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Legal Updates

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Legal Updates

1. Explaining Order 11 - Comments on the Latest NDRC Q&A (Authors: Aaron ZHOU, Gloria XU, Daisy QI, Lu RAN, Kingsley WANG)

Investors engaged in overseas investment have been closely watching the National Development and Reform Commission's ("**NDRC**") *Measures for Administration of Overseas Investments by Enterprises* ("**Order 11**") since its effectiveness on March 1, 2018. To coordinate the implementation of Order 11, NDRC has promulgated *Circular of the National Development and Reform Commission on Issuing the Catalog for Overseas Investment in Sensitive Industries* (Fa Gai Wai Zi [2018] No.251, "**Sensitive Industries List**") and *Circular of the National Development and Reform Commission on Issuing Standard Forms in Support of the Measures for Administration of Overseas Investments by Enterprises (2018 Edition)* (Fa Gai Wai Zi [2018] No. 252 "**Standard Forms**"). Despite this regulatory guidance, however, investors still face many issues regarding how Order 11 is to be implemented and interpreted, such as the specific scope of sensitive industries, NDRC review standards for approving overseas investments in sensitive industries, and whether Order 11 approval is required when the overseas investment funds are entirely sourced from outside of China.

On June 5, 2018, NDRC released the *Questions and Answers Regarding Common Issues in Overseas Investment* ("**Q&A**") on its national overseas investment administration and service network system. The Q&A focuses on questions that NDRC has routinely encountered, clarifies certain ambiguities in Order 11 and is expected to provide clear, practical guidance to facilitate overseas investment. In this article, we will briefly comment on and analyze the key aspects of the Q&A.

I. Further clarifying the scope of "overseas investment"

NDRC defines overseas investment in Article 2 of Order 11 by providing both a general definition and listing examples. However, questions still arise in practice with respect to classifying overseas investments. The Q&A provides further explanations in this respect.

i. Investors

In the Q&A, NDRC makes two clear interpretations of investors. First, Q28 of the Q&A clarifies that the term "domestic natural persons" referenced in Order 11 at Article 63 refers to Chinese nationals residing in China ("**domestic individuals**"). This means that Order 11 may not apply to the overseas investments of a non-domestic individual if, for example, the investment is made through an offshore enterprise under his or her control. However, the provisions on overseas investment by domestic entities that control offshore enterprises *will* apply to a non-domestic individual that makes an overseas investment through the offshore subsidiary of a domestic

entity that he or she controls (specifically, sensitive investment projects are subject to approval; non-sensitive investments projects that exceed USD 300 million are subject to high-value, non-sensitive industry reporting procedures).

Next, Order 11 at Article 2 references “overseas controlled enterprises,” which, during NDRC review, are subject to “look-through under the principle of substance over form.” This means that it is necessary to look through the chain of ownership of an enterprise to the actual controller who directly or indirectly holds 50% or more of the voting rights of the enterprise, or who does not hold 50% or more of the voting rights, but controls the business, financial, personnel, technology and other important affairs of the enterprise (see Q1 and Q35 of the Q&A for details). Combined with the content listed in the Standard Forms, we believe that NDRC will require control methods such as VIE structures and trusts to be subject to look-through to confirm whether the actual controller is a domestic entity or individual (for details, please refer to our article entitled *China Expands Disclosure Requirements over Chinese Enterprises’ Overseas Investment Activities* (Chinese) , dated February 23, 2018).

ii. Types and sources of invested assets

Order 11 stipulates that overseas investments may be in the form of “assets or equity, or providing financing, guarantees, etc.” but fails to clarify the scope of “assets or equity.” Q13 of the Q&A clearly specifies the scope of “assets or equities” to include “currency, securities, tangible goods, technology, intellectual property, equity, creditor’s rights, and other assets and rights.” This is a quite broad definition, covering almost all types of assets and equities that may be used in overseas investment. Together with the catch-all phrase “...and other assets and rights,” we presume that nearly all forms of overseas investment in practice will be subject to the supervision of Order 11. In addition, we believe that “providing financing or guarantees” includes domestic loans, guarantees, mortgages and pledges. Thus, Order 11 may also govern so-called “onshore guarantees for offshore loans” and “domestic enterprises extending loans to offshore enterprises.”

