital market.[576] In the Guidance, major ways of the VCGF participating in venture capital investments include equity participation, follow-up investment and financing guarantees.[577]

Equity participation is the most commonly used model of VCGF operation. Essentially the VCGF plays a role of the fund of funds (FoFs), investing in other venture capital funds. Prior to making an investment, the venture capital fund in which the fund invests must be structured as a stand-alone enterprise.[578] This is to ensure the fund's independence in daily management and investment decisions, as well as ensuring that the government could distance itself from the risky investments.[579] The terms of investment from the VCGF are the same as those of private investors and it shall exit according to pre-agreed terms. In some of the provincial regulations, a VCGF in principal shall not contribute more than 25% of the subscribed sum of capital to the new venture capital fund and shall not become the largest shareholder of the fund. However, the ratio may be relaxed for high-risk venture funds that have great social benefit while being difficult in terms of fund-raising.[580] Accordingly, a VCGF shall achieve its policy objective by multiplying the

---

576 Guanyu Chuanye Touzi Yindao Jijin Guifan Sheli yu Yunzuo de Zhidao Yijian (关于创业投资引导基金规范设立与运作的指导意见) [Guidance on Establishment and Operation of Venture Capital Guiding Funds] (promulgated by SDRC, MOF & MOC, Oct. 18, 2008), Art. 3, para. 1.

577 Id., Art. 3, para. 2.

578 "Venture capital guiding fund … to attract social capital co-sponsors in the establishment of venture capital enterprises." Id.

579 XUEDONG DING & JUN LI, INCENTIVES FOR INNOVATION IN CHINA: BUILDING AN INNOVATIVE ECONOMY 106 (Routledge, 2015).

580 See e.g. Hubeisheng Shengji Guquan Touzi Yindao Jijin Guanli Shixing Banfa (湖北省省级股权投资引导基金管理试行办法) [Hubei Interim Measures on the Administration of the Venture Capital Guiding Fund] (promulgated by Hubei Provincial Gov't, Jun. 23, 2015), Art.14, para.3; Jilinsheng Chanye Touzi Yindao Jijin Guanli Zanxing Banfa (吉林省产业投资引导基金管理暂行办法) [Jilin Interim Measures on the Administration of the Industrial Investment Guiding Fund] (promulgated by Jilin Provincial Gov't, May 21, 2015), Art.15, para.6. In fact, the 25% threshold was regulated in the 2007 Interim Measures on the Administration of the Venture Capital Guiding Fund for High-tech SMEs issued by MOF and MOST. However, this piece of regulation was invalidated in 2014.

amount of venture capital available for innovative start-ups.

Follow-up investment is essentially a co-investment of the VCGF and venture capital funds to the early-stage projects in which the venture capital funds already made investments. The main purpose is to support venture capital funds in the reduction of the investment risk. According to the Guidance, follow-up investment can only be used in early-stage start-ups or high-tech firms that need state support. Moreover, the VCGF shall not participate in the operation of the investment.[581]

VCGF can provide a financing guarantee to those venture capital funds that have a good record and boost their investment capability through debt financing. With financing guarantees provided by the VCGF, the creditor's risk is reduced and the venture capital funds can improve their financial performance as they may pay back the creditors with lower interest rates.[582]

Other means of VCGF's participation in venture capital investment could include an investment subsidy, which involves subsidizing venture capital funds for investment risks that they undertake and compensating for the investment loss, as well as a comfort subsidy, which involves subsidizing the high-tech start-ups after the venture capital fund has made the investments.[583]

Table 3 Means of Financing by VCGF in 2010

	Use of fund	Capital allocation (RMB Billion)
Fund of Funds	54	44.95

[581] Guanyu Chuanye Touzi Yindao Jijin Guifan Sheli yu Yunzuo de Zhidao Yijian (关于创业投资引导基金规范设立与运作的指导意见) [Guidance on Establishment and Operation of Venture Capital Guiding Funds] (promulgated by SDRC, MOF & MOC, Oct. 18, 2008), Art. 3, para. 2. The particular conditions involving VCGF in follow-up investment can be found in provincial or sub-provincial regulations on VCGF.

[582] XUEDONG DING & JUN LI, INCENTIVES FOR INNOVATION IN CHINA: BUILDING AN INNOVATIVE ECONOMY 108 (Routledge, 2015).

[583] These two means are from the now-ineffective Kejixing Zhongxiao Qiye Chuangye Touzi Yindao Jijin Guanli Zanxing Banfa (科技型中小企业创业投资引导基金管理暂行办法) [Interim Measures on the Administration of the Venture Capital Guiding Fund for High-tech SMEs] (promulgated by MOF & MOST, effective July 06, 2007, invalidated Apr. 10, 2014), Ch.5 & 6.

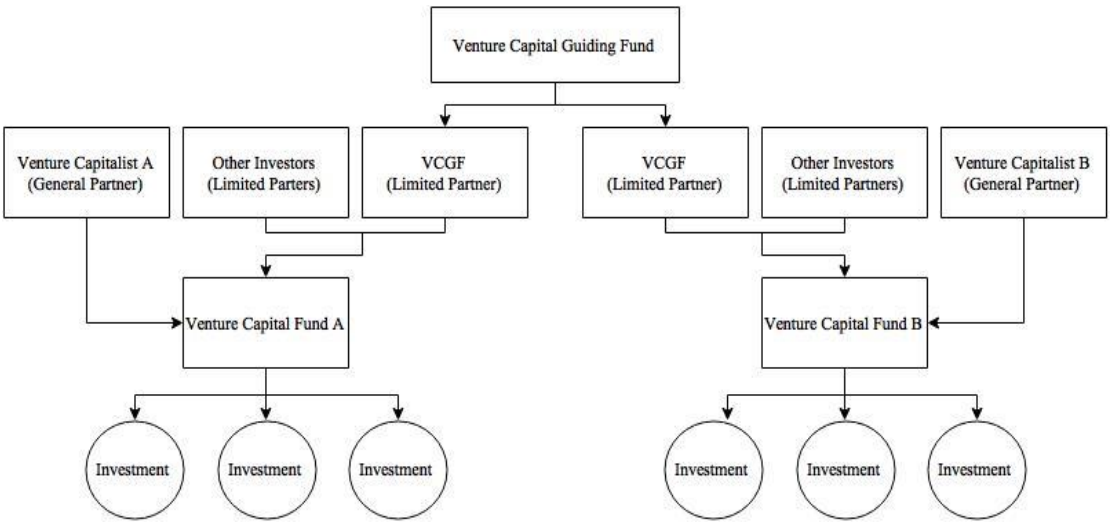
Follow-up investment	34	31.26
Financing guarantee	5	1.6
Investment subsidy	7	4.46

Source: 2011 survey conducted by MOST

6.2.3 VCGF as a Solution to the Agency Problem

Recall, the most commonly used form of VCGF in China is equity participation. Essentially the VCGF plays a role as fund-of-funds, contributing initial capital to a venture capital fund with other private founders. If formed as a limited partnership, the VCGF becomes one of the limited partners, together with other investors/limited partners, establishing a venture capital limited partnership fund with a professional venture capitalist as the general partner.

Figure 25 VCGF in a limited partnership venture capital fund



Source: author

Upon first glance, the VCGF's participation in limited partnership venture capital funds can be easily likened to the so-called public-private partnership (PPP). However, it differs from the PPP in many aspects. By definition, a PPP is a "long-term contract between a private party and a government entity, for providing a public asset or

service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance".[584] The PPP aims to correct the shortcomings of traditional public organizations in efficiency[585] and it is often used in constructing infrastructure, whereby the most common example would be a BOT (build-operate-transfer) when building a new highway. By contrast, the VCGF is a kind of government intervention to support a target private sector development, providing assets, equity or guarantees to otherwise fully private enterprises that are not involved in the provision of public services.[586] In other words, the VCGF aims to motivate private capital to invest in high-tech start-ups with public support.

As discussed in the previous section, Chinese private investors are reluctant to invest in the venture capital market through the investment vehicle of a limited partnership, even though such an organization structure could be beneficial to investment associated with high risk, such as venture investments. The reason for such hesitation – as Chinese investors indicated in the survey – is essentially associated with trust issues. In response to these issues, the VCGF could to some extent help to indicate the trustworthiness of the general partners to gain trust among limited partners.

First, unlike the profit-chasing private investors, the VCGF's purpose is to promote the venture capital market and stimulate private investors' engagement. Therefore, as the limited partnership in a venture fund, the VCGF is very patient about returns, if there are any. Such a feature of the VCGF could have a gap-filling effect in areas that private investors would not touch. According to one research study, the most typical area in which private investors are reluctant to invest is projects involving transformation and commercialization of scientific and technological achievements. Possible reasons may include a very long project cycle of the transformation with vast

---

584 The World Bank, PUBLIC-PRIVATE PARTNERSHIPS REFERENCE GUIDE (2014), p17.

585 Josh Lerner, *When Bureaucrats Meet Entrepreneurs: The Design of Effective "Public Venture Capital" Programs*, 112 ECON. J. 73 (2002).

586 The World Bank, PUBLIC-PRIVATE PARTNERSHIPS REFERENCE GUIDE (2014), p24.

amounts of investment required, the results being difficult to integrate with a commercial model, the researchers' unwillingness to leave the original research institutions to work as employees of an enterprise, etc.[587] Realizing such problems, MOST established the National Guiding Fund for the Conversion of Scientific and Technological Achievements in 2014.[588] Such a fund could attract more market-based funds into this area and to some extent mitigate the problem of market failure. In turn, fund managers could gain more experience in these fields, gradually accumulating their reputation capital.

Second, to bridge the information gap between the limited partners and the general partners and help reveal the true quality of the fund managers, the VCGF will proceed through a detailed evaluation of the venture capitalist during the investment selection phase. It has been stated in the Guidance that the venture capital enterprises that apply for support from the VCGF shall establish performance incentive and risk control mechanisms and the managers shall already obtain good performance records.[589]

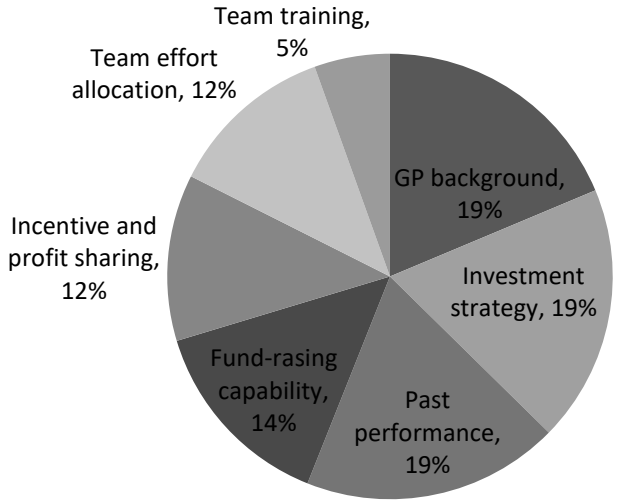
Figure 26 VCGF's evaluation of sub-funds

---

587 2014 Venture Capital Guiding Fund Report, ChinaVenture, released July 20, 2015. Available at: (last visited Oct. 31, 2015).

588 The relevant regulation, see Guojia Keji Chengguo Zhuanhua Yindao Jijin Guanli Zanxing Banfa (国家科技成果转化引导基金管理暂行办法) [Interim Measures for the Management of the National Guiding Fund for the Conversion of Scientific and Technological Achievements] (promulgated by MOF & MOST, July 4, 2011); Guojia Keji Chengguo Zhuanhua Yindao Jijin Sheli Chuangye Touzi Zijijin Guanli Zanxing Banfa (国家科技成果转化引导基金设立创业投资子基金管理暂行办法) [Interim Measures for the Management of the Sub-Venture Capital Fund Established by National Guiding Fund for the Conversion of Scientific and Technological Achievements] (Promulgated by MOST & MOF, Aug. 8, 2014, effective Sep. 8, 2014).

589 Guanyu Chuanye Touzi Yindao Jijin Guifan Sheli yu Yunzuo de Zhidao Yijian (关于创业投资引导基金规范设立与运作的指导意见) [Guidance on Establishment and Operation of Venture Capital Guiding Funds] (promulgated by SDRC, MOF & MOC, Oct. 18, 2008), Art. 6.



Source: 2015 VCGF Report, ChinaVenture

This evaluation conducted by the VCGF could help investors to obtain information about the general partners, and it could be especially beneficial to those individual investors who may be less sophisticated and lack the resources or means – compared to institutional investors – to access information about the manager. Furthermore, since there is not a sound social credit reporting system[590] in China, a performance evaluation conducted by a government-related body could send a more-or-less credible signal of the manager's ability to the market. Further, since the venture capital enterprises would form a venture fund with cooperation of the government and receive funds from the government, the general partners would exert greater effort and act faithfully to maintain a good relationship with the government with the aim ofgaining more future business opportunities.

Third, the VCGF is acting as one of the limited partners in a limited partnership venture capital fund, thus enlarging the pool of possible limited partners. More

590 The Chinese government is planning a system that connects citizen's financial, social and legal credit ratings into one social trustability score, the idea is that if someone breaks trust somewhere, they will be adversely affected everywhere else. See Xinhuanet, China outlines its first social credit system, (last visited Dec. 11, 2016).

importantly, the VCGF's mandate states that it will not participate in the business of the invested sub-funds; therefore, unlike many of the Chinese investors, the VCGF is not an active but a passive investor. The passive role of the VCGF as the limited partner will leave more space for the fund managers to perform and test their real abilities in the investment process.

Furthermore, in December 2014, the State Council issued the Notice on Clearing the Preferential Tax Policies and Other Preferential Policies (State [2014] No.16). According to the notice, except in accordance with special tax laws and regulations, local governments shall not issue policies providing tax preferences without the approval of the State Council.[591] This means that the local government cannot provide tax waivers or subsidies deliberately to attract businesses; instead, the VCGF becomes the alternative choice of the local government to indirectly attract investments into certain preferred industries.[592] Therefore, by suppressing the other direct incentive factors such as local development plans from the government, a good reputation built by the general partners – with help from the VCGF – would play a more important role in attracting investors.[593]

As evidence, it seems that the limited partnership form is favorable when a venture fund has VCGF participation. Take Shanghai VCGF as an example: according to the Announcement on Venture Capital Funds with VCGFSH Participation, in 2014 five out of six venture funds established that year with VCGFSH participation opted for the limited partnership form, while nine out of twelve chose to do so in 2015.[594]

Essentially speaking, the VCGF could help to bridge the gap between the investors

---

591 Art. 3, para. 1.

592 Gui Jieying, *New Era of the VCGF*, available at:
(last visited Nov. 10, 2015).

593 Lin Lin, *Private Equity Limited Partnership in China: a Critical Evaluation of Active Limited Partners*, 13 J. CORP. L. STUDIES 185, 213 (2013) (argues that investors in China are not motivated by reputational constraint of the general partner, but by local preferential policies).

