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HAN KUN

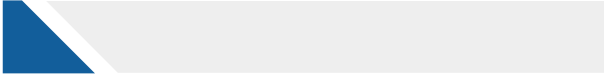
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HAN KUN 2022-2023 Fund Practice Data Analysis Report

2024.11

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Part 1 Introduction

2023 was an eventful year. Although Covid-19 gradually lost its potency to impact on people's lives, the hot wars in Ukraine and Gaza, the continuation of trade wars and the heightened geopolitical tensions dampened investment sentiment across the globe and frustrated the widely anticipated speedy and robust economic recovery in China and elsewhere. Few were spared from the consequences.

These negativities notwithstanding, there were some bright spots. One of them was the domestic private funds industry in China which continued to grow despite the odds. The sector's resilience was due in large part to the government policy goals of stabilizing growth, promoting reforms, adjusting the development paradigm and preventing risks and the cornerstone support of government guide funds which encouraged a broad spectrum of industry investors, such as listed companies and local leading enterprises, to actively participate in fund-related activities.

The amount of legal work we did for our clients was a testament to the resilience of the Chinese domestic fund industry. For example, we served as legal counsel for several hundred fundraising projects during the 2022-2023 period and provided comprehensive legal services covering the entire life cycle of investment funds from their formation and deployment to their dissolution and liquidation.

This report analyzes the Chinese private equity fund industry from the perspective of key transactional terms and conditions, all based on the data collected from projects in which we served as legal counsel during the 2022-2023 period and certain prior years. We believe the evolution of such terms and how they have been used in transactional documents may help readers of this report to profile the current landscape of Chinese private fund industry and better understand the development in China of the fund industry as a whole.

We publish this report annually with a view toward conveying useful information to our clients, friends and professionals interested in the private equity market in China.¹

Unless otherwise defined, the transactions or funds referred to in this report are private equity fund formation transactions we worked on as legal counsel in the specific years as indicated.

¹ This Report only covers fundraising projects on which Han Kun has advised, excluding fund investment projects. In addition, this Report only references statistics from part of the closed fundraising projects Han Kun participated in (including initial and subsequent closings), not all fundraising projects on which we advised during 2022-2023 period.

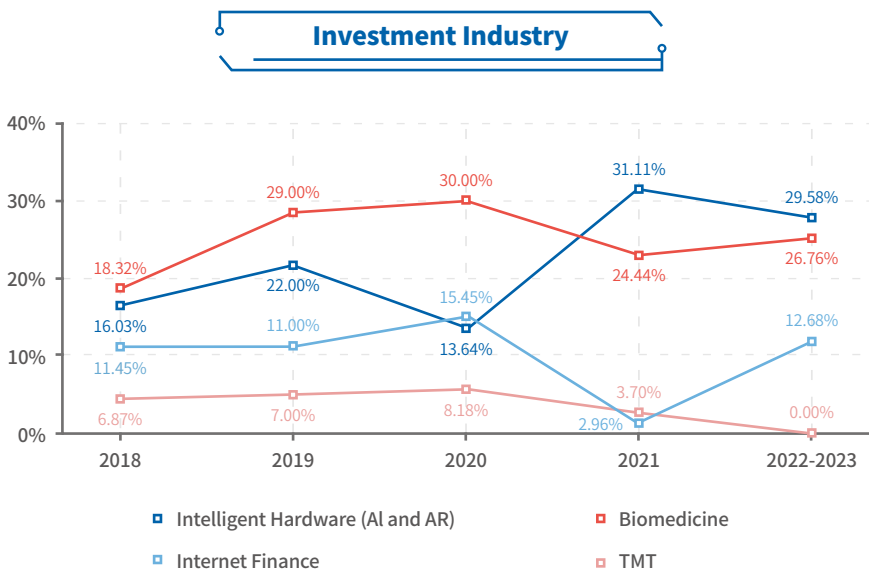
Part 2

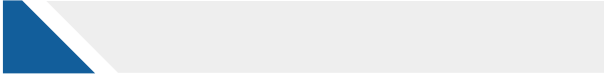
Key Facts, Transactional
Terms and Comparisons

The highlights of the fund transactions during the 2022-2023 period are as follows:

Investment Industry

In the 2022-2023 period, certain industries such as smart hardware (including artificial intelligence and augmented reality), biomedicine and internet finance continued to be favored by private equity investors. Transactions where private equity funds invested in smart hardware and biomedicine accounted for over 50% of the total, while investments in TMT and consumption sectors continued to slide.





While maintaining the existing trend, the market embraced new focal points, albeit with different directions domestically and internationally. For the RMB-denominated funds market, investments rose for new energy infrastructure and other new infrastructure-related sectors, as well as the real-estate sector. Although investments in the real-estate sector by the RMB-denominated funds are subject to various restrictions, such as restricted investment methods and narrowed target assets, their resilience to risks and market fluctuations and relatively stable returns have made them more appealing to institutional investors in the current market environment. With the promulgation and implementation of the *Guidelines for Filing of a Pilot Scheme on Real Estate Private Investment Funds (for Trial Implementation)* at the beginning of 2023, investment by RMB-denominated funds in new infrastructure and other real-estate sectors is expected to continue its path to strength.

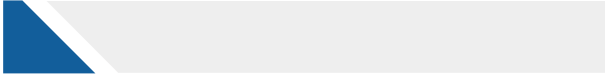
On the other hand, the USD-denominated funds seemed to be more interested in incubating early-stage and innovative portfolios during the same 2022-2023 period. For example, the USD-denominated funds directed to blockchain, and Web3-related fields (based on blockchain technology) reached 13.43% of the total.

Domiciles of Funds

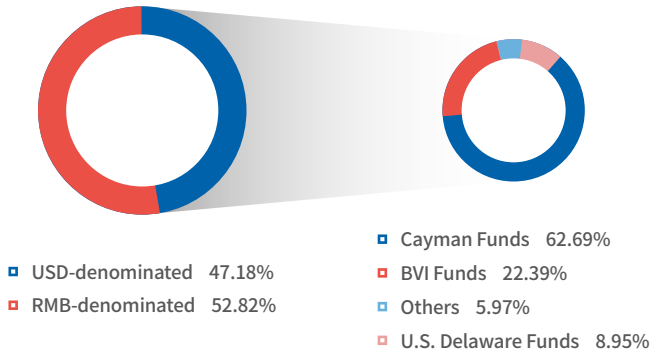
During 2019-2021, the percentage of RMB-denominated funds declined, but this downward trend reversed during 2022-2023, consistent with our observation of the market. As for the USD-denominated funds, the percentage of single-project funds made up 39.53% of the total, a significant increase over that in 2021. In the meantime, top-tier investment institutions dominated the establishment of blind pool funds.

When it comes to the domicile of offshore funds, the Cayman Islands continued to be the prevalent option² although the British Virgin Islands (“**BVI**”) became increasingly popular and its share of being the domicile for offshore funds climbed to 22.39% from 8.96%. As mentioned above, single-project funds had increasing market share, and since they could be exempted from registration in the BVI, the market share of the BVI as the domicile for offshore funds increased as a result. Additionally, the State of Delaware of the United States remained a popular domicile for funds and held steady its market position. The emerging domiciles such as Singapore and Hong Kong SAR are still in the early stage of promotion and development and their market share of being the domicile of funds was limited as of 2023.