It is worth noting that NDRC, in the Q&A, has included “equity” investment as one form of “asset or equity” in overseas investment. Based on our experience, it is difficult to use equity as a form of capital contribution when acquiring ownership in a foreign investee, since non-public companies are currently prohibited from engaging in cross-border share swaps. The inclusion of equity as a form of overseas investment in the Q&A may indicate a relaxing of restrictions on cross-border share swaps. We will keep an eye on this issue.

iii. Scope of “investment activities”

In practice, we often encounter questions from investors as to whether a certain investment project is an overseas investment subject to NDRC approval or record-filing. The reason for uncertainty with these projects is because while the investment may involve the establishment of an offshore entity or the cross-border flow of funds, in many cases, these projects either may

not inherently be investments or the equity to be obtained from the project may ultimately be regarded as a domestic asset. In light of these issues, NDRC has given the following explanation:

First, in the case of bond issuances by domestic enterprise-controlled offshore entities, the Q&A clearly specifies that Order 11 will not apply if the proceeds from an issuance is not used for overseas investment activities. However, Order 11 will apply if the proceeds are used for overseas investment activities, in which case the overseas investment project will be subject to approval or record-filing administration.

Based on the same logic, a shareholder loan from a domestic entity to its offshore entity will not be regarded as an overseas investment where the loan is only to be used for the entity's general corporate operations, payment of service fees, etc. However, Order 11 will apply if the shareholder loan proceeds are used for overseas investment activities, in which case the project will be subject to NDRC approval or record-filing administration.

II. Clarifying the scope of sensitive industries

Investors have encountered some confusion in practice regarding the scope of sensitive industries since Order 11 and the Sensitive Industries List only generally name the sensitive industries but do not determine a detailed scope of those industries. Q16 to Q24 of the Q&A further explains the scope of sensitive industries.

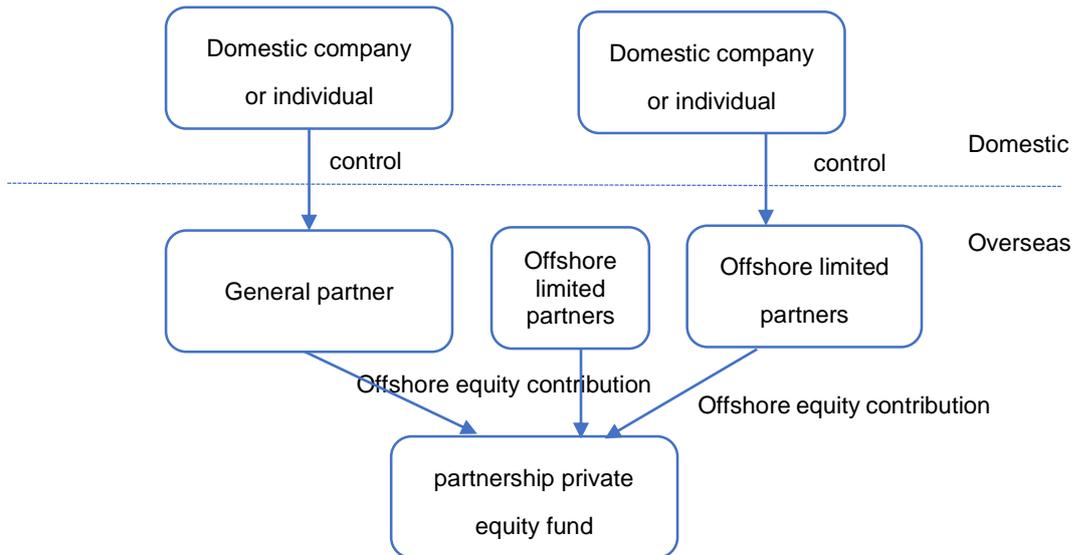
i. Equity investment funds or investment platforms without specific industrial projects

According to the Q&A, "an equity investment fund or investment platform established overseas without any specific industrial project" does not include the following two cases:

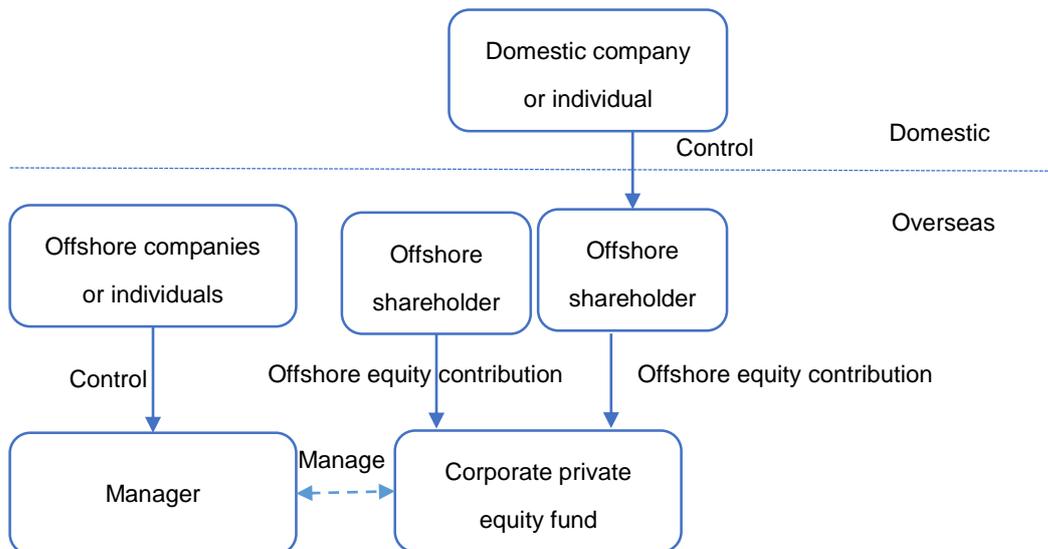
1. Equity investment funds or investment platforms with all funds are raised purely overseas and without any domestic investment in its assets or equities, nor domestic financing or guarantees, etc.;
2. Such offshore equity investment funds or investment platforms that do not engage in specific industrial projects are established by a domestic financial enterprise with the approval of a domestic financial regulatory authority.

With respect to the first case above, we believe that the following two common offshore fund structures may not be regarded as "equity investment funds or investment platforms established overseas without specific industrial projects":

- a. A domestic enterprise or individual directly or indirectly establishes an offshore general partner or management entity that raises funds from offshore investors to establish a partnership or corporate private equity fund (for illustration purposes, the following structure chart is a partnership private equity fund model)



- b. An offshore enterprise or individual directly or indirectly establishes an offshore general partner or management entity that raises funds from offshore investors to establish a partnership or corporate private equity fund (for illustration purposes, the following is a corporate private equity fund model)



The following conditions must be met for the two structures described above:¹

- a. General partner or manager: the general partner or manager of an equity investment fund or investment platform without a specific industrial project is an enterprise or individual that is: (1) offshore, or (2) controlled by a domestic enterprise or individual but has not invested any domestic assets or equities in the offshore private equity fund. In addition, the general partner or manager has not

¹ Under these two structures, popular legal forms for offshore private equity funds include Cayman exempted limited partnerships, Cayman limited liability companies, Delaware limited partnerships, Delaware limited liability companies, BVI companies limited by shares, etc.

accepted any form of domestic financing or guarantees.

- b. Limited partner or shareholder: all limited partners or shareholders (as appropriate) are offshore institutions or individuals that have invested offshore assets or equities in the offshore private equity fund. In addition, all limited partners or shareholders (as appropriate) have not accepted financing or any form of guarantee provided by entities located within China.
- c. Offshore private equity funds: the funds have not accepted assets or equity invested by domestic entities or any financing or any form of guarantee from within China.

NDRC approval based on the Sensitive Industries List is not required for equity investment funds and investment platforms established overseas without specific industrial projects that meet the above conditions from the perspective of having a general partner or manager that is: (1) a domestic enterprise, or (2) an offshore enterprise controlled by a domestic enterprise or individual. In addition, NDRC approval based on the Sensitive Industries List is not required for investments that domestic enterprises or domestic-overseas controlled enterprises make in such equity investment funds or investment platforms.

Regarding the “domestic financial regulatory authority” referenced in the second case, according to our consultation with NRDC, the authority primarily refers to regulators such as the China Securities Regulatory Commission and the China Banking and Insurance Regulatory Commission. Therefore, an investment project could still be considered sensitive even if it has obtained approval from a local financial authority.

ii. Other sensitive industries

The Q&A also further clarifies the scope of other sensitive industries (for details, please see the attached Description of Sensitive Industries). The key points are summarized as follows:

1. The Q&A clearly states that some industries, such as real estate and hotels, should not be regarded as sensitive industries if the investment funds are raised from overseas and do not involve domestically-invested assets or equity and do not involve domestic financing or guarantees. According to our consultation with NDRC, attention will be paid to the source of the investment funds (that is, whether the funds are sourced from overseas) in order to determine whether the funds are raised from overseas, rather than examining the nature of the funder (i.e., whether it is a domestic entity or an offshore entity under its control). Therefore, making offshore investments in those industries with funds sourced from overseas will not be subject to approval procedures applicable to sensitive industries. However, it remains to be seen whether making overseas investments through a QDIE (Qualified Domestic Investment Enterprise) or QDLP (Qualified Domestic Limited Partner,) will be

regarded as an investment involving assets or equity provided by entities located within China.