594 (last visited Nov. 12, 2015).

and the venture capitalist in the venture capital industry. On the one hand, the VCGF attracts investors, and both private and institutional investors would be more willing to invest in funds with the government-background investors taking the lead. On the other hand, the VCGF attracts managerial talents since the government would not participate in fund management such as allocating capital or selecting portfolio companies.

6.2.4 The Challenges of the VCGF

The ultimate goal of the VCGF is to enhance innovation by financing small and medium-sized companies, high-tech companies and start-ups that encounter difficulty in raising equity or credit from the private sector. The VCGF is thus targeting the venture capital market, seeking to accelerate its growth through public-private co-investment.

However, the performance of the VCGF may be impeded by its very nature of public-private cooperation, generally due to the conflict between social benefits pursued by the government and the investment returns demanded by the private investors, as well as classic government failures, namely regulatory capture such as rent-seeking and regulatory risk associated with leadership changes.

Since the major funding source of the VCGF is the local government, it is understandable that the use of the fund can reflect a very strong local-oriented policy. Some of the VCGFs set geographic restrictions on the investments or mandatory requirements that the investments should focus on certain industries. However, this local protection can be against the principle of the VCGF, namely market-based operation. For an innovation-driven development frontier region such as Shenzhen, this local protection might not be problematic since good projects are abundant for the venture funds. By placing restrictions on venture funds in regions that lack such strength such as central and western provinces, a mismatch of demand and supply

might occur.[595] When short of promising projects, the investments of the VCGF could be "either precipitated or blind", as one of the fund managers claimed.[596]

As public capital, the VCGF has a public purpose, which could be in contradiction with the profit-chasing nature of private investment parties. The local governments want their money to be safe, while the cooperation venture capital funds focus on profit maximization. Furthermore, as a commercial investment, venture capital emphasizes market-oriented operation and highly efficient decision-making, while the state-owned assets management requires more prudence. Therefore, the investment decision of the VCGF "tends to be conservative"[597], while cumbersome approval and assessment processes set up by the local government have meant to the establishment of venture funds often being extremely time-consuming and ultimately discouraging private investors.[598]

Finally, government failure could become a great hindrance to the success of the VCGF. It has become a top priority to prevent the VCGF from turning into a rent-seeking tool for government personnel.[599] One fund manager complained about the VCGF being "rather troublesome, need back door deals".[600] In 2009, the involvement of the Tianjin Binhai VCGF in the Dohold Capital illegal fund-raising case[601] raised

---

595 XUEDONG DING & JUN LI, INCENTIVES FOR INNOVATION IN CHINA: BUILDING AN INNOVATIVE ECONOMY 122 (Routledge, 2015).

596 Pu Fan & Zhou Hui, *New Era of the Venture Capital Guiding Fund*, 21 Century Business Herald (July 6, 2015). Available at:
(last visited Oct. 23, 2015).

597 *Id*.

598 Kan Zhidong, *The Awkwardness of the Venture Capital Guiding Fund*, Economic Observers (Dec. 1, 2010). Available at:
(last visited Oct. 26, 2015).

599 2014 VCGF Report, Chinaventure.

600 Pu Fan & Zhou Hui, *New Era of the Venture Capital Guiding Fund*, 21 Century Business Herald (July 6, 2015). Available at:
(last visited Oct. 23, 2015).

601 Dohold Capital (Dohold) was a limited partnership venture capital fund, established by Well Well Group (WWG). The general partner of Dohold was Huang Hao, the board chairman of WWG. Huang was arrested for illegal fund-raising in 2009 and sentenced to life imprisonment in 2010. Since its establishment, Dohold had appeared in the media to have cooperation with the Tianjin Binhai VCGF. After the arrest, the relevant government bodies denied their involvement or any capital commitment to Dohold. The verdict of the Huang Hao case is not available online; for a detailed

serious doubts about the rent-seeking risk of the VCGF.[602] Regarding the regulatory risk, there has been a case whereby one private venture capital institution was invited by the local government to cooperate in forming a venture fund with investment from its VCGF after a long preparation, only to find out that the local leadership whom the institution originally negotiated with had changed office. Subsequently, the enthusiasm of the other private participants began to cool down, fearing the huge time consumption when cooperating with government, which finally led to the miscarriage of the investment plan.[603]

6.3 Taxation

One significant advantage of the limited partnership form is that unlike corporations, the limited partnership income is not subject to taxation at the entity level. After China adopted the limited partnership form in 2007, tax policies on such a form have gradually been established. However, the tax treatment of venture capital limited partnership funds has only been able to enjoy a level playing field with corporations in recent years.

---

description of the case, see Qiu Bihua, Regulation on the Private Funds in China – From the Huang Hao Case, master thesis, Anhui University (2013). The media campaign of Dohold with involvment of Tianjin Binhai VCGF, see e.g. *Dohold Capital: the PE with Government Intergration*, Economic Observer (Jun. 17, 2008). Available at:
(last visited Oct. 27, 2015);

Dohold Capital Established Shanghai Headquarter, China Security Journal (Nov. 10, 2008). Available at:
(last visited Oct. 27, 2015).

The denial of involvement of Tianjin Binhai VCGF, see *Who Conned the VCGF?* China Entrepreneur (July 16, 2009) (the board chairman Yang Xu of the Tianjin Binhai VCGF denied any capital commitment to Dohold Capital). Available at:
(last visited Oct. 27, 2015).

602 Golden Age for Chinese LPs: Operating Rules of the VCGF, zero2ipo Group (May 25, 2015). Available at:
http://news.pedaily.cn/zt/20150514382626.shtml#m007 (last visited Oct. 27, 2015).

603 Kan Zhidong, *The Awkwardness of the Venture Capital Guiding Fund*, Economic Observers (Dec. 1, 2010). Available at:
(last visited Oct. 26, 2015).

7.3.1 Tax Policies for Venture Capital Investments

There are three taxable levels in the venture capital investment process: first, the firms that receive venture capital investments; second, the venture capital enterprises; and third, the venture capital fund investors.

At the firm level, venture capital investments are naturally associated with new and high-technology industries. In China, various tax preference policies are adopted to promote innovation. For example, Article 28 of the Enterprise Income Tax Law states that the enterprise income tax "on important high and new-tech enterprises that are necessary to be supported by the state shall be levied at the reduced tax rate of 15%."[604] For the different types of enterprises engaging in the development of software and integrated circuit industries, they are exempted from the enterprise income tax for the first two years, or five years, or 15% rather than the uniform 25% income tax for all enterprises.[605]

Promoting venture capital investment through taxation was first mentioned in the 2002 Law on the Promotion of Small and Medium-sized Enterprises.[606] Article 17 of the law states that "the State shall encourage various kinds of venture capital institutions established, through taxation policy, to invest more capital in small and medium-sized enterprises." This policy is also mentioned in the 2006 Interim

---

604 Qiye Suodeshui Fa (企业所得税法) [Enterprise Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), Art. 28.

605 Caizhengbu, Guojia Shuiwu Zongju Guanyu Jinyibu Guli Ruanjian Qiye he Jicheng Dianlu Chanye Fazhan Qiye Suodeshui de Tongzhi (财政部、国家税务总局关于进一步鼓励软件产业和集成电路产业发展企业所得税政策的通知) [Notice of the MOF and the SAT on Enterprises Income Tax Policies for Further Encouraging the Development of Software and Integrated Circuit Industires] (promulgated by MOF & SAT, issued Apr. 20, 2012, effective Jan. 1, 2011), Art. 1-3. English version available at:
http://en.pkulaw.cn/display.aspx?cgid=173130&lib=law.

606 Zhongxiao Qieye Cujin Fa (中小企业促进法) [Law on Promotion of Small and Medium-sized Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Jun. 29, 2002, effective Jan. 1, 2003). English version available at:
http://en.pkulaw.cn/display.aspx?cgid=40271&lib=law.

Measures for the Administration of Venture Capital Enterprises.[607] In the 2008 Enterprise Income Tax Law, a venture capital enterprise "engaged in important startup investments that are necessary to be supported and encouraged by the state may deduct from the taxable amount of incomes a certain proportion of the amount of investment."[608]

In terms of the deduction amount, the 2009 Notice of the State Administration of Taxation on Income Tax Preference For Startup Investment Enterprises (SAT [2009] No. 87) states that if a venture capital enterprise "invests in an unlisted small or medium new and high-tech enterprise (SME) for two years (24 months) or more in the form of equity investment, a tax credit of 70% of the amount of investment in the SME can be claimed against the taxable income of the year when two full years end since it holds shares in the SME, and, if the tax credit is less than the taxable income, the tax credit can be carried forward to the next tax year."[609]

Generally speaking, for institutional investors, the income tax will be 25% according to the Enterprise Income Tax Law.[610] For individual investors, incomes from interest, stocks dividend and bonuses are taxed at 20%.[611] However, for different types of

---

607 Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Venture Capital Investment Enterprises] (promulgated by SDRC, MOST & MOF, Nov. 15, 2005, effective Mar. 1, 2006), Art.23. "The state shall adopt tax preferential policies to support the development of startup investment enterprises and direct them to increase investments to small and medium-sized enterprises, especially the small and medium-sized high and new tech enterprises."

608 Qiye Suodeshui Fa (企业所得税法) [Enterprise Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008). English version available at: http://en.pkulaw.cn/display.aspx?cgid=89382&lib=law.

609 Guojia Shuiwu Zongju Guanyu Shishi Chuangye Touzi Qiye Suodeshui Youhui Wenti de Tongzhi (国家税务总局关于实施创业投资企业所得税优惠问题的通知) [Notice of the State Administration of Taxation on Income Tax Preference for Startup Investment Enterprises] (promulgated by the State Administration of Taxation, issued on Apr. 30, 2009, effective on Jan. 1, 2008), Art.2. English version available at: http://en.pkulaw.cn/display.aspx?cgid=116787&lib=law.

610 Qiye Suodeshui Fa (企业所得税法) [Enterprise Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), Art. 4.

611 Geren Suodeshui Fa (个人所得税法) [Individual Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Jun. 30, 2011, effective Sept. 10, 1980), Art. 3(5). English version available at:

venture capital enterprises, different tax measures apply to the investors. This will be discussed in greater detail in the following part.

7.3.2 Tax Regime for the Limited Partnership

The main tax advantage of limited partnerships is that all profits and losses go directly to the limited partners and the business itself pays no tax on the income. Therefore, theoretically speaking, taking limited partnerships as a business form should be beneficial to venture capital funds, given that the fund profit will not be subject to double taxation. However, the actual advantage of the limited partnership is quite doubtful under the Chinese tax regime.

Compared to venture funds taking the corporation as their business form, taxation on limited partnership funds differs in the second and third tax levels, which are at the level of the fund and the investors. In terms of the level of the firms invested in, the enterprise income tax will be lower (generally at 15%) if the venture funds invest in innovative high-tech firms, compared to 25% if they invest in traditional industries. With favorable tax rates and thus a higher ability to generate profit, the firms will have a higher value when the venture capitalist exits through IPO or equity transfer, whereby the venture capitalists can thus have higher investment profit.[612]

At the venture fund level, compared to a fund that takes corporation as the organization form and thus has to pay 25% of the enterprise income tax, a limited partnership fund does not have to pay tax. However, as previously mentioned, corporations may enjoy a 70% income tax reduction if they invest in unlisted medium or small high-tech companies, while limited partnerships may not.[613]

---

http://en.pkulaw.cn/display.aspx?cgid=153700&lib=law.

612 Kou Xianhe (寇祥河), Zhongguo Fengxian Touzi Shuishou Zhengce Baogao (中国风险投资税收政策报告) [Report on the Tax Policies of Venture Capital Investment in China], 349 Zhongguo Fengxian Touzi Nianjian (中国风险投资年鉴) [China Venture Capital Yearbook] (2008).

613 Guojia Shuiwu Zongju Guanyu Shishi Chuangye Touzi Qiye Suodeshui Youhui Wenti de

At the investor level, if the limited partners are institutional investors, the enterprise income tax is 25%, while if they are individual investors, they have to pay a progressive tax rate in excess of a specific amount ranging from 5% to 35%.[614] For venture funds that take a corporation as the business form, the institutional investors are exempt from income tax at this level since it has already been paid at the fund level;[615] however, for individual investors, 20% of personal income tax is levied.

Table 4 Income tax for venture capital investments

Fund type	Tax level 1: Invested firms		Tax level 2: Funds		Tax level 3: Investors	
	High-tech Firms	Traditional Firms	Income Tax	Tax preference	Institutional investors	Individual Investors
Corporation	15%	25%	25%	70% if qualified	none	20%
Limited partnership	15%	25%	none	none	25%	3%-35%

Therefore, for institutional investors, the eventual tax rate would be 25% for both forms of corporation and limited partnership, only differing at the level at which the

---

Tongzhi (国家税务总局关于实施创业投资企业所得税优惠问题的通知) [Notice of the State Administration of Taxation on Income Tax Preference for Startup Investment Enterprises] (promulgated by the State Administration of Taxation, issued on Apr. 30, 2009, effective on Jan. 1, 2008), Art.2(1). "…its industrial and commercial registration shows that it is … with corporate status."

614 Guanyu Geren Duzi Qiye he Hehuo Qiye Touzizhe Zhengshou Geren Suodeshui de Guiding (关于个人独资企业和合伙企业投资者征收个人所得税的规定) [Circular on the Collection of Income Tax on Wholly Individually-owned Enterprises and Partnership Enterprises] (promulgated by the State Council, issued Jun. 20, 2000, effective Jun. 20, 2000). "… the individual income tax (of wholly individually-owned enterprises and partnership enterprises) will be levied on the investor's income derived from manufacturing and operation in the same way as for the income of individual industrial and commercial households derived from manufacturing and operation." As for income tax of private industrial and commercial households, see Geren Suodeshui Fa (个人所得税法) [Individual Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Jun. 30, 2011, effective Sept. 10, 1980), Art. 3(2). "For incomes of private industrial and commercial households from their productions and business operations…the progressive tax rate in excess of specific amount ranging from 5 per cent to 35 per cent is applicable."