² According to the data released by the SEC as of Q3 2023, from Q1 2023 to Q3 2023, the Cayman Islands was the first choice for the establishment of private funds outside the mainland United States: <https://www.sec.gov/data-research/investment-management-data/division-investment-management-private-fund-statistics>.



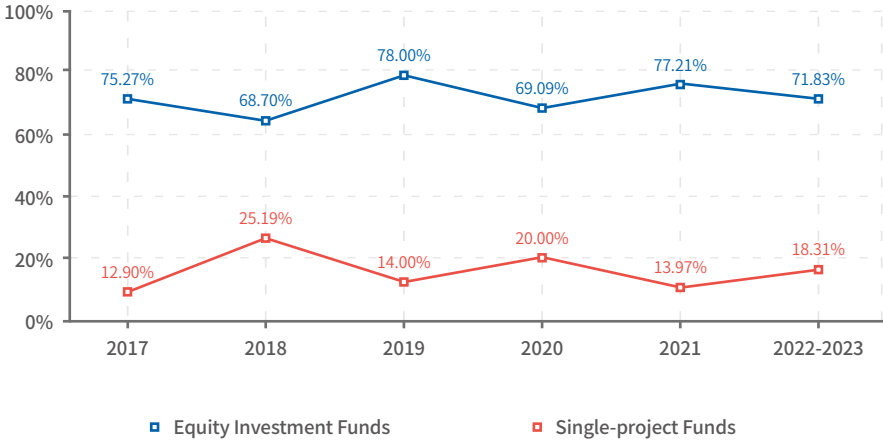
Domiciles of Funds

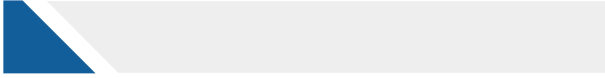


Types of Funds

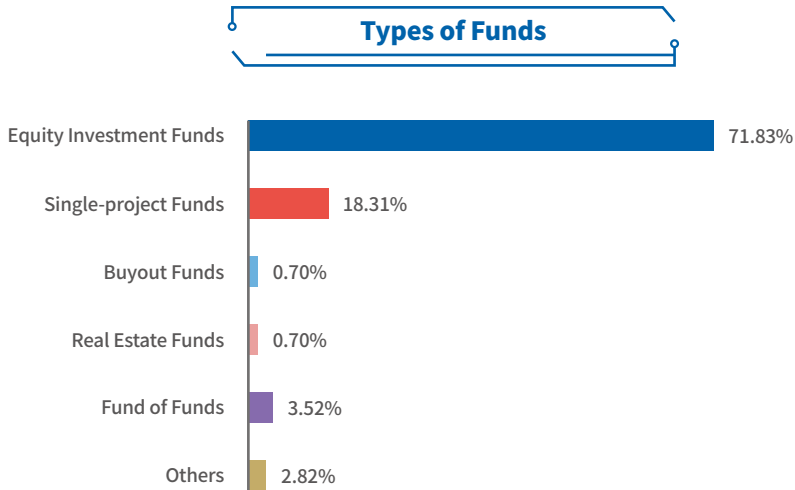
In 2022 and 2023, blind pool equity funds still dominated the industry, accounting for over 70% of the total even when their market share dipped slightly from the level of 2021. In the same period, single-project funds increased their market share.

Types of Funds Trends





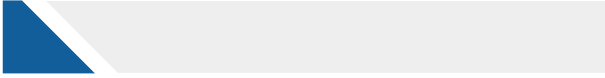
The increase of single-project funds correlated to a more conservative sentiment of the market. Our data show that their market share in 2022 and 2023 was similar to that of 2020.



As to the specific types of funds, the “FOF Investment” is worth paying attention to. On the one hand, fund managers need to fully consider the various demands of their investors, which may require complicated fund structures during the fundraising process. On the other hand, the “FOF investment” as an independent investment strategy is receiving increasing recognition and acceptance under the current market conditions.

Moreover, against the backdrop of the economic slowdown and increasing difficulty in fundraising, government guide funds, established in the form of fund of funds by different levels of the government, have become an indispensable segment of the RMB-denominated fund market. As the market develops and experience accumulates, the government guide funds have become more market-oriented than ever and their operations more sophisticated. Going forward, they are expected to provide a comfort zone for private funds and harness their experience and ability of sourcing investment opportunities and incubating investees to the benefit of all the parties involved.





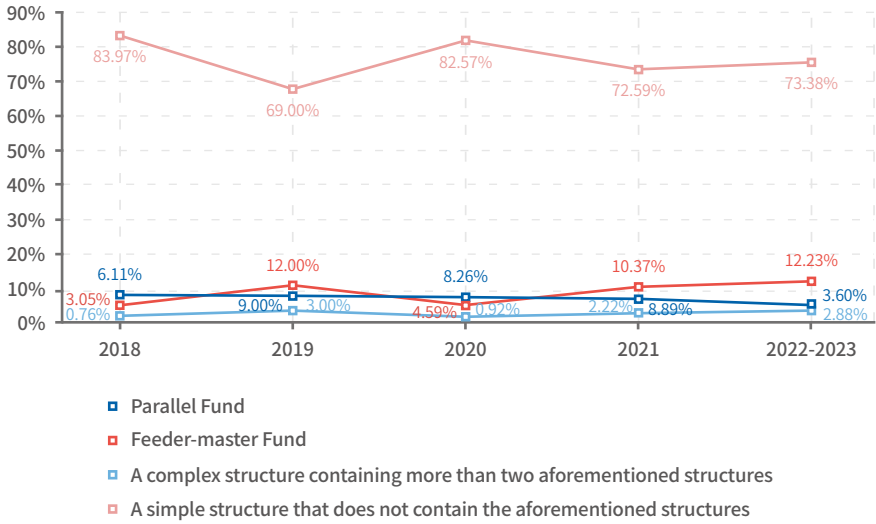
Fund Structures

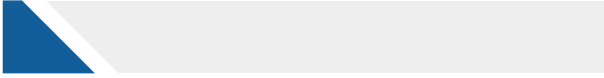
Broadly speaking, fund structure involves primarily the fundraising structure, which aims to accommodate needs of various investors and the governance structure, which deals with the equity arrangement for the fund managers.

Fundraising Structures

Fund structures designed to raise capital typically include, on the one hand, special structures such as the parallel fund structure, feeder-master fund structure, umbrella fund structure and simple fund structure (which does not incorporate any of the aforementioned special structures) and, on the other hand, complex fund structure (which combines two or more of the aforementioned special structures). According to our data of 2022 and 2023, the percentage of market share of each fundraising structure did not change much as compared to the previous years. Among them, the simple fund structure remained the market leader accounting for 73.38% of the total, followed by feeder-master structure, while the usage of parallel fund structure registered a slight decline.