2. The Q&A clearly defines the scope of “entertainment industry,” which mainly refers to the traditional offline entertainment industry. Other Internet-based entertainment business types such as games, culture and music are not classified as sensitive.
3. The Q&A clearly defines “news media” as “offshore news organizations (including news websites), publishing agencies, and broadcast and television organizations that both involve current political affairs and have a major impact on national security.” Other media that do not relate to current political affairs are not classified as sensitive.

It should be noted that industries that are excluded from the scope of sensitive projects are not entirely exempted from Order 11. Investments in these industries are still subject to the regulatory rules applicable to non-sensitive projects.

III. Clarifying the approval criteria for overseas investments in sensitive industries

Order 11 clearly requires NDRC approval for overseas investments that domestic investors directly or indirectly make in sensitive industries, and NDRC has released the Standard Forms to supplement these requirements. In practice, however, investors continue to feel uncertain about what information and materials required to be submitted, and which content is required to be disclosed in an approval application because NDRC has been unclear about its review standards. Q25 of the Q&A partially answers these questions.

The Q&A reiterates the Order 11 review and approval standards for investment projects subject to review, namely: (1) the project is not in violation of PRC laws and regulations; (2) the project is not in violation of China's relevant development plans, macro-control policies, industrial policies and opening-up policies; (3) the project does not violate international treaties and agreements concluded or acceded to by China; (4) the project does not threaten or harm China's national interests and national security.

Due to ambiguity in Order 11 about the scope of “macro-control policies,” the Q&A provides a list of projects that will not be deemed to violate macro-control policies, which include: (1) inter-governmental cooperation projects; and (2) projects for which relevant industry authorities and embassies have clearly expressed their support during the process of soliciting opinions. Therefore, inter-governmental cooperation projects, even those in sensitive industries, will still stand a good chance of approval. For non-governmental cooperation projects, investors may wish to seek support for the investment by communicating in advance with industry regulators and the Chinese embassy where the investment is to be made, which will help to increase the chances for approval.

IV. Further clarifying the content to be disclosed in applications and the form of application materials

In addition to the questions related to substantive issues, the Q&A also answers some questions frequently asked in practice in relation to what content is required to be disclosed in the application as well as the form of the application materials.

For applications by state-owned enterprise subsidiaries, the Q&A clearly specifies that such subsidiaries should apply through the enterprise's group for record-filing and reporting procedures. Such applications are to be made through the group's or parent enterprise's account on the "National Overseas Investment Management and Service Network System."

In addition, the Q&A clarifies that investors are required to submit their latest audited financial statements for approval or record-filing of the overseas investment, i.e., the investor's most recent annual or semi-annual audited financial statements. If the investor is recently established and cannot provide audited financial statements, the latest audited financial statements of the controlling shareholder, general partner or actual controller of the investor should be provided. If the investor has been registered for fewer than two years, it may only provide its credit information for the period from establishment to the date of application, but the investor's controlling shareholder (or general partner) and ultimate controller will also need to submit credit information for the preceding two years.

In addition, in principle, it is not necessary to submit paper materials if the application has been submitted through the Internet. However, investors may apply with paper forms if the relevant project or information involves state secrets or it is not suitable to submit the application through the Internet system.

V. Summary

The Q&A answers many questions that are frequently asked in practice regarding Order 11, especially in terms of the scope of sensitive industries and the scope of "investment activities." However, issues remain that await further NDRC clarification with respect to implementing Order 11 and its supporting documents. For example, NDRC has not explained the purpose of the requirement in Order 11 that investors must provide credit information regarding themselves and of their actual controllers and controlling shareholders. It is not yet clear how this credit information will affect investor applications for overseas investment.

We will continue to closely monitor any new issues that arise in practice and how NDRC deals with these issues, and timely share our opinions with you.