615 Qiye Suodeshui Fa (企业所得税法) [Enterprise Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), Art. 26 (2). "The following incomes of an enterprise shall be tax-free incomes: … (2) Dividends, bonuses and other equity investment proceeds distributed between qualified resident enterprises."

tax is paid. The problem of double taxation thus does not exist regarding institutional investors. However, the venture funds that take the limited partnership as their organization form will not enjoy the 70% tax preference even if they invest in small and medium-sized high-tech firms. Therefore, generally speaking, the tax regime favors venture funds that take the corporation as their business form.

For individual investors, if they invest in corporate venture funds, besides the enterprise income tax of 25%, the personal income from the investments shall still be taxed at 20%, resulting in a problem of double taxation for the individual investors. On the other hand, if individual investors invest in limited partnership venture funds, they face a 5-35% progressive tax. Since most investors who invest in venture capital are wealthy individuals, it is reasonable to assume that their earnings from a profitable fund will be much greater than RMB 100,000 and thus the highest progressive rate applies, which is 35%.[616] It is slightly lower than the tax rate of an individual who invests in a venture fund that takes the corporation form. However, since the corporation could receive 70% tax preference if qualified, ultimately the difference of taxation between the individual investors invest in corporate venture fund and limited partnership venture fund might not be significant.

Considering the above, it is difficult to say which organization form enjoys greater tax advantages under the current Chinese tax regime. It appears that corporate venture funds might be attractive in financing innovative projects due to the 70% tax preference. However, given the possibility that tax is paid at the last level in a limited partnership fund, the investors could enjoy more distributed profit and with more profit the venture firm might receive higher valuation in the venture capital exit process such as IPO, thus building up the manager's reputation as having a good track

---

[616] Geren Suodeshui Fa (个人所得税法) [Individual Income Tax Law] (promulgated by the Standing Comm. Nat'l People's Cong., Jun. 30, 2011, effective Sept. 10, 1980), Appendix 2. It is a progressive tax rate in excess of a specific amount: when the income is higher than RMB 100,000, the excess amount will be taxed at 35%.

record.[617]

7.3.3 Taxation vs. Governance

When discussing the choice of business forms, tax reasons should not be overlooked. Especially when choosing the limited partnership as a venture fund form, the particular tax treatment for limited partnership can be one of the driving factors.

Historically, the limited partnership was attractive as an investment vehicle: first as a way of obtaining limited liability without being incorporated[618] and subsequently being used in natural resource businesses because profits can be passed through to the investors without being taxed at the firm level.[619] In fact, this tax advantage – or tax efficiency – is always considered as one of the main reasons to choose the form of a limited partnership.[620]

It is thus fair to consider the effect of the tax regime for a limited partnership when discussing the choice of venture fund business form in China. Compared to the benefits from the legal characteristics of the organizational design of the limited partnership, the advantages a limited partnership venture fund can have from tax arrangement are much more straightforward. Some of the legal arrangements to deal

---

617 Kou Xianghe (寇祥河), Zhongguo Fengxian Touzi Shuishou Zhengce Baogao (中国风险投资税收政策报告) [Report on the Tax Policies of Venture Capital Investment in China], 350 Zhongguo Fengxian Touzi Nianjian (中国风险投资年鉴) [China Venture Capital Yearbook] (2008).

618 Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835,837 (1988).

619 Mark A. Wolfson, *Empirical Evidence of Incentive Problems and Their Mitigation in Oil and Gax Tax Shelter Programs*, in 101-125 PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, Harvard Business School Press (1985). See also, Robert B. Robbins, *The Fiduciary Duties of Directors of Corporate General Partners; Ten Years after U.S.ACafes*, Mar. 14-16, 437 ALI-ABA Course of Study (2002) ("Limited partnerships … were used for tax-advantaged investments in industries such as real estate and oil and gas."); David H. Hus & Martin Kenney, *Organizing Venture Capital: the Rise and Demise of American Research & Development Corporation, 1946-1973*, 14 INDUS. & CORP. CHANGE 579, 605 (2005).

620 See e.g. Curtis J. Milhaupt, *The 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) ("The limited partnership structure prevails in the industry because it provides the appropriate legal and tax incentives for investors in the fund."); Adrian A. Ohmer, *Investing in Cannabis: Inconsistent Government Regulation and Constrains on Capital*, 3 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 97, 113 (2013).

with the agency problem are under strong debate concerning whether they can produce desired results in mitigating agency costs between partners.[621] While adding cultural reasons when comparing different jurisdictions, the picture becomes even more complicated.

Tax reasons are different: however complicated the tax regime is in one jurisdiction, it always boils down to one simple figure of how much tax should someone pay for their businesses. It is easy to understand that one would opt for a certain kind of organizational form if its bears less tax, whereby tax advantages are one of the most important factors that should be considered, as well as being an easy factor to comprehend. For venture capital funds in China, limited partnership funds do not enjoy the 70% tax preference when they invest in small and medium-sized high-tech firms, reflecting an obvious disadvantage compared to venture funds taking the corporation as their organization form.

However, it is fairly easy for the rule-makers to alter this disadvantage. In the Notice of the State Administration of Taxation on the Management of the Enterprise Income Tax for the Limited Partnership Venture Investing Enterprises in Suzhou Industrial Park (SAT Notice 2013 No. 25), the 70% tax preference is given to investing partners that are incorporated as legal persons.[622] A similar policy was applied to the Zhongguancun National Innovation Demonstration Zone in the same year.[623] Moreover, from October 2015, a legal person partner of a venture capital limited partnership who has invested in an unlisted small or medium-sized high-tech enterprise for at least two years (24 months) is allowed to enjoy the 70% tax

---

621 For example, the debate on whether fiduciary duties shall be waived in the limited partnership agreement.

622 Art. 3.

623 Taxation on Legal Person Partners in Zhongguancun National Innovation Demonstration Zone Limited Partnership Venture Capital Enterprise (关于中关村国家自主创新示范区有限合伙创业投资企业法人合伙人企业所得税试点政策的通知) (Caishui [2013] No. 71) (issued by SAT, Sept. 29, 2013). Available at: http://www.zgc.gov.cn/zcfg10/gj/92544.htm.

deduction.[624] If this piece of tax policy could be implemented effectively and cohesively, it would offer a level playing field for the limited partnership venture capital funds in China.

In conclusion, given the current unique legal conditions in China, venture investors are uneasy when opting for the limited partnership as the organization form of a venture capital enterprise. The Chinese government has been trying to stimulate venture investment through government venture capital guiding funds. Acting as a passive limited partner itself, the VCGF could help to bridge the trust gaps between the investors and the venture capitalist, which is vital to the venture capital market. Aside from these governance measures, tax policies towards limited partnerships have been gradually improving to encourage venture investments.

---

[624] Expansion of Pilot Tax Policies in National Innovation Demonstration Zones to all of China (关于将国家自主创新示范区有关税收试点政策推广到全国范围实施的通知) (Caishui [2015] No. 116) (issued by MOF & SAT, Oct. 23, 2015). Available at:
;
For information in English, see
http://fujaelaw.com/news/china-issues-more-new-tax-policies-to-encourage-technology-innovation/.

Conclusion

This thesis has furthered the research of organizational responses to agency problems in the special field of the venture capital industry through a comparison between the U.S. and China.

Venture capital funds provide and manage the capital to create and support the most innovative and promising companies, with new ideas and great risks; these companies may otherwise have a hard time accessing traditional bank financing. Furthermore, venture capital is more than money: venture capital partners become actively engaged with a company through daily interaction with the management team and they hold vital importance for the business plan of an innovative idea, gradually turning it into a mature organization.

The venture industry is characterized by the substantial level of uncertainty regarding investment returns and a high degree of information asymmetry between principals and agents. The limited partnership is a popular choice of business form among venture capital funds. Besides tax reasons, it could offer certain merits including insulation against hostile take overs and patient passive investors, which facilitate the development of investment strategies in a risky business. At the same time, the agency problems can be mitigated through legal measures: general partners can be held liable under the breach of fiduciary duties, the limited partnership agreement addresses areas of conflict between the venture capitalist and the limited partners through covenants, the compensation system is designed to give the venture capitalists proper incentives and the control rule could improve the efficiency of the reputation mechanism, thus completing the venture capital cycle.

The special feature of the choice of business forms in the Chinese venture capital market reflects the concern about the agency problems of Chinese investors. The facts that Chinese investors continued to choose a corporate form of venture capital funds even after the newly enacted limited partnership regulation, and those who opted for the limited partnership form tend to be active in daily fund management, are all governance responses to the agency problems when there is an absent of the countermeasures. The Chinese limited partners could not be adequately protected by a sophisticated and perfectly tailored partnership agreement, and there is an absence of fiduciary duties that can be imposed on the general partners in partnership law. These reasons have made it more difficult for the limited partners to trust their powers to the general partners and, consequently, investors favor the corporate form, in which, as shareholders, they have more power over corporate decision-making.

As the limited partnership form is still new to the Chinese venture capital market, it remains to be seen how it will develop in the future. One problem associated with studies about China is that there is always a strong cultural influence behind the scenes. Especially in this time of transition and reform, when diving deeply into one particular issue about new organization forms and transplanted legislations, the problem of acclimatization cannot be overlooked.

For example, the new version of PEL with the limited partnership chapter was promulgated in 2006 and enacted in 2007, already five years after ULPA 2001. Why would the legislators still want a strong version of control rule? It may well be the case that they would love to see an efficient reputation mechanism, where the general partner can signal his or her true ability without interference. They wanted to impose harsh liability on limited partners who want to control the partnership, given that they might well know that Chinese limited partners are quite active and the *Guanxi* relationship had been complicating the scene, and they just wanted a pure limited

partnership in its original settings. However, in terms of the choice of business form, the activism of the Chinese investors should be taken into consideration and accepted as it is, while not simply ruling that such a preference is anti-efficiency or anti-market. Indeed, legal reform may be born out of the conflicts between these two preferences.

Of course, one may take the viewpoint that the "patches" made to the legal rules and contractual designs aimed at promoting limited partnership venture capital funds in China are not quite adequate. However, this does not mean that optimizing legal rules, contractual designs and reputation constraints would not work in China; rather, it simply implies that the Chinese venture market is still evolving and Chinese venture investors are still on the road to becoming familiarized with this new investment vehicle. Meanwhile, realizing the inability of the parties to conclude well-tailored contracts and the special *guanxi* relationship in the business world, legal reform should take these factors into consideration and adapt to the environment of an active investment culture.

References

Aboody, David, and Baruch Lev. 2000. “Information Asymmetry, R&D, and Insider Gains.” *The Journal of Finance* LV (6): 2747–66

Admati, AR, and Paul Pfleiderer. 1994. “Robust Financial Contracting and the Role of Venture Capitalists.” *Journal of Finance* XLIX (2): 371–402

Aghion, Philippe, and Patrick Bolton. 1992. “An Incomplete Approach to Contracts Financial Contracting.” *The Review of Economic Studies* 59 (3): 473–94

Ahlstrom, David, Garry D. Bruton, and Kuang S. Yeh. 2007. “Venture Capital in China: Past, Present, and Future.” *Asia Pacific Journal of Management* 24 (3): 247–68

Ahn, Sanghoon. 2002. “Competition, Innovation and Production Growth: A Review of Theory and Evidence.” *OECD Economics Working Paper No. 317*

Akerlof, GA. 1970. “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism.” *The Quarterly Journal of Economics* 84 (3): 488–500.

Allen, Franklin, and Andrew Winton. 1994. “Corporate Financial Structure, Incentives and Optimal Contracting.” *Rodney L White Center for Financial Research 15-94*. Available at [Last visited April 5, 2016]

Amit, Raphael, Lawrence Glosten, and Eitan Muller. 1990. “Entrepreneurial Ability, Venture Investments, and Risk Sharing.” *Management Science* 36 (10): 1232–45

Armour, John. 2002. “Law, Innovation and Finance: A Review.” Available at: [Last visited March 30, 2016]

Atanasov, V, V Ivanov, and Kate Litvak. 2007. “The Effect of Litigation on Venture Capitalist Reputation.” 13641. *EFA 2009 Bergen Meetings*

Atkinson, Robert D. 2014. “Understanding the U. S. National Innovation System.” Available at: [Last visited March 30, 2016]

Axelson, Ulf. 2009. “Why Are Buyouts Levered? The Financial Structure of Private Equity Funds.” *The Journal of Finance* 64 (4): 1549–82.