Fund Structures Trends





As a general matter, the primary objective of any given fund structure is to imbed sufficient flexibility to accommodate different types of investors and capital. Correspondingly, fund managers will have to bear increased operational and compliance costs. Complex fund structures are often used for large-scale funds with numerous investors and complex capital compositions.

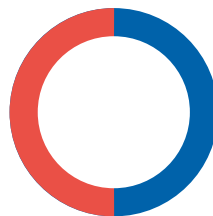
The fundraising structures as they exist today may very well reflect the following: Firstly, all fund managers are currently experiencing some difficulty in progressing capital raising and the fund sizes have shrunk. Secondly, since single-project funds predominantly adopt simple fund structure, the relative increase of single-project funds naturally leads to an increase of simple fund structures. Thirdly, the higher compliance requirements for RMB-denominated funds and the increased management cost for the complex fund structure necessitate fund managers to opt for economically efficient structures.

| Governance Structure |

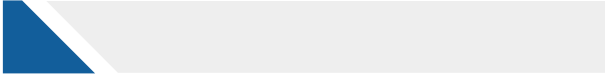
As to the governance structure, attention needs to be paid to the management authority and constraints on the incentive plans.

Since the limited partnership is still the predominant organizational form for private funds, managers primarily exercise control over the funds by (i) serving as the GPs (the GP and the manager being the same entity) or (ii) by establishing a separate GP entity and retaining the ultimate control of both the manager and the GP (the GP and the manager being separate entities). According to our data, (i) above was equally popular as (ii).

Governance Structure



- GP and Manager being separate entities 50.00%
- GP and Manager being the same entity 50.00%

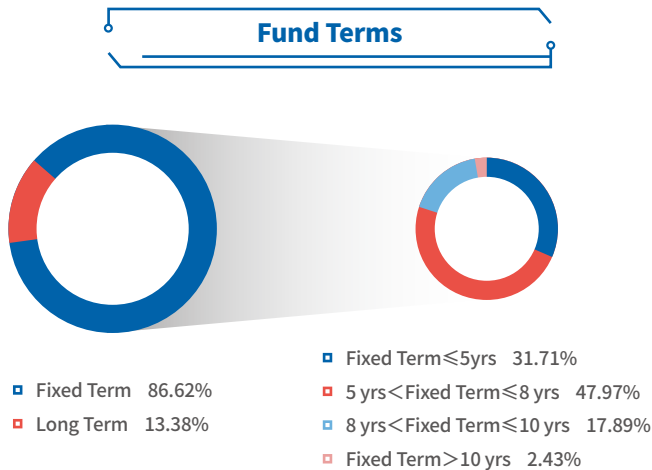


As to the incentive constraints, both employee co-investment and the distribution of carried interest are generally accommodated. This topic is further discussed below under the caption Employee Co-investment.

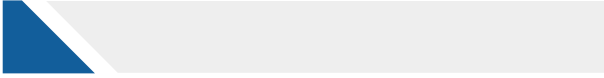
Fund Terms

Initial Fund Terms³

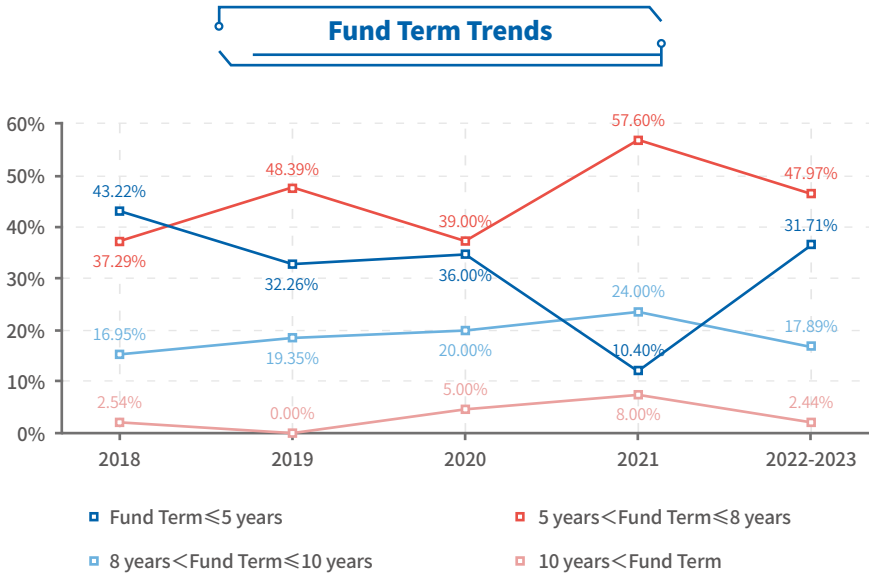
According to our data for 2022 and 2023, 86.62% of the private funds had fixed terms and 13.38% of them were long-term funds. This is the first time that fixed-term funds fell below 90% in the past five years. Among the fixed-term funds, the majority had a term between five to eight years, accounting for 47.97% of the total, followed by those with terms of less than five years, accounting for 31.71%. Eight to ten years' funds accounted for 17.89%. Funds with an initial term of more than ten years accounted for 2.44%, an absolute minority.



³ Unless otherwise specified, extension period is not included in the fund term.

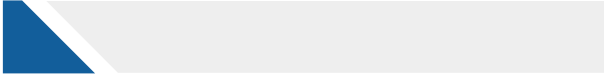


During the 2022-2023 period, funds with a term less than five years increased from 10.4% to 31.71%. These funds were generally small in size focused on late-stage investments or single-project funds. As to RMB-denominated funds, the Asset Management Association of China (the “AMAC”) issued in 2023 the *Measures for the Registration and Filing of Private Investment Funds (“Filing Measures”)*, which retained the existing requirement that private equity funds must have a term of no less than five years unless an exception applies and, at the time, urged fund managers to set up private funds with terms not less than seven years (Article 36 of the Filing Measures). The AMAC may provide guidance on the market through a series of new self-disciplinary rules such as the *Filing Measures* and, as a result, private equity funds with terms of seven years or longer term are expected to be accepted by RMB-denominated fund investors over time.



Extension of Terms by GP

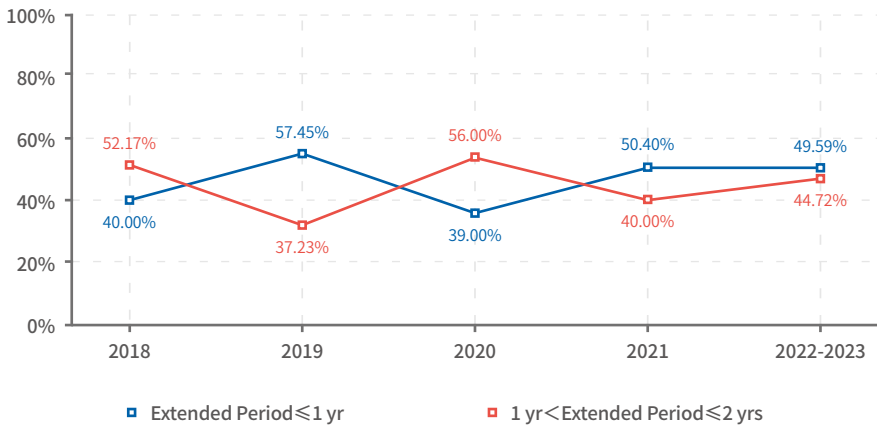
Since 2022, due to multiple factors such as the volatility of the domestic and overseas capital markets and halting economic recovery, it has been difficult for private equity funds to exit investment in their portfolio companies through IPO. As a result, many private funds were caught in the unenviable position of not being able to exit while their terms were soon to expire. Consequently, GPs started to demand greater autonomy to extend fund terms during fundraising negotiations.