Attachment: Description of Sensitive Industries

Sensitive Industries	Sensitive Investment Projects	Non-sensitive Investment Projects
(1) equity investment funds or investment platforms established offshore without a specific industrial project	(2) Equity investment funds or investment platforms established overseas without specific industrial projects, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China.	(3) Equity investment funds or investment platforms whose funds are raised entirely overseas and which do not involve domestic investment in assets or equities, nor involve domestic financing or guarantees, etc. (4) Offshore equity investment funds or investment platforms that do not engage in any specific industrial projects and which are established by a domestic financial enterprise upon the approval of a domestic financial regulatory authority.
Real estate	(1) Construction or acquisition of residential or commercial real estate projects, or acquisition of land for construction of residential or commercial real estate, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China; (2) Establishment or acquisition of offshore real estate enterprises, increases in capital to existing offshore real estate enterprises, or investments in offshore real estate funds, funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China.	(1) Investments in property managers or real estate agency services; (2) Construction or acquisition of office space, staff company dormitories for self-use; (3) Investments in the construction of infrastructure and development of buildings that will be used for physical business operations, such as industrial parks, science parks, warehouse logistics parks, etc. (4) Construction enterprises may make small scale investments in planned construction projects for the purposes of obtaining project contracts. (5) Projects for which NDRC has issued approval documents or record-filing notices in accordance with law, but which have not yet been completed; (6) Projects that raise funds entirely from overseas without involving assets or equities invested by domestic entities nor involving financing or guarantees provided by domestic entities.
Hotels	Construction or acquisition of star-rated hotels, tourist resorts, business hotels or ordinary hotels funded by assets or equities invested by entities located within the territory of China or by financing or guarantees provided by entities located within the territory of China.	(1) Investments in the hotel management industry that do not hold hotel property assets; (2) Investments in the catering industry that do not include accommodation; (3) Projects for which NDRC has issued approval documents or record-filing notices in accordance with law, but which have not yet been completed; (4) Projects that raise funds entirely from overseas without involving assets or equities invested by domestic entities nor involving

Sensitive Industries	Sensitive Investment Projects	Non-sensitive Investment Projects
		financing or guarantees provided by domestic entities.
Entertainment industry	(1) Construction or acquisition of offshore indoor entertainment facilities (song and dance halls, electronic entertainment halls, Internet cafes, etc.); (2) Construction or acquisition of offshore amusement parks, theme parks, etc.; (3) Construction or acquisition of offshore lottery enterprises;	-
News media	Establishment or acquisition of offshore news organizations (including news websites), publishing agencies, and broadcast and television organizations that both involve current political affairs and have a major impact on national security.	-
Studios	Construction or acquisition of offshore cinemas and cinema companies.	-
Sports clubs	Establishment or acquisition of organizations, institutions and enterprises that engage (or rent) athletes for sports competitions, performances, training, counseling, management, etc.	-
Cross-border water resources development	Development and use of water resources of rivers that pass through two or more countries.	-
Development, production and maintenance of weaponry	R&D, production, maintenance, safeguarding of weapons.	-

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2. Cayman LLC - A New Form of Overseas Private Equity Fund (Authors: James WANG, Qing JING, Xiao DING, Zhiwei LIU)

The Cayman Islands (the “**Caymans**”), one of the world's premier offshore financial centers, has long been attractive to investors due to its tax incentives, mature legal system, and corporate secrecy, and has become one of the most popular places for establishing international private equity funds. The *2016 Limited Liability Companies Law* (“**Cayman LLC Law**”) ², effective on July 8, 2016, provides for a new alternative entity form for organizing Cayman funds—the limited liability company (“**Cayman LLC**”) ³—in addition to the exempted company, exempted limited partnership (“**Cayman ELP**”), and unit trust. In the past two years, an increasing number of Cayman LLCs have come into public view.

A highlight of the Cayman LLC is that it adopts features of the Cayman exempted company to be recognized as an independent legal person and to afford limited liability protection to its members. In addition, the Cayman LLC adopts corporate governance and profit and loss sharing mechanisms by reference to the Cayman ELP, which provides for more flexibility than the Cayman exempted company. The Cayman LLC is derived from the U.S. Delaware limited liability company (“**Delaware LLC**”) and has been modified based on the existing Cayman legal system.

This article focuses on the main features, advantages and practical applications of the Cayman LLC, and compares the Cayman LLC with the Delaware LLC and Cayman ELP in order to provide readers with an overview of the Cayman LLC's characteristics and practical applications.