Baker, Malcolm, and Paul A. Gompers. 1999. “Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists.” *Unpublished Working Paper. Harvard*, 1–39. Available at: [Last visited March 30, 2016]

———. 2003. “The Determinants of Board Structure at the Initial Public Offering.” *Journal of Law and Economics* XLVI (October): 569–98

Bankman, Joseph. 1994. “The Structure of Silicon Valley Start-Ups.” *UCLA Law Review* 41 (7): 1737–68

Barney, JB, and MH Hansen. 1994. “Trustworthiness as a Source of Competitive Advantage.” *Strategy Manage Journal*, no. 33: 141–52

Barry, CB. 1994. “New Directions in Research on Venture Capital Finance.” *Financial Management* 23 (3): 3–15

Baumol, William J. 1986. “Williamson’s The Economic Institutions of Capitalism.” *The Rand Journal of Economics* 17 (2): 279–86

Beane, Leona. 1979. “The Fiduciary Relationship of a Partner.” *J. Corp. L.*, no. 5: 483

Becker, GS. 1962. “Investment in Human Capital: A Theoretical Analysis.” *The Journal of Political Economy* 70 (5): 9–49

———. 2009. *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education*. 3rd ed. The University of Chicago Press

Bengtsson, Ola. 2009a. “Intermediaries in Negotiations of Complex Contracts: The Role of Attorneys in Venture Capital Transactions.” Available at: [Last visited March 30, 2016]

———. 2009b. “Restrictive Covenants in Venture Capital Contracts.” Available at: [Last visited March 30, 2016]

Bergemann, D, and U Hege. 2002. “The Value of Benchmarking.” . Available at [Last visited March 30, 2016]

———. 1998. “Venture Capital Financing, Moral Hazard, and Learning.” *Journal of Banking & Finance* 22 (October): 703–35

Berglof, Erik. 1994. “Control Theory of Venture Capital Finance, A.” *JL Econ. & Org.* 10 (2): 247–67

Beveridge, N. 1990. “Duty of Care: The Partnership Cases.” *Oklahoma City University Law Review*, no. 15: 753

Bichler, Josef. 2012. “The Chinese Indigenous Innovation System and Its Impact on Foreign Enterprises.” *Munich Business School Working Paper*. Available at [Last visited March 30, 2016]

Bienz, Carsten, and Julia Hirsch. 2006. “The Dynamics of Venture Capital Contracts.” 2006/11. *CFS WP*. Available at [Last visited March 30, 2016]

Bienz, Carsten, and Uwe Walz. 2006. “Evolution of Decision and Control Rights in Venture Capital Contracts: An Empirical Analysis.” Available at [Last visited March 30, 2016]

———. 2010. “Venture Capital Exit Rights.” Available at [Last visited March 30, 2016]

Bishop, Carter G. 2004. “The New Limited Partnership Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability.” *Suffolk University Law Review* 37 (37): 667

Black, Bernard S., and R Gilson. 1998. “Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets.” *Journal of Financial Economics 47: 243-277*

Black, F, and Myron Scholes. 1973. “The Pricing of Options and Corporate Liabilities.” *The Journal of Political Economy* 81 (3): 637–54

Black, Fisher. 1986. “Noise.” *Journal of Finance*, no. 41: 529

Block, DJ, MJ Maimone, and SB Ross. 1993. “The Duty of Loyalty and the Evolution of the Scope of Judicial Review.” *Brook. L. Rev.*, no. 59: 65

Blume, Marshall E., and Irwin Friend. 1974. “The Asset Structure of Individual Portfolios and Some Implications for Utility Functions.” *Journal of Finance* 30 (2): 585–603

Bobrow, Adam. 2008. “China Law.” *International Law* 42: 945

———. 2009. “China Law.” *International Law* 43: 1073

———. 2010a. “China.” *International Law* 44: 631

———. 2010b. “China Law.” *International Law* 44: 631

Boocock, G., and M. Woods. 1997. “The Evaluation Criteria Used by Venture Capitalists: Evidence from a UK Venture Fund.” *International Small Business Journal* 16 (1): 36–57

Booth, R. 1997. “Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies.” *J. Small & Emerging Bus. L.* 55: 55–72

Booz&co. 2012. “The Global Innovation 1000.” Available at [Last visited March 30, 2016]

Boroush, Mark, and Michael Falk. 2007. “Experiences on the U.S. Knowledge Transfer and Innovation System.” *Proton Europe*. Available at [last visited March 30, 2016]

Bowen, Ray M, et al. 2012. “Research & Development, Innovation, and the Science and Engrineering Workforce.” Available at [March 30, 2016]

Brandt, Jordan. 2011. “China Law.” *International Law* 45: 487

Bratton, WW. 2002. “Venture Capital on the Downside: Preferred Stock and Corporate Control.” *Michigan Law Review*, no. 100: 891–945

Brophy, David J., and Michael R. Haessler. 1994. “Evaluating the Venture Capital Fund Agreement.” *Managerial Finance* 20 (1): 53–64

Burke, Michael E. 2002. “China Law.” *International Law* 36: 815

———. 2003. “China Law.” *International Law* 37: 927

———. 2004. “China Law.” *International Law* 38: 577

———. 2005. “China Law.” *International Law* 39: 555

———. 2006. “China Law.” *International Law* 40: 547

———. 2007. “China Law.” *International Law* 41: 777

Calabresi, Guido. 2016. *The Future of Law and Economics*, Yale University Press

Callison, JW. 1997. “Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond.” *J. Small & Emerging Bus. L.* 1: 109

Campbell, RB. 2007. “Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes.” *Kentucky Law Journal*, no. 96: 163

Carpenter, Robert E, and Bruce C Petersen. 2002. “Capital Market Imperfections, High-tech Investment, and New Equity Financing.” *The Economic Journal* 112 (1997): 54–72

Carson, Benjeming. 2013. “IBT Resources XIV. Investing in China Appendix Pp. Venture Capital in Twenty First Century China: A Regulatory Analysis.” *International Business Transactions*, no. September 2013: 1–16

Casamatta, Catherine, Carole Haritchabalet, and Carole Harichabalet. 2007. “Experience, Screening and Syndication in Venture Capital Investments.” *Journal of Financial Intermediation* 16 (3): 368–98

Cestone, Giacinta. 2013. “Venture Capital Meets Contract Theory: Risky Claims or Formal Control?” *ECGI – Finance Working Paper No. 349*. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2216662 [Last visited March 30, 2016]

Chan, YS. 1983. “On the Positive Role of Financial Intermediation in Allocation of Venture Capital in a Market with Imperfect Information.” *Journal of Finance* 38 (5): 1543–68

Chang, Maria Hsia. 1996. “The Thought of Deng Xiaoping.” *Communist and Post-Communist Studies* 29 (4): 377–94

Chen, Jiandong and Douglas J. Cumming, and Wenxuan Hou, and Edward Lee. 2014 “CEO Accountability for Corporate Fraud: Evidence from the Split Share Structure Reform in China.” *Journal of Business Ethics, Forthcoming*. Available at [Last visited March 30, 2016]

Chen, Xiao Ping, and Chap C. Chen. 2004. “On the Intricacies of the Chinese Guanxi: A Process Model of Guanxi Development.” *Asia Pacific Journal of Management* 21 (3): 305–24

Chen, York, Liu Manhong, and Liao Junxia. 2011. *China’s Venture Capital 20 Years*. (中国创投 20 年) China Development Press (中国发展出版社)

Cheung, Steven N.S. 1983. “The Contractual Nature of the Firm.” *Journal of Law and Economics* 26 (1): 1–21

China Venture Capital Research Institute (中国风险投资研究院). 2007-2013. *China Venture Capital Year Book* (中国风险投资年鉴).

Chow, DCK. 1998. "Limited Partnership Joint Venture Model in the People's Republic of China, The." *Law & Pol'y Int'l Bus.* 30: 1

Chung, JW, BA Sensoy, Lea Stern, and Michael S. Weisbach. 2012. "Pay for Performance from Future Fund Flows: The Case of Private Equity." *Review of Financial Studies* 25 (11): 3259–3304

Clapp, RA. 1938. "A Fiduciary's Duty of Loyalty." *Md. L. Rev.*, no. 3: 221

Clark, RC. 1978. "Vote Buying and Corporate Law." *Case W. Res. L. Rev.*, no. 29: 776

Cohen, Randolph B., Paul a. Gompers, and Tuomo Vuolteenaho. 2002. "Who Underreacts to Cash-Flow News? Evidence from Trading between Individuals and Institutions." *Journal of Financial Economics* 66 (2-3): 409–62

Cole, Rebel a. 2011. "How Do Firms Choose Legal Form of Organization?" S*BA, Office of Advocacy*. Available at [Last visited March 30, 2016]

Commons, JR. 1931. "Institutional Economics." *The American Economic Review* 21 (4): 648–57

Cornelli, Francesca, and O Yosha. 2003. "Stage Financing and the Role of Convertible Debt." *The Review of Economic Studies* 70(1): 1–32

Cosenza, Elizabeth. 2005. "Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights of First Refusal in the Venture Capital Context." *Am. UL Rev.* 55: 87

Cosh, Andy, Douglas Cumming, and Alan Hughes. 2009. "Outside Entrepreneurial Capital." *The Economic Journal* 119 (October): 1494–1533

Cossin, Didier, B Leleux, and Entela Saliasi. 2002. "Understanding the Economic Value of Legal Covenants in Investment Contracts: A Real-Options Approach to Venture Equity Contracts." *FAME Research Paper No.63*. Available at [Last visited March 30, 2016]

Coval, Joshua D, David a Hirshleifer, and Tyler Shumway. 2005. "Can Individual Investors Beat the Market?" *HBS Finance Working Paper No. 04-025*, Available at [Last visited March 30, 2016]

Cressy, R. 1996. “Are Business Startups Debt-Rationed?” *The Economic Journal* 106 (438): 1253–70

Cumming, Douglas. 2005. “Agency Costs, Institutions, Learning, and Taxation in Venture Capital Contracting.” *Journal of Business Venturing*, 20: 573–622

———. 2008. “Contracts and Exits in Venture Capital Finance.” *Review of Financial Studies* 21 (5): 1947–82

Cumming, Douglas, and Jeffrey G. MacIntosh. 2002. “Comparative Venture Capital Governance: Private versus Labour Sponsored Venture Capital Funds.” *CESifo Working Paper No.853*. Available at [Last visited March 30, 2016]

———. 2003. “A Cross-Country Comparison of Full and Partial Venture Capital Exits.” *Journal of Banking & Finance* 27 (3): 511–48

———. 2004. “Boom, Bust, and Litigation in Venture Capital Finance.” *Willamette L. Rev.*, no. 416

Cumming, Douglas, Grant Fleming, and Armin Schwienbacher. 2006. “Legality and Venture Capital Exits.” *Journal of Corporate Finance* 12 (2): 214–45

Cumming, Douglas, Bruce Haslem, and April Knill. 2011. “Entrepreneurial Litigation and Venture Capital Finance.” *International Conference of the French Finance Association (AFFI), May 2011*. Available at [Last visited March 30, 2016]

Cumming, Douglas, and Sofia A. Johan. 2009. *Venture Capital and Private Equity Contracting*. Academic Press

Cumming, Douglas, and Brian Broughman. 2010. “Investor Opportunism and Governance in Venture Capital.” In *Venture Capital: Investment Strategies, Structures, and Policies*. John Wiley & Sons, Inc.

D’Ambrosio, thomas A. 1987. “The Duty of Care and the Duty of Loyalty in the Revised Model Business Corporation Act.” *Vand. L. Rev.*, no. 40: 663

De Long, B, A Shleifer, LH Summers, and R Waldmann. 1990. “Noise Trader Risk in Financial Markets.” *Journal of Political Economy* 98 (4): 703–38

DeAngelo, H, and L DeAngelo. 1985. “Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock.” *Journal of Financial Economics* 14: 33–69

DeMott, Deborah a. 1988. “Beyond Metaphor: An Analysis of Fiduciary Obligation.” *Duke Law Journal* 1988 (5): 879–924

Deng, Feng (邓峰). 2011. “The System of Boards of Directors: its Origin and Evolution and China’s Learning Experience.” (董事会制度的起源、演进与中国的学习) *Social Science in China* (中国社会科学) 1:164

Deng, Xiaoping (邓小平). 1994. *The Selected Works of Deng Xiaoping*. Available at [Last visited April 5, 2016]

Deng, Xuehong (邓雪鸿). 2015. “Limited Partnership in Chinese PE.” (有限合伙制在中国 PE 中的运用) *Chinese Market* (中国市场) 30:51

Dessi, R. 2009. “Contractual Execution, Strategic Incompleteness and Venture Capital.” *CEPR Discussion Paper No. DP7413*. Available at [Last visited March 30, 2016]

Diamond, SF. 2011. “Beyond the Berle and Means Paradigm: Private Equity and the New Capitalist Order.” In *The Embedded Firm Corporate Governance, Labor, and Finance Capitalism*, edited by Cynthia A. Williams and Peer Zumbansen. Cambridge University Press

Dibadj, R. 2005. “Misguided Transformation of Loyalty into Contract.” *Tulsa L. Rev.*, no. 41: 451

Dickerson, CM. 1993. “Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act.” *U. Colo. L. Rev.*, no. 64: 111

Ding, Xuedong, and Jun Li. 2015. *Incentives for Innovation in China: Building an Innovative Economy*. Routledge

Dodd, Peter. 1980. “Merger Proposals, Management Discretion and Stockholder Wealth.” *Journal of Financial Economics*, no. 8: 105

Donald, CJH. 2006. “Limited Partnerships and the Control Liability of Limited Partners.” *Can. Bus. LJ*, no. 44: 398

Donn, AG. 2014. “Is the Liability of Limited Liability Entities Really Limited.” In *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations*. Edited by Robert W. Hillman and Mark J. Loewenstein. Edwatd Elgar Publishing

Duffner, Stefan. 2003. “Principal-Agent Problems in Venture Capital Finance.” *WWZ/Department of Finance, Working Paper No. 11/03*. Available at [Last visited March 30, 2016]

Dutta, Soumitra, and INSEAD. 2012. “The Global Innovation Index 2012.”