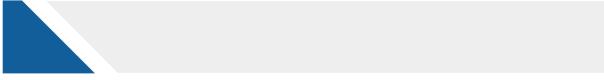


According to our data of the past five years, GPs were usually permitted to extend fund terms up to one or two years and one-year extensions were equally as popular as the two-year ones. It is interesting to observe the dynamics between one-year and two-year extensions. In each of 2018 and 2020, more than half of the GPs had the discretion for a two-year extension while no more than 40% of the GPs had the one-year extension discretion. In each of 2019 and 2021, on the other hand, more than 50% of the GPs only had the one-year extension discretion, while no more than 40% of the GPs could independently extend fund terms by two years. During the 2022-2023 period, 49.59% of the funds extended the fund terms by one year, while 44.72% by up to two years. In summary, the extension by one or two years was the mainstream practice in the market.

The GPs' power and discretion to extend fund terms are often circumscribed by the types of funds: (i) blind pool funds generally limit GPs' discretion to a one-year extension, and (ii) single-project funds tend to allow a two-year extension. Based on our observations, in each of 2019 and 2021, due to the higher number of blind pool funds launched than other years, there was a higher percentage of funds having one-year extensions. In contrast, the proportion of funds with a two-year extension was relatively high in other years.

Fund Period Extension Trends





Investment Period

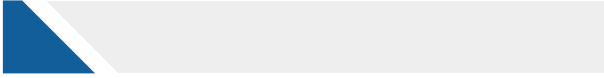
Investment period is critical for a fixed-term blind pool fund. The fund manager will actively source and invest in projects during the investment period, which requires a high level of management effort. Once the period expires, investment activities of the fund will subside. In addition to tracking and managing the investment portfolios, the manager is likely to devote less effort to source and invest in new projects and may instead divert its primary attention to fundraising and investing in subsequent funds. Therefore, from an economic point of view, the calculation basis or the rate of the management fee during the investment period will be relatively high. In addition, the length of the investment period will also have a direct impact on the flexibility of the fund manager in making investments. In fact, the length of the investment period depends largely on two factors: (i) objectively, the economic situation and market vitality, and (ii) subjectively, the ability of the fund manager to source investment opportunities and forecast market developments.

According to our data, the percentage of private funds with an investment period of no more than three years increased significantly to 39.08% in 2022-2023, far exceeding the average of 24% in the past four years. One would speculate that the increase of blind pool funds with such a tight investment period was a result of the mounting difficulty in fundraising and the requirements of government guide funds.

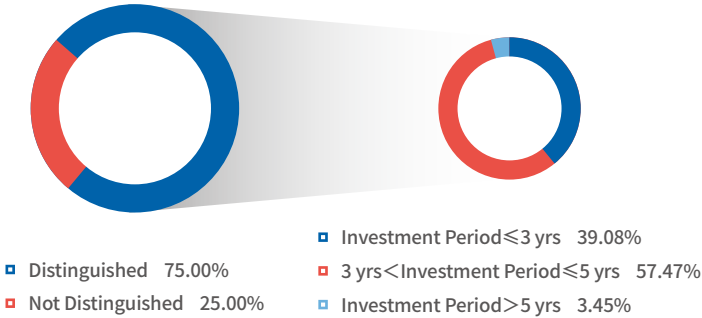
Despite the sharp increase of private funds with one-to-three-year investment period, the three-to-five-year period was still the mainstream, accounting for 57.47% of the total. In addition, the government policy encouraging high-quality growth had a direct impact on the trajectory of the private equity industry. On the one hand, managers focused more than ever on project quality rather than investment speed and they tended to set longer investment periods than before to pursue better quality projects and higher investment returns. On the other hand, since it became increasingly difficult to source good investment opportunities, managers tended to set longer investment periods to retain flexibility for the investment progress and deal with contingencies caused by unexpected changes in the market.

In 2022-2023, more than half of the private funds did not set any extension for the investment period. As a general matter, where the extension is provided for, it usually is very short. Where the original investment period is long, it would be difficult to request an extension. In addition, the extension is generally subject to agreement by investors.





Investment Period Clauses of Blind Pool Funds

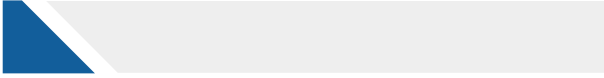


Plans for Liquidation

Since the promulgation in 2006 of the amendment to the *Partnership Law of the People's Republic of China* which embraced “limited partnership”, domestic private fund industry has developed rapidly, especially around 2010 when many private equity funds were set up locally and began making investments. Today, most of the early funds have come to the end of their lifespan of eight to ten years or, at the expiration of their term extensions, are being liquidated. As legal counsel assisting clients to deal with dissolution and liquidation, we have found that the liquidation arrangements of some funds are at odds with what is required for dissolution and liquidation. The main issues are as follows:

Firstly, documents of private funds often provide, in the spirit of autonomy of will, that the fund may be dissolved and liquidated if a certain percentage of the partners agree to do so instead of unanimity of all partners. However, many local regulatory departments require that the decision to dissolve a fund must be based on a unanimous agreement among all partners of the fund. This requirement in effect gives each partner veto power to the decision. If the partners have conflicting interests or if one of them remains incommunicado or otherwise does not participate in the fund's operation, the requirement would be an impediment to the proper dissolution and liquidation of the fund.



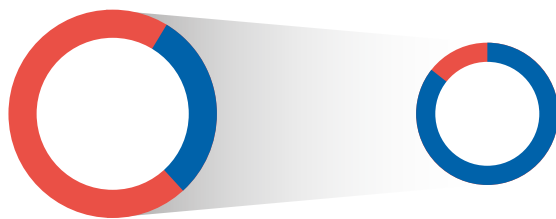


Secondly, although many private funds explicitly provide for the liquidation period, they may not be dissolved if the projects or assets invested by the funds have not been completely disposed of when the liquidation period expires. Considering the current difficult environment for investors to exit investments, it is likely that the liquidation period would be exceeded if the manager starts to dispose of the non-performing assets only after it has announced plans to put the fund through dissolution and liquidation. It is, therefore, advisable for a fund manager to plan for asset disposal and fund liquidation well in advance to avoid being caught off guard. To help investors completely exit their investment and pave way for the fund to be dissolved and liquidated, one thing to consider is to set up a separate fund to hold the assets in the original fund waiting to be dissolved. Alternatively, when the liquidation period is about to expire, the fund manager may consider setting up an SPV and transfer to the SPV assets held by the fund which are otherwise difficult to dispose of.