I. The main features Cayman LLCs and the advantages

i. Independent legal personality

Unlike the Cayman ELP, the Cayman LLC has legal personality, which is the same as the Cayman exempted company and the Delaware LLC. The Cayman LLC Law clearly specifies that a Cayman LLC is to be regarded as a body corporate with legal personality that is independent of its members. Similarly, the Delaware Limited Liability Company Act (“**Delaware LLC Act**”) expressly provides that Delaware LLCs are regarded as separate legal entities.

² The Limited Liability Companies Law, 2016 及其不时修订更新版。

³ It should be noted that Delaware LLCs and limited liability companies under PRC law are significantly different, particularly with respect to taxation. Under U.S. federal tax law, a Delaware LLC that has two or more members is by default regarded as a partnership (and thus is not required to pay federal income taxes at the entity level), a Delaware LLC with only a single member is considered disregarded as an entity separate from its member (a “disregarded entity,” which is also not subject to entity-level taxation). For Cayman entities, U.S. federal tax law by default deems Cayman LLCs and exempted companies to be corporations and Cayman ELPs to be partnerships. Entities that are not deemed “per se corporations” (e.g., a PRC company limited by shares) may elect to be treated as either a corporation or a partnership by filing Form 8832 to make a so-called “check-the-box” election. Thus, Delaware LLCs and the Cayman entities we discuss in this article can elect either partnership or corporate treatment under U.S. tax law, depending on the interests and objectives of the investors involved.

ii. **Limited liability protection and statutory obligation to return distributions**

1. **Limited liability protection**

Cayman LLC and Delaware LLC members by default have limited liability, although other arrangements can be made in the LLC Agreement (i.e., the LLC organization document).⁴ Pursuant to the Cayman LLC Law, Cayman LLC members are not required to individually assume any debt, obligation or liability of the Cayman LLC, unless otherwise agreed in the LLC Agreement or other agreements. The contributions of Cayman LLC members need not exceed their capital commitments as provided in the LLC Agreement or other agreements. Similar provisions can be found in the Delaware LLC Act. However, according to the *Exempted Limited Partnership Law (2018 Revision)* (“**Cayman ELP Law**”),⁵ the general partner of a Cayman ELP is subject to unlimited liability for a Cayman ELP’s debts and obligations, which cannot be excluded by agreement. Limited partners that do not actively participate in the operation of the Cayman ELP only assume limited liability for the Cayman ELP’s debts and liabilities, unless otherwise stipulated in the partnership agreement or with respect to the return of distributions in accordance with the Cayman ELP Law (see below for the details).⁶

2. **Statutory obligation to return distributions**

Limited liability does not apply to the statutory obligation of members to return distributions, and this obligation applies to Cayman LLCs, Delaware LLCs and Cayman ELPs. Specifically, in a Cayman LLC or Cayman ELP, the members’ statutory obligation to return distributions is triggered if the company is insolvent (including where the insolvency is caused by the distribution or a release from obligations) at the time when the members have received distributions or are exempt from certain obligations. With respect to Delaware LLCs, the statutory obligation to return distributions is triggered if the LLC’s outside obligations exceed the fair value of the company’s assets following a distribution to its member (which do not include the obligations of LLC members with respect to their LLC interests or the rights of creditors to specific assets of the LLC).

For all three types of entities, an investor must have been aware of the entity’s insolvency in order to be subject to a distribution return obligation. Merely the fact that the enterprise became insolvent does not necessarily trigger a distribution return obligation, which indicates that all three types of entities provide substantial protections to investors. The largest difference among these three entities is the time period within which an investor may

⁴ Limited Liability Company Agreement, also known as the Operating Agreement. It should be noted that the Delaware LLC Act does not obligate the Delaware LLC to have a written LLC agreement.

⁵ Exempted Limited Partnership Law (2018 Revision), as revised from time to time.