Easterbrook, FH, and DR Fischel. 1985. “Limited Liability and the Corporation.” *U. Chi. L. Rev.* 52 (1): 89–117

———. 1993. “Contract and Fiduciary Duty.” *JL & Econ.*, no. 36: 425

Edgerton, Jesse. 2012. “Agency Problems in Public Firms : Evidence from Corporate Jets in Leveraged Buyouts.” *Journal of Finance* 67 (6): 2187–2213

Eifert, JL. 1986. “Removal of General Partners: A Method of Intrapartnership Dispute Resolution for Limited Partnerships.” *Vand. L. Rev.*, no. 39: 1407

Eisenberg, MA. 1989. “The Duty of Care of Corporate Directors and Officers.” *U. Pitt. L. Rev.*, no. 51: 945

Elitzur, Ramy, and Arich Gavious. 2006. “A Model of Venture Capital Screening.” Available at [Last visited March 30, 2016]

Ernst & Young. 2011. “Globalizing Venture Capital.” Available at [Last visited March 30, 2016]

European-American Business Council. 2011. “The Atlantic Century II, Benchmarking EU & U.S. Innovation and Competitiveness.” Available at [Last visited March 30, 2016]

EVCA. 2012. “Yearbook 2012 Activity Data on Fundraising, Investments and Divestments by Private Equity and Venture Capital Firms in Europe.” Available at [Last visited March 30, 2016]

Fairchild, R. 2004. “Contracting Between Managers and Venture Capitalists: the Role of Value-added Services, Reputation Seeking.” *Journal of Financial Research* XXVII (4): 481–95

Fama, EF, and MC Jensen. 1983. “Separation of Ownership and Control.” *Journal of Law and Economics* 26 (May): 301–25

Fan, P. 2011. “Innovation Capacity and Economic Development: China and India.” *Economic Change and Restructuring* 44(1): 49-73

Fan, Ying. 2007. “Guanxi, Government and Corporate Reputation in China Lessons for International Companies.” *Marketing Intelligence & Planning* 25 (5): 499–510

Fenn, GW, Nellie Liang, and Stephen Prowse. 1995. “The Economics of the Private Equity Market.” *Federal Reserve Staff Studies*. Available at [Last visited March 30, 2016]

Filippetti, Andrea, and Daniele Archibugi. 2011. “Innovation in Times of Crisis: National Systems of Innovation, Structure, and Demand.” *Research Policy* 40 (2): 179–92

Fischel, DR. 1978. “Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers.” *Tex. L. Rev.*, no. 57: 1

———. 1987. “Organized Exchanges and the Regulation of Dual Class Common Stock.” *The University of Chicago Law Review* 54 (1): 119–52

Fleischer, Victor. 2003. “The Rational Exuberance of Structuring Venture Capital Startups.” *Bepress Legal Series* 1: 137–86

Fombrun, Charles. 1990. “What’s in a Name? Reputation Building and Corporate Strategy.” *Academy of Management Journal* 33 (2): 233–258

Fombrun, Charles, and Violina P Rindova. 1998. “Reputation Management in Global 1000 Firms: A Benchmarking Study.” *Corporate Reputation Review* 1 (3): 205–12

Fornahl, Dirk, Tom Broekel, and Ron Boschma. 2011. “What Drives Patent Performance of German Biotech Firms? The Impact of R&D Subsidies, Knowledge Networks and Their Location.” *Papers in Regional Science* 90 (2): 395–418

Frankel, T. 1983. “Fiduciary Law.” *Cal. L. Rev.*, no. 71: 795

———. 1995. “Fiduciary Duties as Default Rules.” *Or. L. Rev.*, no. 74: 1209

Freel, Mark S. 1999. “The Financing of Small Firm Product Innovation within the UK.” *Technovation* 19 (12): 707–19

———. 2007. “Are Small Innovators Credit Rationed?” *Small Business Economics* 28 (1): 23–35

Fried, JM, and Mira Ganor. 2006. “Agency Costs of Venture Capitalist Control in Startups.” *NYUL Rev.* 81: 101–56

Galoob, Stephen R., and Ethan J. Leib. 2014. “Intentions, Compliance, and Fiduciary Obligations.” *Legal Theory* 20 (02): 106–32

Gan, Peizhong, and Li Kezhen (甘培忠, 李科珍). 2012. “The Power and Limit of Participating Partnership Business of Venture Capital Limited Partners.” (论风险投资有限合伙人“执行合伙事务”行为暨权力之边界), *Law Review* (法学评论)172: 33

Georgakopoulos, Nicholas L. 2005. *Principles and Methods of Law and Economics*. Cambridge University Press

Geu, TE, and Y Wu. 2007. “The New PRC Limited Partnership Enterprise Law and the Limited Partnership Law of the United States: A Selective Analytical Comparison.” *UCLA Pacific Basin Law Journal*, no. 25: 133

Geu, Thomas E., and Barry B. Nekritz. 2002. “Expectations for the Twenty-First Century: An Overview of the New Limited Partnership Act.” *Prob. & Prop.* 16: 47

Ghadri, F. Philipp. 2012. “IPOs and Venture Backed IPOs.” Available at [March 30, 2016]

Gifford, S. 1997. “Limited Attention and the Role of the Venture Capitalist.” *Journal of Business Venturing* 12: 459–82

Gilson, R, and B Black. 1998. “Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets.” *Journal of Financial Economics* 47: 243–77

Gilson, R. 1981. “A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers.” *Stanford Law Review* 33 (5): 819–91

———. 1987. “Evaluating Dual Class Common Stock: The Relevance of Substitutes.” *Virginia Law Review* 73 (5): 807–44

———. 1999. “Does Venture Capital Require an Active Stock Market?” *Journal of Applied Corporate Finance* 11 (4): 36–48

———. 2003. “Engineering a Venture Capital Market: Lessons from the American Experience.” *Stanford Law Review* 55 (4): 1067–1103

———. 2009. “Locating Innovation: The Endogeneity of Technology, Organizational Structure and Financial Contracting.” *Columbia Law Review, Forthcoming; ECGI – Law Working Paper No. 133/2009; Columbia Law and Economics Working Paper No. 353; Stanford Law and Economics Olin Working Paper No. 377.* Available at [Last visited March 30, 2016]

Giudici, G, and Stefano Paleari. 2000. “The Provision of Finance to Innovation: A Survey Conducted among Italian Technology-Based Small Firms.” *Small Business Economics* 14: 37–53

Gladstone, David, and Laura Gladstone. 2004. *Venture Capital Investing*. Financial Times Prentice Hall

Gold, AS. 2006. “On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms.” *Wake Forest L. Rev.*, no. 41: 123

Cannice, Mark V, Cathy Goldberg, and Ling Ding. 2012. “Venture Capital in China : Development, Confidence, and Lessons.” , no. 14: 9–27

Gompers, P, Anna Kovner, Josh Lerner, and David Scharfstein. 2006. “Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs.” Available at [Last visited March 30, 2016]

Gompers, P, and Josh Lerner. 1996. “The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements.” *Journal of Law and Economics* 39 (2): 463–98

———. 1997. “Conflict of Interest and Reputation in the Issuance of Public Securities: Evidence from Venture Capital.” Available at [Last visited March 31, 2016]

———. 1998. “The Determinants of Corporate Venture Capital Success: Organizational Structure, Incentives, and Complementarities.” *NBER Working Paper 6725*. Available at [Last visited March 31, 2016]

———. 1999a. “What Drives Venture Capital Fundraising?” *NBER Working Paper 6906*. Available at [Last visited March 31, 2016]

———. 1999b. “An Analysis of Compensation in the U. S. Venture Capital Partnership.” *Journal of Financial Economics* 51: 3–44

———. 2001. “The Venture Capital Revolution.” *The Journal of Economic Perspectives* 15 (2): 145–68

———. 1999. *The Venture Capital Cycle*. MIT Press.

Gompers, P. 1995. “Optimal Investment, Monitoring, and the Staging of Venture Capital.” *The Journal of Finance* 50 (5): 1461–89

———. 1997. “Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments.” Available at [Last visited March 31, 2016]

Gorman, Michael, and William A. Sahlman. 1989. “What Do Venture Capitalists Do?” *Journal of Business Venturing* 4: 231–48

Gornall, Will, and Ilya A. Strebulaev. 2015. “The Economic Impact of Venture Capital: Evidence from Public Companies.” *Stanford University Graduate School of Business Research Paper No. 15-55*. Available at [Last visited March 31, 2016]

Gregory, WA. 2005. “The Fiduciary Duty of Care: A Perversion of Words.” *Akron L. Rev.*, no. 38: 181

———. 2001. *THE LAW OF AGENCY AND PARTNERSHIP*. 3rd ed.

Grossman, SJ, and Oliver D. Hart. 1986. “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration.” *The Journal of Political Economy* 94 (4): 691–719

Guiso, Luigi. 1998. “High-Tech Firms and Credit Rationing.” *Journal of Economic Behavior & Organization* 35 (1): 39–59

Gulinello, Christopher. 2006. “Venture Capital Funds, Organizational Law, and Passive Investors.” *Albany Law Review* 70: 267–327

Guttenberg, D. 2013. “Waiving Farewell Without Saying Goodbye: the Waiver of Fiduciary Duties in Limited Liability Companies in Delaware, and the Call for Mandatory Disclosure.” *S. Cal. L. Rev.* 86: 869

Haar, Brigitte. 2001. “Venture Capital Funding for Biotech Pharmaceutical Companies in an Integrated Financial Services Market: Regulatory Diversity within the EC.” *European Business Organization Law Review* 2: 585–602

Haitian, Lu, Tan Yi, and Chen Gongmeng. 2007a. “Venture Capital and the Law in China.” *Hongkong Law Journal* 37: 229

Hall, B. H. 2002. “The Financing of Research and Development.” *Oxford Review of Economic Policy* 18 (1): 35–51

———. 2008. “The Financing of Innovation.” In *The Handbook of Technology and Innovation Management*, edited by Scott Shane, 409. Wiley.

Hamilton, RW. 1997. “Corporate General Partners of Limited Partnerships.” *J. Small & Emerging Bus. L.*, no. 1: 73

Hanno, Christopher. 2010. “The Other ‘F’ Word: Fiduciary Duties, Fiduciary Waivers, and the Delaware Limited Liability Company.” *South Texas Law Review*, no. 52: 101

Harris, Milton, and Artur Raviv. 1979. “Optimal Incentive Contracts with Imperfect Information.” *Journal of Economic Theory* 20: 231–59

Harris, RS, T Jenkinson, and Steven N. Kaplan. 2012. “Private Equity Performance: What Do We Know?” *NBER Working Paper 17874*. Available at [Last visited March 31, 2016]

Hart, Oliver, and John Moore. 1990. “Property Rights and the Nature of the Firm.” *Journal of Political Economy* 98 (6): 1119–58

———. 1998. “Default and Renegotiation: A Dynamic Model of Debt.” *The Quarterly Journal of Economics* CXIII (February): 1

———. 1999. “Foundations of Incomplete Contracts.” *Review of Economic Studies* 66 (1): 115–38

Hartmann-Wendels, Thomas, Georg Keienburg, and Soenke Sievers. 2011. “Adverse Selection, Investor Experience and Security Choice in Venture Capital Finance: Evidence from Germany.” *European Financial Management* 17 (3): 464–99

Hellman, T, and Manju Puri. 2000. “The Interaction between Product Market and Financing Strategy: The Role of Venture Capital.” *Review of Financial Studies* 13 (4): 959–84

———. 2002a. “On the Fundamental Role of Venture Capital.” *Economic Review-Federal Reserve Bank of Atlanta* Q4: 19–23

———. 2002b. “Venture Capital and the Professionalization of Start‐Up Firms: Empirical Evidence.” *The Journal of Finance* 57 (169-197)

Hellmann, T. 1998. “The Allocation of Control Rights in Venture Capital Contracts.” *The Rand Journal of Economics* 29 (1): 57–76

———. 2006. “IPOs, Acquisitions, and the Use of Convertible Securities in Venture Capital.” *Journal of Financial Economics* 81 (3): 649–79

Heyne, PT, PJ Boettke, and DL Prychitko. 2010. *The Economic Way of Thinking*. 12th ed. Pearson Education International

Hirshleifer, David. 2001. “Investor Psychology and Asset Pricing.” *Journal of Finance* 56 (4): 1533–97

Hoecke, M Van, and Mark Warrington. 1998. “Legal Cultures, Legal Paradigms and Legal Doctrine: Towards a New Model for Comparative Law.” *The International and Comparative Law Quarterly* 47 (3): 495–536

Holmstrom, B, and Jean Tirole. 1998. “Private and Public Supply of Liquidity.” *Journal of Political Economy* 106 (1): 1–40

Holmstrom, B. 1979. “Moral Hazard and Observability.” *The Bell Journal of Economics* 10 (1): 74–91

Hooker, K. 1988. “Power of Limited Partners to Remove and Replace the General Partner of a Limited Partnership, The.” *Tex. Tech L. Rev.*, no. 19: 1

Hoover, ER. 1956. “Basic Principles Underlying Duty of Loyalty.” *Clev.-Marshall L. Rev.*, no. 5: 7

Horsey, HR. 1994. “The Duty of Care Component of the Delaware Business Judgment Rule.” *Del. J. Corp. L.*, no. 19: 971

Hottenrott, Hanna, and Bettina Peters. 2012. “Innovative Capability and Financing Constraints for Innovation: More Money, More Innovation?” *Review of Economics and Statistics* 94 (4): 1126–42

Howson, Nicholas Calcina. 2010. “Corporate Law in the Shanghai People’s Courts, 1992-2008: Judicial Autonomy in a Contemporary Authoritarian State.” *East Asia Law Review* 5: 303

Hsu, D. H., and Martin Kenney. 2005. “Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946-1973.” *Industrial and Corporate Change* 14 (4): 579–616

Huffcut, Ernest W. 1901. *The Law of Agency*. 3rd ed. Vol. 1

Hynes, JD. 1995. "Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract." *Law and Contemporary Problems*, no. 58: 29

———. 1997. "Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency." *Wash. & Lee L. Rev.*, no. 54: 439

Inderst, Roman, and Holger M. Müller. 2004. "The Effect of Capital Market Characteristics on the Value of Start-up Firms." *Journal of Financial Economics* 72 (2): 319–56

Ip, Po Keung. 2009. "The Challenge of Developing a Business Ethics in China." *Journal of Business Ethics* 88 (SUPPL. 1): 211–24

Jaffee, DM, and Franco Modigliani. 1969. "A Theory and Test of Credit Rationing." *The American Economic Review* 59 (5): 850–72

Jeng, LA, and PC Wells. 2000. "The Determinants of Venture Capital Funding: Evidence across Countries." *Journal of Corporate Finance* 6 (3): 241–89

Jensen, J. Bradford, and Robert H. McGukin. 1997. "Firm Performance and Evolution: Empirical Regularities in the U.S. Microdata." *Industrial and Corporate Change* 6: 25–47

Jensen, Michael C., and William H. Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3 (4): 305–60

Johnson, L. 2011. "Delaware's Non-Waivable Duties." *BUL Rev.*, no. 91: 701.