In addition, the length of the liquidation period is likely to affect the management fee charged during the liquidation period and investors increasingly demand that no management fee should be due and payable during the liquidation period. Only when a manager takes the initiative to fulfill its duties and provides valuable services during liquidation would it be entitled to negotiate with investors for management fees during the liquidation period.

Finally, private funds are complex in terms of their structure, finance accounting and tax arrangement. This complexity is an impediment to a timely and orderly liquidation of the funds.

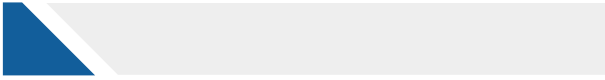
Liquidation Periods Clauses



■ Specified 29.58%
■ Not Specified 70.42%

■ 1 yr 85.71%
■ 2 yrs 14.29%



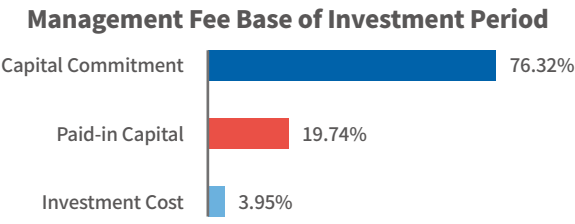


Calculation of Management Fees

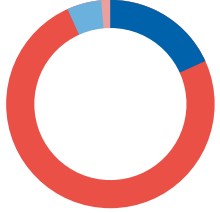
Management fees are the primary source of income for a fund manager to maintain its own day-to-day operations. As noted earlier, the amount of fees varies depending on the manager’s commitment to the fund, its costs, and its sources of income during and after the investment period. It is a market practice that higher fees are paid to the fund manager before the investment period ends and lower fees thereafter.

According to our data for 2022-2023, 76.32% of private funds chose the amount of committed capital as the basis for calculating the management fees for the investment period, while 19.74% of them chose the total paid-in capital as the basis for the fee calculation, which was significantly higher than 17.86% as recorded in 2020. The changes in fee calculation corresponded to the changes in the fundraising market where government guide funds and state-owned investors, which generally require to use the paid-in capital for calculating management fees, gained a bigger say in the market. Since some fund managers charged lower rates of fees to government guide funds in exchange for a profit-sharing arrangement with such funds, the use of paid-in capital to calculate management fees may in effect have been higher than 19.74%. As to the rate of management fees during the investment period, 2% per annum was the market norm in 2022-2023, accounting for 75% of the funds. This figure was 75.99% from 2017 to 2023.

Calculation of Management Fee (Investment Period)



Management Fee Rate of Investment Period

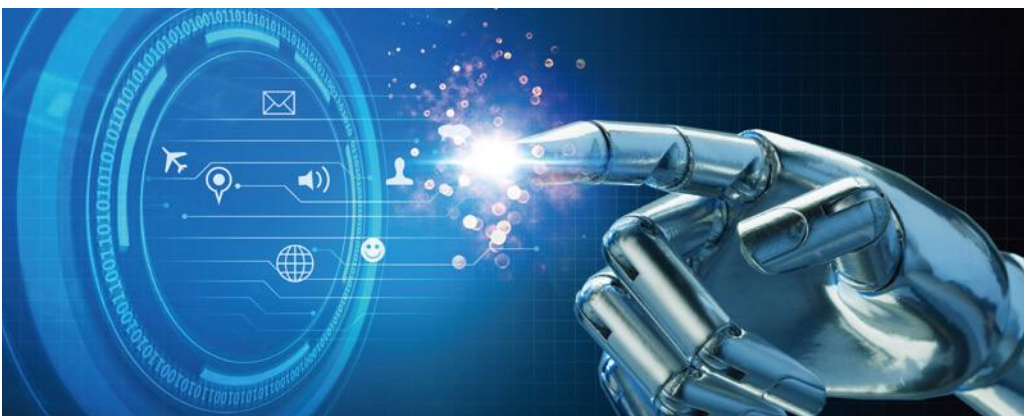
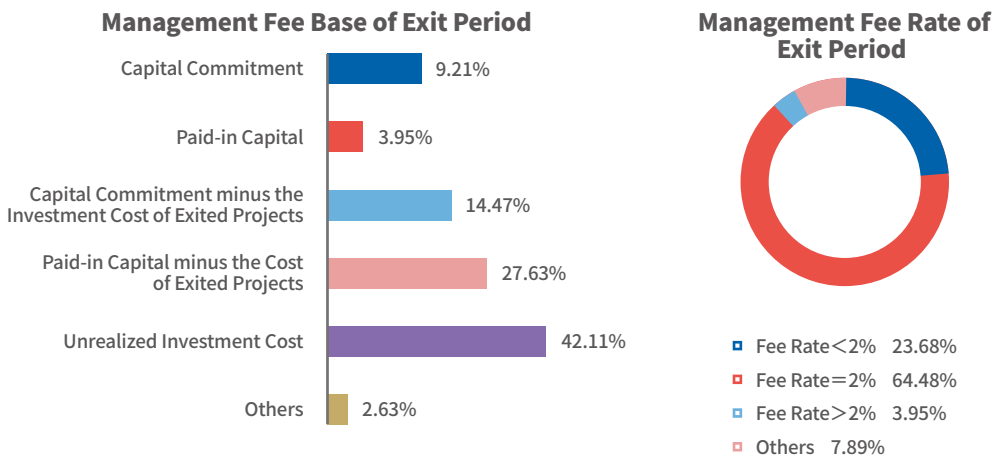


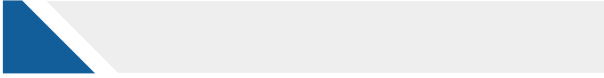
- Fee Rate < 2% 18.42%
- Fee Rate = 2% 75.00%
- Fee Rate > 2% 5.26%
- Others 1.32%



In the past, management fees for the exit period were based on the investment cost of non-exited projects. In 2020 and 2021, over 50% of the funds used this method. In 2022-2023, however, that figure went down to 42.11%. The percentages of funds using other methods to calculate management fees for the exit period were as follows: paid-in capital contributions minus investment costs of exited projects (27.63%), committed capital minus investment costs of exited projects (14.47%), committed capital (9.21%) and paid-in capital contributions (3.95%). For 64.47% of the funds, the rate of fees for this period was the same as for the investment period—2% per annum, while 23.68% used a rate lower than 2%, reflecting some funds may use the same basis of calculation but apply different rates.