⁶ According to the Cayman ELP Law, if a limited partner was actively involved in Cayman ELP’s operations when the Cayman ELP became insolvent, the limited partner may be subject to unlimited liability with respect to transaction counterparties who knew of the limited partner’s participation in the business operations and believed that the limited partner was a general partner with respect to the debts and obligations that the company incurred during the limited partner’s active participation in the operation of the company.

be subject to a distribution return obligation. Specifically, there is no time limit for Cayman LLCs, which means that the company may require its members to return distributions at any time. For Delaware LLCs, the time limit is three years after the corresponding distribution is made, unless otherwise required by the LLC Agreement. For Cayman ELPs, the time limit is six months after the corresponding distribution is made. In practice, most mature funds will further clearly stipulate about the investors' obligations to return distributions in their organizational documents, but in no way should such provisions exclude the statutory distribution return obligation.

iii. Easy registration process

First, compared to the Cayman ELP, a key advantage of the Cayman LLC is that its establishment only requires the registration of one Cayman entity, while the establishment of a Cayman ELP necessarily requires the registration of not only a Cayman ELP entity, but also at least one local entity in the Caymans to act as a general partner (which may be a foreign company or a foreign partnership in accordance with Cayman law). The Cayman LLC and Delaware LLC have no requirements for residency of their members, which means all Cayman LLC and Delaware LLC members can be investors either registered or residing outside of the Caymans.

Second, compared to the Delaware LLC, Cayman LLCs are subject to simpler registration procedures, with the process being quite similar to that of the Cayman ELP. Specifically, one only needs to submit a registration statement containing basic information to the Cayman LLC Registry to register a Cayman LLC and pay the required filing fee. No LLC agreement is required to be submitted as part of the registration process, and the registration statement itself may be used as the LLC agreement if so agreed by the members. Both Cayman LLCs and Cayman ELPs are required to have a registered office in the Caymans, but need not designate a registered agent responsible for receiving documents. Delaware LLCs, however, must designate a registered agent for receiving the official and legal documents.

iv. Flexible corporate governance

As mentioned above, the Cayman ELP is managed by a GP, and LPs are not allowed to actively participate in business operations as a condition to having limited liability. The Cayman LLC is very different in this respect. Both Cayman LLC and Delaware LLC members can freely select the management structure that they find most appropriate. The LLC may be managed by one or more members, by one or more managers elected from outside the members or by a management team that comprises both.⁷ Members who serve as managers are still be entitled to limited liability despite their management duties. Thus, managers are not required to assume any debt, obligations or liabilities of the LLC in their own name, unless otherwise agreed in the

⁷ In private equity fund practice, in most cases, management of a Delaware LLC undertaken by one (or more) members.

LLC Agreement. In addition, both LLC managers in Cayman and Delaware are entitled to statutory indemnification for their management services unless otherwise agreed in the LLC Agreement.

In terms of management rights, the management of a simple majority of a Cayman LLC's members have decision-making authority shall be vested in its members acting by a majority in number over the LLC, unless otherwise stipulated in the LLC Agreement. By default, members holding a majority of the profits interests of a Delaware LLC have decision-making authority.

v. Minimum duty of good faith

One of the issues that most influences the choice of fund entity are the fiduciary duties and duty of good faith imposed on managers. The Cayman ELP, Cayman LLC and Delaware LLC all have different statutory requirements in this regard.

1. Cayman ELP

According to the Cayman ELP Law, the GP of a Cayman ELP is obligated to act in good faith with respect to the Cayman ELP, and is required to act in the interests of the Cayman ELP unless as otherwise expressly provided in the partnership agreement.

2. Cayman LLC

According to the Cayman LLC Law, a manager is only obligated to act in good faith, unless the LLC Agreement otherwise stipulates. This duty of good faith can be limited but cannot be excluded by the LLC Agreement. Managers do not have any other legal obligations to a Cayman LLC, such as fiduciary duties, etc.

3. Delaware LLC

Under the Delaware LLC Act, the managers or members have obligations to the Delaware LLC and to other managers and members, including fiduciary duties. Except for the implied contractual covenant of good faith and fair dealing, the LLC Agreement can limit or exclude the obligations of the managers or members.⁸

In summary, all three entity types may limit the obligations of managers through a partnership agreement or an LLC agreement, but managers are subject to a duty of good faith under the applicable laws.

vi. Flexible equity ownership and capital contribution and distribution methods

One of the biggest highlights of LLCs is that they allow the management of the company to be governed to the maximum extent by its organization documents (i.e., the LLC Agreement).

⁸ Black's Law Dictionary: implied contractual covenant of good faith and fair dealing refers to an implied covenant to cooperate with the other party to an agreement so that both parties may obtain the full benefits of the agreement; an implied covenant to refrain from any act that would injure a contracting party's right to receive the benefit of the contract.