Jones, G H, B H Jones, and P Little. 2000. "Reputation as Reservoir: Buffering Against Loss in Times of Economic Crisis." *Corporate Reputation Review* 3 (1): 21–29

Joseph J. Basile, Jr., and JJ Basile Jr. 1985. "Limited Liability for the Limited Partners: An Argument for the Abolition of the Control Rule." *Vand. L. Rev.* 1: 1199

Kandel, Eugene. 2011. "VC Funds: Aging Brings Myopia." *Journal of Financial and Quantitative Analysis* 46 (02): 431–57

Kaplan, SN, and Per Strömberg. 2003. “Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts.” *Review of Economic Studies* 70 (2): 281–315

———. 2001. “Venture Capitalists as Principals: Contracting, Screening, and Monitoring.” *The American Economic Review*, NBER Working Paper, 91 (2): 426–30

———. 2000. “How Do Venture Capitalists Choose Investments.” *University of Chicago Working Paper*. Available at [Last visited March 31, 2016]

Kaplan, SN, Frederic Martel, and Per Strömberg. 2003. “How Do Legal Differences and Learning Affect Financial Contracts.” *NBER Working Paper 10097*. Available at [Last visited March 31, 2016]

Kaplan, SN., and Antoinette Schoar. 2005. “Private Equity Performance: Returns, Persistence and Capital Flows.” *The Journal of Finance* 60 (4): 1791–1823

Kenney, M., and R. Florida. 2000. “Venture Capital in Silicon Valley: Fueling New Firm Formation.” In *Understanding Silicon Valley: The Anatomy of an Entrepreneurial Region*, 98–123

Klausner, M, and Kate Litvak. 2001. “What Economists Have Taught Us about Venture Capital Contracting.” In *Bridging the Entrepreneurial Financing Gap: Linking Governance with Regulatory Policy,* edited by Michael J. Whincop, Ashgate/Dartmouth

Klein, Benjamin, RG Crawford, and AA Alchian. 1978. “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process.” *Journal of Law and Economics* 21 (2): 297–326

Kleinberger, Daniel S. 2004. “The Reporter’s Rejoinder.” *Suffolk UL Rev.*, no. 37: 967

Kornhauser, lewis a. 1983. “Reliance, Reputation, and Breach of Contract.” *Journal of Law and Economics* 26 (3): 691–706

Kortum, Samuel, and Josh Lerner. 2000. “Assessing the Contribution of Venture Capital to Innovation.” *Rand Journal of Economics* 31 (4): 674

Kriechel, Ben, and Gerard a. Pfann. 2005. “The Role of Specific and General Human Capital after Displacement.” *Education Economics* 13 (2): 223–36

Krishnan, C.N.V. 2011. “Venture Capital Reputation, Post-IPO Performance, and Corporate Governance.” *Journal of Financial and Quantitative Analysis* 46 (05): 1295–1333

Lai, M. 2006. “Venture Capitalist Screening Criteria and Associated Tools: Progressive Screening Matrix & Mean-IRR Index.” iTM Ventures Inc. Available at [Last visited March 31, 2016]

Lam, Wing. 2010. “Funding Gap, What Funding Gap? Financial Bootstrapping: Supply, Demand and Creation of Entrepreneurial Finance.” *International Journal of Entrepreneurial Behaviour & Research* 16 (4): 268–95

Lee, Charles M C, Andrei Shleifer, and Richard H Thaler. 2008. “Investor Sentiment and the Closed-End.” *Security* 46 (1): 75–109

Lee, Rebecca. 2007a. “Fiduciary Duty Without Equity: ‘Fiduciary Duty’ of Directors Under the Revised Company Law of the PRC.” *Virginia Journal of International Law* 47 (4): 897–926

Lerner, J. 1994. “The Syndication of Venture Capital Investments.” *Financial Management* 23 (3): 16–27

———. 1997. “Venture Capital and Private Equity: A Course Overview.” Available at [Last visited March 31, 2016]

———. 2002a. “Boom and Bust in the Venture Capital Industry and the Impact on Innovation.” *Economic Review-Federal Reserve Bank of Atlanta* 2002 (Q4): 25–39.

———. 2002b. “When Bureaucrats Meet Entrepreneurs: The Design of Effective "Public Venture Capital" Programmes.” *Economic Journal* 112 (Lerner): F73–84

Lerner, J, and A Schoar. 2004. “The Illiquidity Puzzle: Theory and Evidence from Private Equity.” *Journal of Financial Economics* 72 (1): 3–40

———. 2005. “Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity.” *The Quarterly Journal of Economics* 120 (1): 223–46

Lerner, J, A Schoar, and Wan Wong. 2007. “Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle.” *The Journal of Finance* 62 (2): 731–64

Lewis, WA. 2013. “Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies.” *Fordham L. Rev.*, no. 82: 1017

Lewis, William Draper. 1917. “The Uniform Limited Partnership Act.” *Univesrity of Pennsylvania Law Review and American Law Register* 65 (8): 715–31

Li, Jing. 2012. “Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations.” *Michigan Journal of Private Equity & Venture Capital Law* 1: 1

Li, Josson Yinya. 2005. *Investing in China: The Emerging Venture Capital Industry*. GMB Publishing Ltd

Li, Yining (厉以宁). 2004. “History, Present, and Problem of China’s Venture Capital Investment.” (中国创业投资业发展沿革、现状与问题) *China Venture Capital and High-tech* (中国创业投资与高科技) 07:17

Li, Zhongsheng (李钟声). 1985. *Chinese Law* (中华法系)

Lin, Lin. 2011. “The Limited Parnter’s Derivative Action: Problems and Prospects in the Private Equity Market of China.” *Hongkong Law Journal* 41: 201

———. 2013. “Private Equity Limited Partnerships in China: A Critical Evaluation of Active Limited Partners.” *Journal of Corporate Law Studies* 13 (1): 185–217

Litvak, Kate. 2004. “Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements.” *American Law & Economics Association Annual* 76 (1): 161–218

Loughlin, Peter Joseph. 2003. “The Domestication of the Trust Bridging the Gap between Common Law and Civil Law.” Available at [Last visited March 31, 2016]

Lu, Haitian, Yi Tan, and Hong Huang. 2013. “Why Do Venture Capital Firms Exist: An Institution-Based Rent-Seeking Perspective and Chinese Evidence.” *Asia Pacific Journal of Management* 30 (3): 921–36

Lubben, SJ, and Alana J. Darnell. 2006. “Delaware’s Duty of Care.” *Del. J. Corp. L.*, no. 31: 589

Lucas, Robert E. 1988. “On the Mechanics of Economic Development.” *Journal of Monetary Economics* 22 (1): 3–42

Luo, Yadong, and Min Chen. 1996. “Managerial Implications of Guanxi-Based Business Strategies.” *Journal of International Management* 2: 293–316

MacLeod, W. Bentley. 2007. “Reputation, Relationships and Contract Enforcement.” *Journal of Economic Literature* 45: 595–628

MacMillan, IC. 1987. “Criteria Distinguishing Successful from Unsuccessful Ventures in the Venture Screening Process.” *Journal of Business Venturing* 2: 123–37

Malkiel, BG, and EF Fama. 1970. “Efficient Capital Markets: A Review Of Theory And Empirical Work.” *The Journal of Finance* 25 (2): 28–30

Manigart, Sophie, Andy Lockett, Miguel Meuleman, Hans Landstrom, and Philippe Desbrieres. 2002. “The Syndication of Venture Capital Investments in Europe: Evidence from Five European Countries.” Working Papers CREGO1021202. Available at [Last visited March 31, 2016]

Mann, R. 1999. “Verification Institutions in Financing Transactions.” *Georgetown Law Journal*, no. 87: 2225

Manne, HG. 1965. “Mergers and the Market for Corporate Control.” *The Journal of Political Economy* 73 (2): 110–20

———. 1967. “Our Two Corporation Systems: Law and Economics.” *Virginia Law Review* 53 (2): 259–84

Marshall, Alfred. 1890. *Principles of Economics*. 8th ed. Macmillan and Co

Marx, Leslie M. 1998. “Efficient Venture Capital Financing Combining Debt and Equity.” *Review of Economic Design* 3 (4): 371–87

Massa, Massimo, and Andrei Simonov. 2006. “Hedging, Familiarity and Portfolio Choice.” *Review of Financial Studies* 19 (2): 633–85

Matheson, John H. 2006. “Convergence, Culture and Contract Law in China.” *Minn. J. Int’l L.* 15: 329

McMurray, MM. 1987. “Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule, An.” *Vand. L. Rev.*, no. 40: 605

McNally, Kevin. 1995. “Corporate Venture Capital: The Financing of Technology Businesses.” *International Journal of Entrepreneurial Behaviour & Research* 1 (3): 9–43

Mehran, H, and M Quintyn. 1996. “Financial Sector Reforms in China.” *Finance and Development*. March: 18. Available at [Last visited March 31, 2016]

Mehta, Vijay. 2004. “Principal-Agent Issues in Private Equity and Venture Capital.” *Wharton Research Scholars Journal* April. Available at [Last visited March 31, 2016]

Mendoza, Jose Miguel, and Erik P. M. Vermeulen. 2011. “The ‘New’ Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity.” *Lex Research Topics in Corporate Law & Economics Working Paper*, no. 1/2001. Available at [Last visited March 31, 2016]

Metrick, Andrew, and Ayako Yasuda. 2010. “The Economics of Private Equity Funds.” *Review of Financial Studies* 23 (6): 2303–41

———. 2011. *Venture Capital and the Finance of Innovation*. *Venture Capital*. 2nd ed.

Milhaupt, CJ. 1996. “Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate.” *Nw. UL Rev.* 91: 865

Myers, SC. 1977. “Determinants of Corporate Borrowing.” *Journal of Financial Economics* 5 (2): 147–75

Myers, Stewart C., and Nicholas S. Majluf. 1984. “Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have.” *Journal of Financial Economics* 13 (2): 187–221

Nahata, Rajarishi. 2008. “Venture Capital Reputation and Investment Performance.” *Journal of Financial Economics* 90 (2): 127–51

NVCA. 2013. *National Venture Capital Association Yearbook 2012*.

———.

Obrimah, Oghenovo. 2004. “Law, Finance, and Venture Capitalists’ Asset Allocation Decisions.” *EFA 2004 Maastricht Meetings Paper No. 4152*. Available at [Last visited March 31, 2016]

OECD. 2007. “OECD Reviews of Innovation Policy: China.”

———.2008. “OECD Reviews of Innovation Policy: China.” Available at [Last visited April 5, 2016]

———. 2012. “Main Science and Technology Indicators” 2012. Available at [Last visited March 31, 2016]

———.

Ohmer, Adrian A. 2013. “Investing in Cannabis: Inconsistent Government Regulation and Constrains on Capital.” *Michigan Journal of Private Equity & Venture Capital Law*, no. 3: 97

Osano, Hiroshi, and Mami Kobayashi. 2005. “Double Moral Hazard and Renegotiation.” *Research in Economics* 59 (4): 345–64

Pan, Lin (潘林). 2014. “The Limited Partnership Control Rule in Venture Capital Investment Practice in China.” (有限合伙控制规则的功能境遇与实现) *Contemporary Law* (当代法学) 3:102

Park, Seung Ho, and Yadong Luo. 2001. “Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms.” *Strategic Management Journal* 22 (5): 455–77

Parker, SC. 2002. “Do Banks Ration Credit to New Enterprises? And Should Governments Intervene?” *Scottish Journal of Political Economy* 49 (2): 162–95

Pattison, Patricia, and Daniel Herron. 2003. “The Mountains Are High and the Emperor Is Far Away : Sanctity of Contract in China.” *American Business Law Journal* 40: 459

Porter, M. E. 2000. “Location, Competition, and Economic Development: Local Clusters in a Global Economy.” *Economic Development Quarterly* 14 (1): 15–34

Pukthuanthong, Kuntara, and Thomas Walker. 2007. “Venture Capital in China: A Culture Shock for Western Investors.” *Management Decision* 45 (4): 708–31

Pye, L.W. 1995. “Factions and the Politics of Guanxi: Paradoxes in Chinese Administrative and Political Behavior.” *China Journal*, no. 34: 35–53

Rall, LGL. 2004. “A General Partner’s Liability under the Uniform Limited Partnership Act (2001).” *Suffolk UL Rev.*, no. 37: 913

Rati, Victoria J. 2011. “Do Individual Investors Have Asymmetric Information Based on Work Experience?” *CFA Digest* 41 (4): 15

Reid, Wayne D. 1992. “The Limited Partnership : An Ideal Vehicle for Start-Up Ventures.” *Taxes* 70: 745

Repullo, Rafael, and Javier Suarez. 2004. “Venture Capital Finance: A Security Design Approach.” *Review of Finance* 8 (1): 75–108

Ribstein, LE. 1988. “Applied Theory of Limited Partnership, An.” *Emory LJ* 37: 835

———. 1993. “The Revised Uniform Partnership Act: Not Ready for Prime Time.” *The Business Lawyer* 49: 45

———. 1998. “Limited Partnerships Revisited.” *U. Cin. L. Rev.*, no. 67: 953

———. 2003. “Fiduciary Duties and Limited Partnership Agreements.” *U Illinois Law & Economics Research Paper No. LE03-004*. Available at [Last visited March 31, 2016]

———. 2004. “Fiduciary Duties and Limited Partnership Agreements.” *Suffolk UL Rev.*, no. 37: 927

———. 2005. “Are Partners Fiduciaries?” *U. Ill. L. Rev.*, no. 2005: 209

Rin, Marco Da, TF Hellmann, and Manju Puri. 2011. “A Survey of Venture Capital Research.” *NBER Working Paper 17523*. Available at [Last visited March 31, 2016]

Ritter, JR, and Ivo Welch. 2002. “A Review of IPO Activity, Pricing, and Allocations.” *The Journal of Finance* 57 (4): 1795–1828

Robbins, Robert B. 2002. “The Fiduciary Duties of Directors of Corporate General Partners; Ten Years after U.S.Acafes.” *ALI-ABA Course of Study* SG072: 437

Robinson, D, and B Sensoy. 2013. “Manager Compensation, Ownership, and the Cash Flow Performance of Private Equity Funds.” *Review of Financial Studies* 26 (11): 2760-2797

Rosenberg, David. 2002. “Venture Capital Limited Partnerships: A Study in Freedom of Contract.” *Colum. Bus. L. Rev.* 2002: 363

———. 2003. “The Two ‘Cycles’ of Venture Capital.” *Journal of Corporation Law* 28: 419

Rossman, Mark C, and Brendan H Frey. 2008. “Partnership and the Fiduciary Component: Duties, Obligations, Rights, and Remedies.” *Michigan Bar Journal*, no. December: 18–21

Rusokla, Teemu. 2002. “Law without Law, or Is Chinese Law an Oxymoron.” *Wm. & Mary Bill Rts. J.* 11: 655

Sahlman, WA. 1990. “The Structure and Governance of Venture-Capital Organizations.” *Journal of Financial Economics* 27: 473–521

Schmidt, Daniel, and Mark Wahrenburg. 2003. “Contractual Relations between European VC-Funds and Investors: The Impact of Reputation and Bargaining Power on Contractual Design.” *CFS Working Paper No. 2003/15*. Available at [Last visited April 4, 2016]