Calculation of Management Fee (Exit Period)

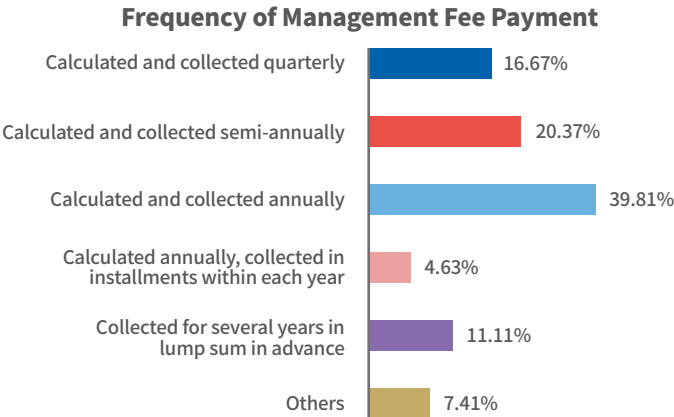




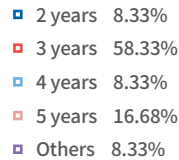
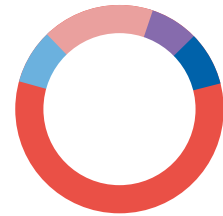
Frequency of Management Fee Payment

The frequency of management fee payment has become a point of contention for both managers and investors. On the one hand, management fees are the main source of income for managers to maintain stability of the management team before receipt of the carried interest. A stable income is crucial for the managers to both grow and optimize the management team and to attract and retain talent. For investors, on the other hand, they want managers to constantly improve the efficiency of capital to be invested and the accuracy of accounting. To that end, investors often demand strict limitations on the use of each installment of their capital contribution and restrict the amount of capital reserved for the management fees. According to our data, more and more funds decide to pay management fees on an annual basis and that percentage was 39.81% in 2022-2023, an all-time high.

Frequency of Management Fee Payment



Collected for Several Years in Lump Sum in Advance



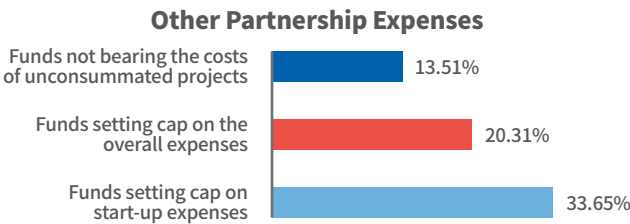
For single-project funds, managers often choose to withdraw all their fees in a lump sum or set aside an amount sufficient for a multi-year management fee payment. This is because for a single-project fund, all money would be invested in a single project and there is no need to reserve money for future projects. Furthermore, most single-project funds require a lump sum capital contribution and once they complete the target investments, the funds will not receive any additional capital for a long time or ever. It is, therefore, more efficient for such funds to allow a lump sum payment of multi-year management fees. In 2022-2023, 58.33% of the single-project funds chose to pay management fees in a lump sum, an all-time high.



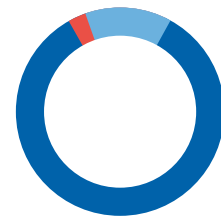
Other Partnership Expenses

Apart from the management fees, partnership expense is another point of contention between managers and investors. Questions such as whether the funds should bear the costs of failed investments and whether any specific or overall partnership expense should be capped frequently dominate fundraising negotiations. According to our data of 2022-2023, 13.51% of the funds chose not to be responsible for the cost of failed projects, a huge increase from 7.25% recorded in 2021, even as 83.78% of the funds, a predominant majority, decided to bear such cost. In addition, 20.31% of the funds set a cap on the overall expenses, while 33.65% of them put a cap on start-up expenses. This balanced arrangement between managers and investors seems to have addressed each other's concerns.

Other Partnership Expenses



Costs of Unconsummated Investments

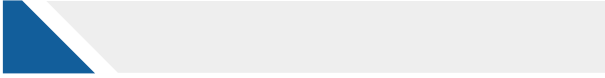


- Borne by the fund 83.78%
- Borne by the fund with a cap 2.70%
- Not borne by the fund 13.52%

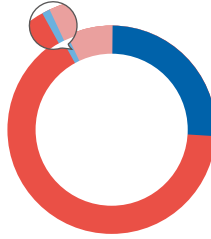
Distribution Mechanisms

Partner-by-Partner Allocation

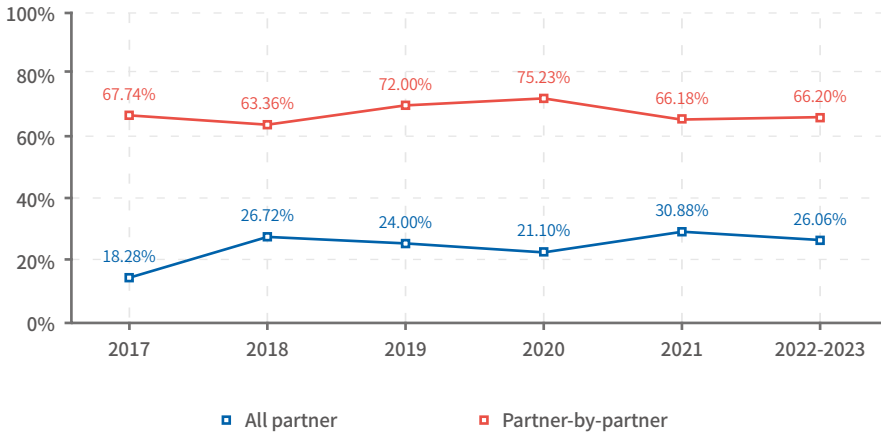
Compared to 2021, more funds adopted the partner-by-partner allocation method for distribution in 2022 and 2023, as opposed to the all-partner allocation method, accounting for over 60% of the total. For one thing, this method offers greater flexibility for partner distribution. For another, more and more government guide funds and state-owned capital investors have come to appreciate and accept the partner-by-partner allocation method.



Partners Distribution Mechanisms



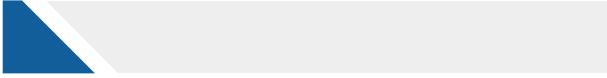
- All partner 26.06%
- Partner-by-partner 66.20%
- Mixed 0.70%
- Others 7.04%



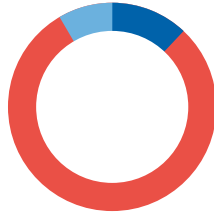
Capital Return

Over the past six years, the by-fund distribution was more popularly adopted than the by-deal distribution by a large margin. Although the popularity of the by-fund method slipped a knot in 2022 and 2023 compared to 2021, it remained the method of choice.

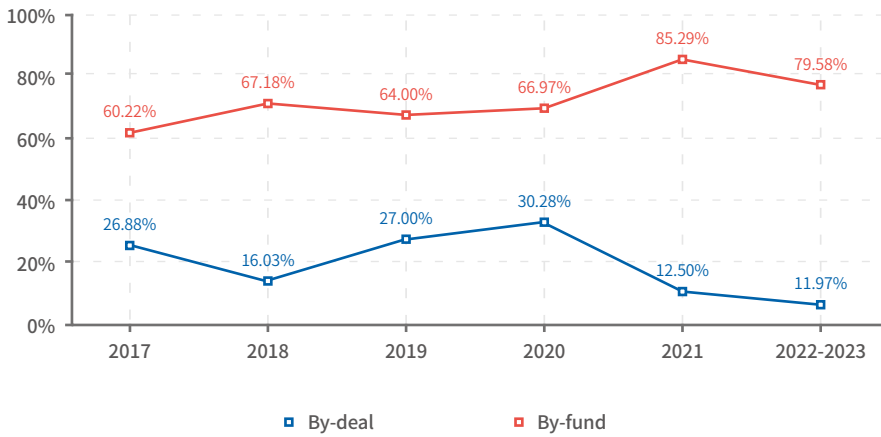




Return of Capital

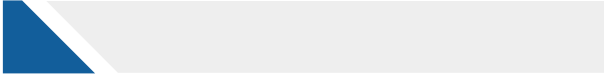


- By-deal 11.97%
- By-fund 79.58%
- Others 8.45%



As is shown in our data, investors increasingly favored the preferred return for their capital investment which was met with equal measure of acceptance by fund managers and GPs.