Both the Cayman LLC and the Delaware LLC allow members to freely decide on various matters, including capital contributions, voting rights and distributions, while also ensuring the limited liability of each member and maintaining the independent legal personality of the LLC. For example, members of LLCs are required to pay contributions only in accordance with the LLC agreement. Pursuant to the LLC agreement, such contributions may be made in the form of cash, property or other assets, and in the form of services (e.g., contributions of labor). Cayman LLCs may establish capital accounts for members, share profits and losses and make distributions according to the LLC agreement rather than based upon proportionate ownership. Such distributions are not subject to “same shares, same rights” restrictions. Cayman LLC ownership interests can be divided into different classes, with each class carrying different economic benefits and management rights.

vii. Advantageous tax preference

The Cayman islands are a tax neutral jurisdiction, which creates special advantages for Cayman entities, including Cayman LLCs and Cayman ELPs. The Caymans do not currently levy taxes on the profits, income or gains of Cayman LLCs or their members, which is the same for Cayman ELPs. The Cabinet may on application give Cayman LLCs can also apply to the Financial Secretary for a tax undertaking certificate that will exempt the Cayman LLC from income and inheritances taxes for a period of up to 50 years should the Caymans enact legislation that would otherwise impose taxes on the Cayman LLC.

II. Advantages of forming private equity funds using the Cayman LLC form

The Cayman LLC combines the features and advantages of the Cayman exempt company and the Cayman ELP, and it has similarities with the Delaware LLC, which is familiar with private equity industry insiders and brings certain unique advantages for the formation of private equity funds:

i. Limited liability protection and independent form, flexible internal governance and assignment of rights and interests

As mentioned above, the Cayman LLC is similar to the Delaware LLC in that it integrates the flexibility of a Cayman ELP while retaining the legal personality and limited liability of a Cayman exempt company. The LLC agreement, like a Cayman ELP partnership agreement, can be used to freely agree upon almost all Cayman LLC internal governance mechanisms and the assignment of rights and interests. Cayman LLCs can set up capital accounts for members and can flexibly agree on investment obligations, income distributions, loss sharing and accounting mechanisms without the restriction of affording the same rights to the same shares in the case of the Cayman exempt company. These features are quite important for fund entities, especially for common tax distributions (that is, making distributions to individual investors to meet their tax obligations).

ii. Managers need only to act in good faith and are not required to undertake

burdensome fiduciary duties

As stated earlier, unless the LLC agreement stipulates otherwise, a Cayman LLC manager is required only to undertake a minimum duty of good faith. This advantage is particularly reflected in the case of an LLC manager that manages multiple funds. For many large institutions, the management of more funds they manage, may lead to the greater possibility occurrence of conflicts of interest may occur, which will place increasing pressure on fund managers to undertake fiduciary and due diligence duties. With a Cayman LLC, the fund manager can agree on its obligations and those of the fund on the basis of a minimum statutory duty of good faith, which will bring convenience to the operation of the fund.

iii. Convenient formation of onshore-offshore fund structures

The Cayman LLC is, to a large extent, a new type of entity form that the Cayman authorities have provided in response to market demand, with much of that demand deriving from the requirement of U.S. fund managers that the interests of both onshore and offshore investors be as consistent as possible. In view of the wide adoption of the LLC form in the United States (particularly Delaware LLCs), the similarities between the Cayman LLC and the Delaware LLC have greatly facilitated the design of onshore-offshore fund structures by U.S. fund managers to ensure that the obligations of both onshore and offshore investors may be substantively uniform. The use of similar structures can simplify the relevant documents and reduce drafting and review costs.

III. Applications for Cayman LLCs

Due to the advantages of the Cayman LLC, it has become widely used in the establishment of funds and has been welcomed particularly by U.S. fund managers.

Based on data published by the Cayman Islands Government General Registry, 1,073 Cayman LLCs have been formed since their introduction until the end of February 2018. While it is difficult to say how many of these Cayman LLCs are fund entities, we certainly believe that both private equity funds and mutual funds have all considered utilizing the Cayman LLC form and that Cayman LLCs will continue to be established. In addition to direct be used as fund entities, Cayman LLCs have increasingly been accepted as entities of private equity fund companies have increasingly accepted Cayman LLCs as conventional fund general partners and fund managers.

The Cayman LLC presents a number of advantages in theory as a vehicle for private equity and mutual funds, although it has not yet become widely adopted due to its the limited time since its introduction to in the market. Clearly, the Cayman LLC still requires a certain amount of time for acceptance by the industry, but longer term many of its advantages may attract more fund managers to form Cayman LLCs.

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Important Announcement

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