Schmidt, KM. 2003. “Convertible Securities and Venture Capital Finance.” *The Journal of Finance* LVIII (3): 1139

Schumpeter, J A. 1934. *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business.* Cambridge, MA: Harvard University Press

Schwienbacher, Armin. 2008. “Innovation and Venture Capital Exits.” *Economic Journal* 118 (533): 1888–1916

———. 2009. “Venture Capital Exits.” In *Companion to Venture Capital*, edited by D. Cumming. Vol. 2009. Wiley/Blackwell

Scott, AW. 1949. “The Fiduciary Principle.” *California Law Review* 37 (4): 539–55

Sealy, L. S. 2009. “Fiduciary Relationships.” *The Cambridge Law Journal* 20 (01): 69–81

Seasholes, Mark S., and Ning Zhu. 2010. “Individual Investors and Local Bias.” *Journal of Finance* 65 (5): 1987–2010

Shen, Han. 2008. “A Comparative Study of Insider Trading Regulation Enforcement in The U.S. and China.” *Journal of Business & Securities Law* 9 (Fall): 45–72

Shi, Yubin (石育斌). 2011. *China PE Investor Protection* (中国私募股权投资人权益保护指南) Law Press (法律出版社)

Silberglied, RC, and B Rohrbacher. 2011. "TOU.S.A, U.S.ACafes, and the Fiduciary Duties of a Parent's Directors upon a Subsidiary's Insolvency." *Ann. Surv. of Bankr. Law* 2011: 2

Sjovall, Andrea M, and Andrew C Talk. 2004. "From Actions to Impressions: Cognitive Attribution Theory and the Formation of Corporate Reputation." *Corporate Reputation Review* 7 (3): 269–81

Smith, DG. 1997. "The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?" *Tennessee Law Review* 65 (1): 79

———. 1998. "Venture Capital Contracting in the Information Age." *J. Small & Emerging Bus. L.* 2: 134

———. 2004. "Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts." *Willamette L. Rev.* 40: 825–52

———. 2005. "The Exit Structure of Venture Capital." *UCLA L. Rev.* 53: 315

Standifird, Stephen S. 2006. "Using Guanxi to Establish Corporate Reputation in China." *Corporate Reputation Review* 9 (3): 171–78

Starr, Paul, and Annalee Saxenian. 1995. *Regional Advantage: Culture and Competition in Silicon Valley and Route 128. Contemporary Sociology*

Stiglitz, JE, and Andrew Weiss. 1981. "Credit Rationing in Markets with Imperfect Information." *The American Economic Review* 71 (3): 393–410

Trester, Jeffrey J. 1998. "Venture Capital Contracting under Asymmetric Information." *Journal of Banking & Finance* 22 (6-8): 675–99

Triantis, GG. 2001. "Financial Contract Design in the World of Venture Capital." *The University of Chicago Law Review* 68: 305

Tykvová, T. 2007. "What Do Economists Tell Us about Venture Capital Contracts?" *Journal of Economic Surveys* 21 (1): 65–89

U.S. Congress, and Office of Technology Assessment. 1995. “Innovation and Commercialization of Emerging Technologies.” Available at [Last visited March 30, 2016]

U.S. Department of Commerce, and National Economic Council. 2012. “The Competitiveness and Innovative Capacity of the United States.” Available at [Last visited March 30, 2016]

Ueda, Masako. 2004. “Banks versus Venture Capital: Project Evaluation, Screening, and Expropriation.” *The Journal of Finance* LIX (2): 601

Ueda, Masako, and Masayuki Hirukawa. 2008. “Venture Capital and Industrial ‘Innovation’.” Available at [Last visited April 4, 2016]

Ulen, Thomas S. 1984. “The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies.” *Michigan Law Review* 83: 341

UNU-MERIT, and European Commission. 2011. “Innovation Union Scoreboard 2010.” Available at [Last visited April 4, 2016]

United Nations Economic Commission for Europe. 2012. “Fostering Innovative Entrepreneurship.” Available at [Last visited March 30, 2016]

Utset, M. 2002. “Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms.” *Wisconsin Law Review*, 2002:45

Vaughn, Christopher M. 2002. “Venture Capital in China: Developing a Regulatory Framework.” *Columbia Journal of Asian Law* 16: 227

Vestal, AW. 1993. “Choice of Law and the Fiduciary Duties of Partners Under the Revised Uniform Partnership Act.” *Iowa L. Rev.* 79: 219

———. 1995. “Advancing the Search for Compromise: A Response to Professor Hynes.” *Law and Contemporary Problems* 58: 55

Veugelers, Reinhilde. 2013. “The World Innovation Landscape: Asia Rising?” *Brugel Policy Contribution* 2013/02. Available at [Last visited April 4, 2016]

Wang, Leyu (王乐宇). 2013. “Limited Partnership General Partner’s Fiduciary Duty in China.” (论我国有限合伙企业普通合伙人的信义义务) *Economic Forum* (经济论坛) 511: 173

Wälde. 2002. “Law, Contract and Reputation in International Business: What Works.” *Business Law International*, no. 2: 190

Wang, Susheng, and Hailan Zhou. 2004. “Staged Financing in Venture Capital: Moral Hazard and Risks.” *Journal of Corporate Finance* 10 (1): 131–55

Wang,Yuan, Xin Sheng Zhang and Rob Goodfellow. 1998. *Business Culture in China*. Reed Academic Publishing Asia

Weidner, DJ. 1995. “RUPA and Fiduciary Duty: The Texture of Relationship.” *Law and Contemporary Problems* 58: 81

Wessner, Charles, and Alan Wolff. 2012. *Rising to the Challenge: U.S. Innovation Policy for Global Economy*. National Research Council

Whincop, M. 2001. “Entrepreneurial Governance.” In *Bridging the Entrepreneurial Financing Gap: Linking Governance with Regulatory Policy:* 75–97. Aldershot: Ashgate

White, Steven, Jian Gao, and Wei Zhang. 2005. “Financing New Ventures in China: System Antecedents and Institutionalization.” *Research Policy* 34 (6): 894–913

Wilke, RK. 1984. “Limited Partnership Control: A Reexamination of Creditor Reliance.” *Ind. LJ* 60: 515

Williamson, OE. 1979. “Transaction-Cost Economics: The Governance of Contractual Relations.” *Journal of Law and Economics* 22 (2): 233–61

———. 1981. “The Economics of Organization: The Transaction Cost Approach.” *American Journal of Sociology* 87: 548–77

———. 1985. *The Economic Institutions of Capitalism*. Vol. 12. Free Press

———. 1992. “Markets, Hierarchies, and the Modern Corporation: An Unfolding Perspective.” *Journal of Economic Behavior & Organization* 17: 335–52

———. 1996a. “Economic Organization: The Case for Candor.” *Academy of Management Review* 21 (1): 48–57

———. 1996b. *The Mechanisms of Governance*. Oxford University Press

———. 2007. “Transaction Cost Economics: An Introduction.” *Economics Discussion Paper No. 2007-3*. Available at [Last visited April 4, 2016]

Wilson, Robert. 1985. “Reputations in Games and Markets.” *Gametheoretic Models of Bargaining*, 96:27–62

Wolfson, M A. 1985. “Empirical Evidence of Incentive Problems and Their Mitigation in Oil and Gas Tax Shelter Programs.” In *Principals and Agents: The Structure of Business*, Boston: MA:101–25

Wong, Anson. 2011. “The Evolution of the Venture Capital Market in China: Current Trends in Venture Capital Financing Strategies and Investment Preferences.” *Journal of Investing* 20 (4): 16–26

Wu, Yong, and Thomas Earl Geu. 2007. “The New PRC Limited Partnership Enterprise Law and the Limited Partnership Law of The United States: A Selective Analytical Comparison.” *UCLA Pac. Basin LJ* 25: 133

Xu, XE. 2006. “Venture-Backed IPOs and the Exiting of Venture Capital in China.” *Journal of Entrepreneurial Finance, JEF* 11 (3): 39–56

Xu, Xiaoqing Eleanor. 2002. “Venture Capital Finance in China.” *The Journal of Entrepreneurial Finance* 7 (1): 11–22

Yang, Kui (杨葵). 2007. *Venture Capital Investment Fund Raising* (风险投资的筹资研究). Shanghai University of Finance and Economics Press (上海财经大学出版社)

Yang, Xiejun (杨解君). 2005. “The Change and Enlightenment of the Contract Culture (second).” (契约文化的变迁及其启示(下)) *Law Review* (法学评论) 129: 28

Yao, Xiaomin (姚晓敏). 2015. “Disputes on Limited Partnership Funds.” (有限合伙基金法律纠纷求解) *Legal Entity* (法人) 1: 68

Yao, Xuexia (姚学侠). 2008. “Interpreting the Limited Partnership Law in the New PEL.” (解读新《合伙企业法》有限合伙制度) Co-operating Economics and Science Technology (合作经济与科技) 340:115

Yerramilli, Vijay. 2006. “Joint Control and Redemption Rights in Venture Capital Contracts.” *ECGI – Finance Working Paper No. 37/2004*. Available at [Last visited April 4, 2016]

Zacharakis, Andrew L, and G Dale Meyer. 2000. “The Potential of Actuarial Decision Models: Can They Improve the Venture Capital Investment Decision?” *Journal of Business Venturing* 15: 323–46

Zeng, F. 2004. “Venture Capital Investments in China.” *Pardee RAND Graduate School*.

Zero2IPO Research Center (清科研究中心). 2002-2015.*China Venture Capital Annual Report*. (中国创业投资年度研究报告)

Zhang, Qianlin, and Bai Lituan (张黔林, 柏立团). 2013. “First PE Bribery Case: the Double-edged Sword of Co-investment.” (争议“PE 受贿第一案”), *Directors & Boards* (董事会) December: 72

Zhao, Yu (赵玉). 2010. “Legal Thinking about Localization of Limited Partnership Stock Rights Investment Fund.” (有限合伙型股权投资基金的本土化法律思考) *Legal Magazine* (法学杂志) December: 132

Zhou, Linbin, and Wen Yajing (周林彬，文雅靖). 2014. “Judicial Application Status Quo of Senior Executive Violating Fiduciary Duties and Its Perfection.” (公司高管违反信义义务责任的司法适用现状与完善) *Seeking Truth* (求是学刊) 41: 71

Zyglidopoulos, S, and N Phillips. 1999. “Responding to Reputational Crises: A Stakeholder Perspective.” *Corporate Reputation Review* 2 (4): 333–50

Author N/A. 1977. “Procedures and Remedies in Limited Partners’ Suits for Breach of the General Partner's Fiduciary Duty.” *Harvard Law Review* 90 (4): 763–89

Appendix

Appendix I

Cases quoting Art. 5 and Art.7 of the PEL

No.	Case name	Case filing number	Date
1	马光等与潘泽玉合伙协议纠纷上诉案	(2010)邵中民一终字第 444 号	2010.10.18
2	张双旭与张宏文合伙纠纷上诉案	(2011)三民终字第 170 号	2011.04.26
3	游欢等与余丽姗等合伙协议纠纷上诉案	(2011)南市民二终字第 477 号	2011.09.29
4	梁某某等与黄某某等合伙协议纠纷上诉案	(2013)钦民二终字第 7 号	2013.02.18
5	岑丽文与张玉桃合伙协议纠纷上诉案	(2013)穗中法民二终字第 1578 号	2013.12.12
6	李定义与韦玉成等合伙协议纠纷上诉案	(2013)南市民二终字第 287 号	2013.08.07
7	宋伟诉褚志强合伙协议纠纷案	(2013)嘉民一初字第 282 号	2013.03.01
8	张从进诉朱士兵等民间借贷纠纷案	(2014)盐民终字第 0698 号	2014.06.18
9	王菲与高七奎合作协议纠纷案	(2014)临商终字第 74 号	2014.03.14
10	扈森增等诉扈天东等合伙纠纷案	(2014)南民二终字第 00632 号	2014.09.11
11	黄希烈等与黄日南退伙协议纠纷再审案	(2012)南市民抗再字第 8 号	2012.09.06

Appendix II

Cases under “damage company’s interest” in 2013 and 2014

No.	Case name	Case filing number	Date
1	上海善极计算机科技有限公司与姜祖望损害公司利益责任纠纷案	(2014) 沪一中民四(商)终字第1922号	2014.12.19
2	孙荣平与天津市新阳电子有限公司损害公司利益责任纠纷上诉案	(2014)二中民二终字第294号	2014.12.04
3	唐昱等诉徐波公司利益责任纠纷案	(2014) 沪二中民四(商)终字第1228号	2014.11.19
4	张丰奎等诉李玉平等损害公司利益责任纠纷案	(2014)洛民终字第586号	2014.11.04
5	南京超力磁业有限公司与伍先应、雍小琴损害公司利益责任纠纷案	(2014)宁商终字第898号	2014.10.08
6	沈晓云等诉崔晓宏公司利益责任纠纷案	(2014)苏知民终字第0106号	2014.09.26
7	京山金孔雀俱乐部有限责任公司诉向红梅等损害公司利益责任纠纷案	(2014)昆民五终字第16号	2014.09.23
8	南京金斯瑞生物科技有限公司与王蕊萍等公司利益责任纠纷上诉案	(2014)宁商终字第857号	2014.09.18
9	张桂萍等与盛趣信息技术（上海）有限公司损害公司利益责任纠纷上诉案	(2014)一中民终字第5729号	2014.09.17
10	恩平市汉邦陶瓷有限公司与刘福来公司利益纠纷上诉案	(2014)韶中法民二终字第81号	2014.09.05
11	赵夫义等与徐州市久丰运输有限公司损害公司利益责任纠纷上诉案	(2014)徐商终字第0377号	2014.09.05
12	新乡市佳禾置业有限公司与吴立力、赵云泉损害公司利益责任纠纷案	(2014)新中民二终字第203号	2014.09.01
13	郑玉林诉如皋市金鼎置业有限公司等损害公司利益责任纠纷案	(2014)通中商终字第0286号	2014.08.21
14	东莞市德克特射箭器材有限公司与黄某某公司利益责任纠纷上诉案	(2013)东中法民二终字第994号	2014.08.16
15	常州市索源电气照明设备有限公司与杨宝元公司利益责任纠纷上诉案	(2014)常商终字第194号	2014.07.28
16	李孟辰等诉尹东华等损害公司利益责任纠	(2014)邢民二终字第152号	2014.07.28