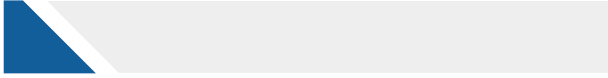
In addition, more than half of private funds adopted a GP claw-back clause in 2022 and 2023. When combined with the GP claw-back, the by-deal distribution would simply lead to an earlier distribution of carried interest without significantly impacting on the amount of the carried interest allocated to the fund managers/GPs. If the by-deal distribution is adopted and the GP claw-back actually occurs, the GPs would be required to return some of their carried interest to meet the claw-back obligation and consequently result in financial pressure. As a general matter, managers/GPs routinely take into consideration the market condition, investment stage and the exit expectations when they decide which distribution mechanism to adopt.

Preferred Return

Based on our data, around 57.04% of private funds had a preferred return arrangement in 2022 and 2023, showing a slight decline from the 2021 level, although such funds grew in number by about 2% in each of 2021, 2022 and 2023 when compared with 2020. For leading fund managers with robust experience and proven track record, the preferred return would not substantially affect the ultimate amount of carried interest if the private funds under their management can achieve the desired returns and the GP catch-up arrangement is imbedded in the funds. The preferred return arrangement can also help new fund managers to raise capital because it gives confidence to the investors when they invest in the funds under the management of the new managers.

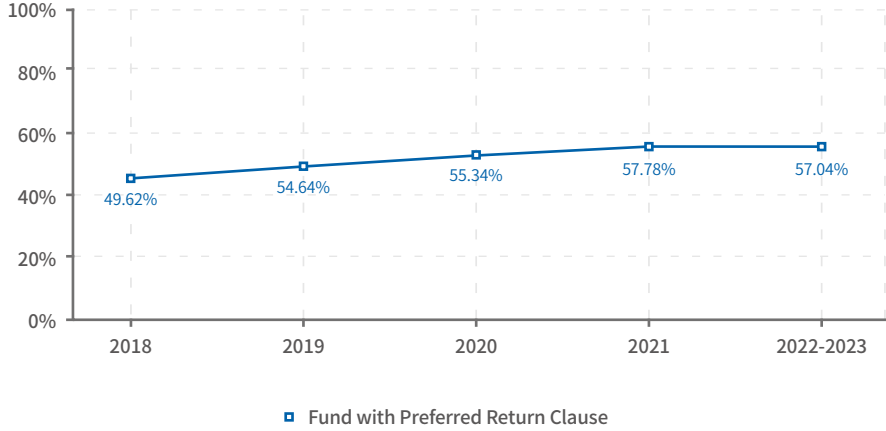
In 2022 and 2023, among all private funds that incorporated the preferred return arrangement, approximately 80% to 90% of them opted for an 8% annual return (including simple interest and compound interest) consistent with the level in 2020 and 2021. This consistency shows that the 8% annual return is the market norm and meets the expectations of investors.



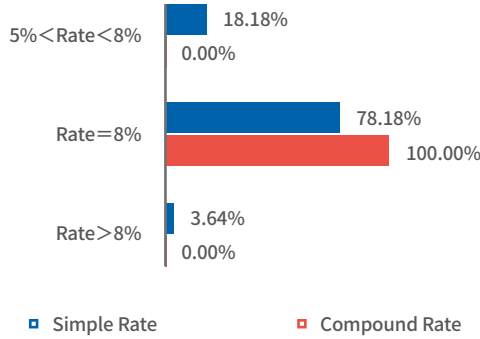


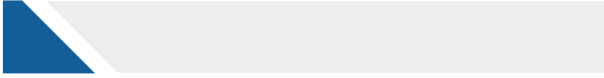
Preferred Return Rate

Preferred Return Clause



Preferred Return Rate

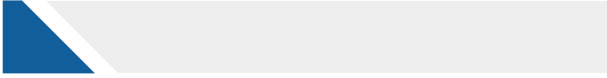




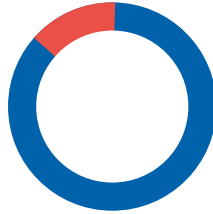
I Tier-Carry I

Under the tier-carry arrangement, if a private fund achieves an overall return higher than benchmark, the GP is entitled to additional carried interest as an incentive to the GP to create value for investors. The tier-carry arrangement generally falls into two categories. The first enables GPs to withdraw additional carried interest from the portion of the return greater than the benchmark amount without retrospectively adjusting the proportion of the carried interest already distributed. The second allows GPs to withdraw additional carried interest from the portion of the return greater than the aggregate capital contributions by investors, with retrospective adjustment to the carried interest already distributed. Although the second model may require investors to share more profits with GPs, it incentivizes GPs to improve the performance of funds under their management. It is not clearcut whether one model is better than the other. In fact, funds with the tier-carry arrangement experienced decline recently. They decreased from 19.1% in 2020 and 17.8% in 2021 to 13.76% during the 2022-2023 period. This decline corresponded with the ascent of government guide funds and state-owned capital investors in the RMB-denominated fund market and the fact that more GPs/managers took a more conservative approach to carried interest in response to the challenging economic conditions.