	纷案		
17	袁其明与滨海县泽群纸业有限公司损害公司利益纠纷上诉案	(2014)盐商终字第 0192 号	2014.07.14
18	上海水生环境工程有限公司等与上海水生环境科技有限公司等损害公司利益责任纠纷上诉案	(2014)沪二中民四(商)终字第 757 号	2014.07.11
19	韩晓明与上海途翔物业管理有限公司损害公司利益责任纠纷上诉案	(2014)沪一中民四(商)终字第 772 号	2014.07.04
20	平顶山市民用爆破器材专营有限公司与毛振忠损害公司利益责任纠纷案	(2014)平民二终字第 162 号	2014.06.26
21	吴俊等诉黄敏公司利益责任纠纷案	(2014)昆民五终字第 23 号	2014.06.24
22	上海东山种猪养殖有限公司与左云祥公司利益责任纠纷上诉案	(2014)沪二中民四(商)终字第 351 号	2014.06.20
23	张丰奎等与方红卫等公司利益责任纠纷上诉案	(2014)洛民终字第 585 号	2014.06.17
24	广州市威通贸易发展有限公司与许昭银等公司利益责任纠纷上诉案	(2014)穗中法民二终字第 692 号	2014.06.17
25	北海融富海湾房地产开发有限公司与高日华等公司利益责任纠纷上诉案	(2014)北民二终字第 15 号	2014.06.15
26	图尔克（天津）传感器有限公司诉马利祥等公司利益责任纠纷案	(2014)津高民二终字第 0043 号	2014.06.11
27	立洲（青岛）五金弹簧有限公司与刘波公司利益责任纠纷上诉案	(2014)青民二商终字第 382 号	2014.06.09
28	李斌等诉孙建国公司利益赔偿纠纷案	(2014)苏商外终字第 0002 号	2014.06.06
29	郭晟君与闫振智公司利益责任纠纷上诉案	(2014)张商终字第 182 号	2014.05.27
30	苏荣山等诉苏荣熙等损害公司利益责任纠纷案	(2014)穗中法民二终字第 716 号	2014.05.26
31	南京强新企业有限公司与程中军等损害公司利益责任纠纷上诉案	(2014)宁商终字第 405 号	2014.05.06
32	郑嫩英等与肖仙华等损害公司利益责任纠纷上诉案	(2014)沪一中民四(商)终字第 266 号	2014.04.21
33	广州邦禾健身有限公司与闫秀珍等损害公司利益责任纠纷上诉案	(2014)穗中法民二终字第 353 号	2014.04.16

34	广州赏识教育咨询有限公司与周弘损害公司利益责任纠纷上诉案	(2014)穗中法民二终字第 190 号	2014.04.14
35	上海普联房地产开发有限公司与马生为等损害公司利益责任纠纷上诉案	(2014)沪一中民四(商)终字第 171 号	2014.04.11
36	广东中兴液力传动有限公司等诉李艳芳损害公司利益责任纠纷案	(2014)穗中法民二终字第 270 号	2014.04.08
37	上海广茂达光艺科技股份有限公司与王丽萍损害公司利益责任纠纷上诉案	(2014)沪一中民四(商)终字第 109 号	2014.03.20
38	汤跃辉与张家界百龙天梯旅游发展有限公司公司利益责任纠纷上诉案	(2014)张中民二终字第 6 号	2014.03.19
39	杨桂芝与高更仁公司利益责任纠纷上诉案	(2014)石民四终字第 00107 号	2014.03.09
40	克拉玛依市准噶尔税务师事务（所）有限责任公司与畅永生等损害公司利益责任纠纷上诉案	(2014)克中民二终字第 00026 号	2014.03.04
41	林红梅诉姚惠仙等损害公司利益责任纠纷案	(2013) 沪二中民四(商)终字第 1302 号	2014.02.20
42	上海容之自动化系统有限公司与李怀军损害公司利益责任纠纷上诉案	(2013) 沪一中民四(商)终字第 2005 号	2014.01.24
43	上海美福集网络科技有限公司与胡经科损害公司利益责任纠纷上诉案	(2013) 沪一中民四(商)终字第 2071 号	2014.01.22
44	张贤明与上海天恩桥绝缘材料有限公司等损害公司利益责任纠纷上诉案	(2013) 沪二中民四(商)终字第 1414 号	2014.01.16
45	洪波与上海六合顺风餐饮有限公司损害公司利益责任纠纷上诉案	(2013)沪二中民四(商)终字第 898 号	2014.01.07
46	麻阳新代锰业有限责任公司与李胜损害公司利益责任纠纷案	(2013)怀中民二终字第 244 号	2013.12.24
47	南京新海达实业发展有限公司与广东新广国际集团有限公司损害公司利益责任纠纷管辖权异议上诉案	(2013)粤高法立民终字第 589 号	2013.12.18
48	郭立学等与兰州亿德实业有限公司损害公司利益责任纠纷上诉案	(2013)甘民二终字第 238 号	2013.12.10
49	周泽南与深圳市鸿泰洋装饰设计工程有限公司损害公司利益责任纠纷案	(2013)深中法商终字第 2046 号	2013.12.09
50	重庆大贺巴蜀传媒有限公司与贾华等损害	(2013)渝高法民终字第 00234 号	2013.12.09

	公司利益责任纠纷上诉案		
51	天津井田科工贸集团有限公司与任新强公司利益纠纷上诉案	(2012)一中民三终字第 612 号	2013.11.28
52	李彤等诉刘振海损害公司利益责任纠纷上诉案	(2013)一中民二终字第 111 号	2013.11.28
53	高炜与刘跃龙等损害公司利益责任纠纷上诉案	(2013)成民终字第 4283 号	2013.10.31
54	上诉人杨波与被上诉人李伟民损害公司利益责任纠纷案	(2013)郑民三终字第 966 号	2013.10.30
55	王旭东与四川泸州宏达路桥有限公司损害公司利益责任纠纷上诉案	(2012)泸民终字第 687 号	2013.10.22
56	柴某某与上海光仁塑胶制品有限公司损害公司利益责任纠纷上诉案	(2013)沪二中民四(商)终字第 724 号	2013.10.21
57	中腾甘肃燃气有限公司（China NTG Gansu Gas Limited）与宋联忠等损害公司利益责任纠纷上诉案	(2013)甘民二终字第 188 号	2013.09.30
58	北京鑫明海能源设备开发有限公司与葛某某损害公司利益责任纠纷上诉案	(2013)一中民终字第 9850 号	2013.09.17
59	唐某某与永州市冷水滩某某有限公司损害公司利益纠纷上诉案	(2013)永中法民一终字第 213 号	2013.09.09
60	王顺祥与敖庆九损害公司利益责任纠纷上诉案	(2013)扬商终字第 0164 号	2013.08.19
61	上诉人罗二仁与被上诉人河南姚花春酒业有限公司损害公司利益责任纠纷案	(2013)许民二终字第 218 号	2013.08.19
62	北京华立得实业有限责任公司与王某损害公司利益责任纠纷上诉案	(2013)一中民终字第 8738 号	2013.08.15
63	陈正明等与李毅平等损害公司利益责任纠纷上诉案	(2013)民一终字第 103 号	2013.08.12
64	庄武龙与陈东航损害公司利益责任纠纷上诉案	(2013)琼民二终字第 4 号	2013.07.29
65	邸泽龙与康胜损害公司利益责任纠纷上诉案	(2013)甘民二终字第 179 号	2013.08.01
66	陈义与徐兴兰等损害公司利益责任纠纷上诉案	(2013)成民终字第 3890 号	2013.07.25

67	陆 A 诉 B 厂损害公司利益责任纠纷案	(2013)沪一中民四(商)终字第 493 号	2013.07.11
68	A 公司与吴 B 等损害公司利益责任纠纷上诉案	(2013)沪一中民四(商)终字第 737 号	2013.07.09
69	江发生与广州德古门业有限公司公司利益责任纠纷上诉案	(2013)穗中法民二终字第 526 号	2013.07.08
70	甘肃天昱置业有限公司与深圳市朗钜实业集团有限公司损害公司利益责任纠纷上诉案	(2013)甘民二终字第 40 号	2013.06.20
71	上海光仁塑胶制品有限公司与上海塑灿贸易有限公司损害公司利益责任纠纷上诉案	(2013)沪二中民四(商)终字第 469 号	2013.06.20
72	周某某与李某等损害公司利益责任纠纷上诉案	(2013)沪一中民四(商)终字第 812 号	2013.06.17
73	深圳市中泰来投资控股股份有限公司与黄明皓损害公司利益责任纠纷上诉案	(2013)粤高法民四终字第 28 号	2013.06.14
74	甘肃成纪生物药业有限公司与陈溯损害公司利益责任纠纷上诉案	(2013)天民二终字第 00035 号	2013.06.07
75	广州白云国际广告有限公司与广东天骏传媒有限公司等损害公司利益责任纠纷上诉案	(2013)民二终字第 38 号	2013.06.05
76	郑 A 等与 C 公司损害公司利益责任纠纷上诉案	(2013)沪一中民四(商)终字第 464 号	2013.05.30
77	奉化市泰欣水产种苗有限公司与李维波损害公司利益责任纠纷上诉案	(2013)浙甬商终字第 127 号	2013.05.27
78	李维波与奉化市湖头渡苗种养殖有限公司损害公司利益责任纠纷上诉案	(2013)浙甬商终字第 130 号	2013.05.27
79	上海派安模餐饮娱乐有限公司与邝某某损害公司利益责任纠纷上诉案	(2013)沪高民二(商)终字第 S7 号	2013.05.22
80	广州真功夫快餐连锁管理有限公司与涂晓翔损害公司利益责任纠纷上诉案	(2013)穗中法民二终字第 125 号	2013.05.15
81	张来与林凤姣等损害公司利益责任纠纷上诉案	(2013)浙杭商终字第 554 号	2013.05.08
82	广东某某药业有限公司等与黄二等损害公司利益责任纠纷上诉案	(2012)江中法民二终字第 269 号	2013.05.06

83	宁海县大梁山泉有限公司与顾月娥损害公司利益责任纠纷上诉案	(2013)浙甬商终字第 248 号	2013.04.23
84	蒋国海诉叶华忠公司利益责任纠纷案	(2013)浙舟商终字第 19 号	2013.04.18
85	南京徐工汽车制造有限公司与江苏春兰自动车有限公司等损害公司利益责任纠纷案	(2013)苏商终字第 0073 号	2013.04.16
86	甲汽车公司与乙巴士公司损害公司利益责任纠纷案	(2013)沪一中民四(商)终字第 398 号	2013.04.10
87	苏冬梅与南阳市华发汽车销售有限公司损害公司利益责任纠纷案	(2013)南民一终字第 133 号	2013.03.30
88	鲍某某等与蔡乙损害公司利益责任纠纷上诉案	(2013)浙湖商终字第 91 号	2013.03.29
89	李玉环与王云喜损害公司利益责任纠纷上诉案	(2013)宁商终字第 68 号	2013.03.25
90	蔡甲与鲍甲等损害公司利益责任纠纷上诉案	(2013)浙湖商终字第 29 号	2013.03.21
91	某某与某某等损害公司利益责任纠纷上诉案	(2013)乌中民二终字第 133 号	2013.03.14
92	邬某某与甲厂损害公司利益责任纠纷案	(2013)沪一中民四(商)终字第 399 号	2013.03.12
93	杜某与上海毅初实业有限公司损害公司利益责任纠纷上诉案	(2012)沪二中民四(商)终字第 1335 号	2013.02.27
94	陈 A 等诉 C 公司损害公司利益责任纠纷案	(2012)沪一中民四(商)终字第 2065 号	2013.02.27
95	上海齐茂网络工程技术有限公司与徐某某等损害公司利益责任纠纷上诉案	(2012)沪二中民四(商)终字第 1286 号	2013.02.19
96	吴某与甲公司损害公司利益责任纠纷案	(2012)沪一中民四(商)终字第 1339 号	2013.01.23
97	李某某等与上海铠灵金属制品有限公司损害公司利益责任纠纷案	(2012)沪二中民四(商)终字第 1205 号	2013.01.17
98	陈某某与郑某某等损害公司利益赔偿纠纷案	(2012)沪一中民四(商)终字第 1881 号	2013.01.15
99	上海联华合纤股份有限公司与龙元建设集团股份有限公司等损害公司利益责任纠纷案	(2012)沪二中民四(商)终字第 1121 号	2013.01.11

Appendix III

Chinese limited partnership agreements (on file with the author)

1. Tianjin XX Investment Center (Limited Partnership) Partnership Agreement
2. Beijing XX Investment Fund (Limited Partnership) Partnership Agreement
3. Dongguan XX Equity Investment Partnership (Limited Partnership) Partnership Agreement
4. XX Venture Capital Fund Limited Partnership Agreement
5. XX Private Equity Fund Limited Partnership Agreement
6. Henan XX Investment Fund Managing Center (Limited Partnership) Partnership Agreement
7. Guangzhou XX Investment Partnership (Limited Partnership) Partnership Agreement
8. Beijing XX Capital Management Center (Limited Partnership) Partnership Agreement

Acknowledgement

I would like to express my sincere gratitude to my supervisor Prof. Feichtner, for her continuous support of my doctoral study, for her patience, motivation, and insightful ideas. The Ph.D. forum, which was organized by her, had helped me tremendously in my research and writing of this thesis. Not only she guided me through my research, but also cared about me on other life matters. She had helped me to get funding to support my study and living here in Germany, and introduced me to professionals who helped me with my future career. She had saved me from my darkest hours, and had given me a silver lining which illuminate my way beyond. I could not have imagined having a better supervisor and mentor for my doctoral study.

I would also like to thank the LEMF Program, for providing such a great opportunity to continue my study in Germany. My sincere thanks also goes to Prof. Haar, for organizing this wonderful program, and many of her research ideas and her strict attitude in scientific research had provided me with inspirations and disciplines while writing this thesis.

I thank my fellow doctoral students for the stimulating discussions, various ideas, and all the fun we have had in the last years. Thank you Tugba, for encouraging me to get to work on the thesis, the days we spent together in the study room will forever be treasured in my life.

I would like to thank my parents, for their mental and financial support throughout writing this thesis. Last but not least, I thank my boyfriend Fang Dong, who is also a doctoral candidate in the field of biochemistry, had set a perfect example and role model of a bright, resolute, and diligent doctoral student.