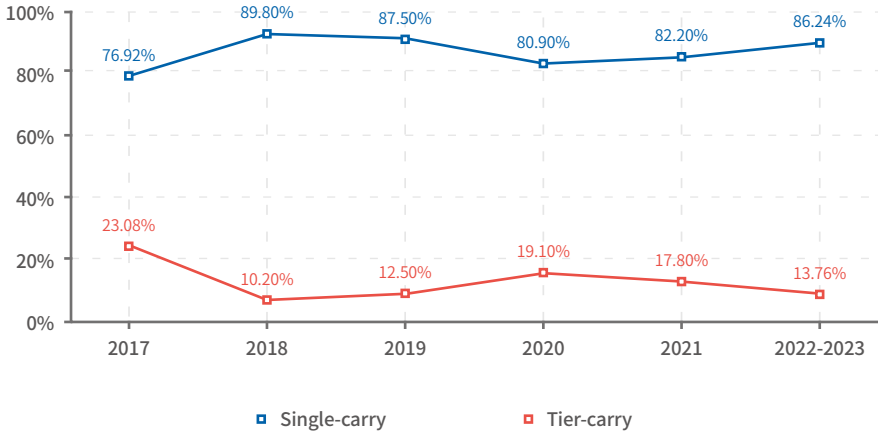




Tier-Carry Arrangements

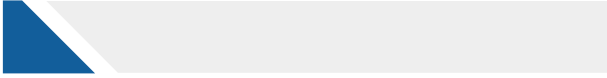


- Single-carry 86.24%
- Tier-carry 13.76%

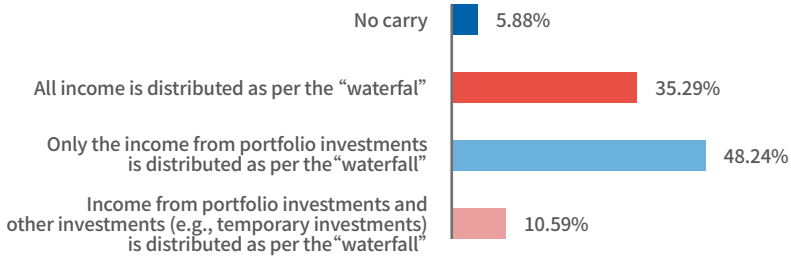


Distribution of Income

Private funds often adopt different methods of distribution to parcel out different types of income. For example, income from portfolio investments is often allocated through a “waterfall” approach, allowing GPs to receive their carried interest. It is common for income produced from temporary investments, liquidated damages and indemnities to be distributed directly to investors on a pro-rata basis. Based on our data, approximately 35% of private funds in 2022 and 2023 chose to distribute their entire income by way of the “waterfall”, higher than any of the past four years. At the same time, around 48% of the funds used the “waterfall” only for income from portfolio investments, a significantly lower percentage than the 60% of 2021.



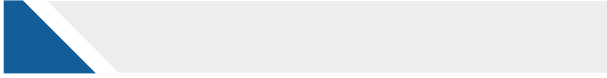
Distribution of Income



GP Claw-back

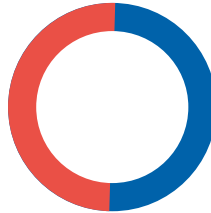
Based on our data, more than half of the private funds in 2022 and 2023 had a GP claw-back clause, less than the 2021 level of 63.97%. In theory, the GP claw-back obligation could be triggered by either a modified by-fund distribution or a modified by-deal distribution mechanism. In practice, however, the GP claw-back obligation is more likely triggered under the modified by-deal distribution scenario. To ensure that GPs could fulfill their claw-back obligation, investors often require the GPs to deposit a portion of their carried interest into an escrow account up to a target amount or a target ratio. In 2022 and 2023, funds with the escrow account arrangement further declined to 4.23% as compared to 9.17% in 2020 and 8.82% in 2021. The decline seemed to correlate directly with the corresponding increase of funds adopting the modified by-fund distribution arrangement.





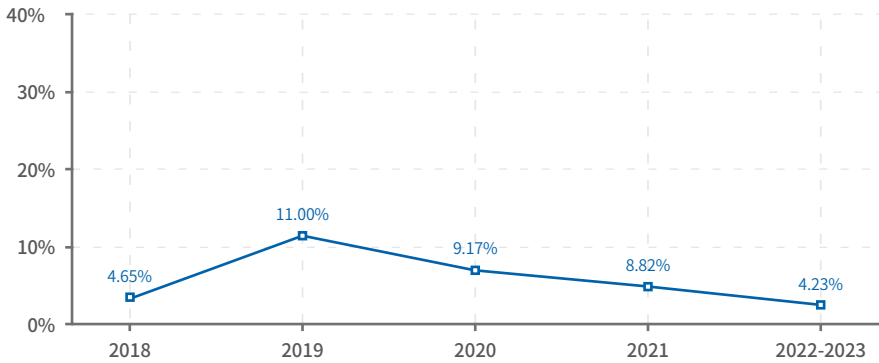
GP Claw-back

GP Claw-back Clause



- With GP Claw-back 50.70%
- Without GP Claw-back 49.30%

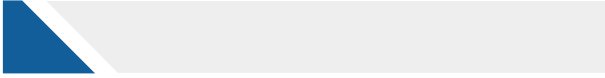
Escrow Accounts Clause



- With Escrow Accounts Clause

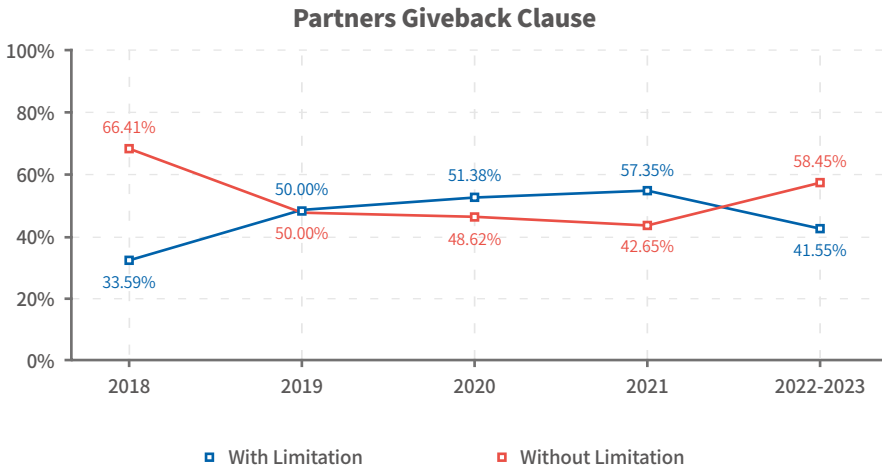
Partner Givebacks

The counterpart to the GP claw-back provision is the limited partner giveback provision (LP giveback). The LP giveback requires that under specific circumstances investors must return the profits they have received back to the funds, such as when the funds have insufficient money to meet their debt obligations arising from expenditures for taxation or litigation. Based on our data, approximately 41.55% of private funds in 2022 and 2023 included the LP giveback clause, showing a decrease from 57.35% in 2021. For those funds with the LP giveback clause, it is common to set limits on the amount and timing of the giveback to ensure certainty of distribution.

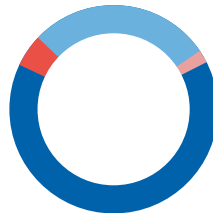


This often includes a cap on the amount of giveback or a stop date such that the investors are not required to return profit past a certain date of profit distribution or liquidation of the funds.

Partners Givebacks



Limitations on Partners Giveback



- Limitations on Amount 64.42%
- Limitations on Timing 5.08%
- Limitations on Timing and Amount 28.81%
- Others 1.69%

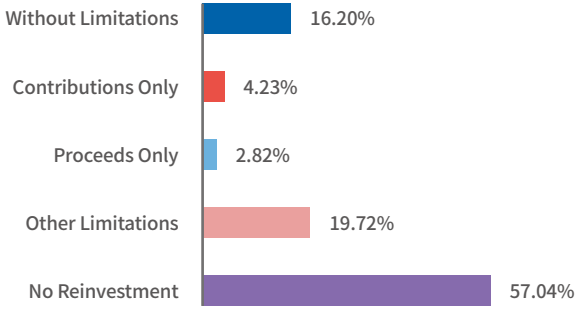
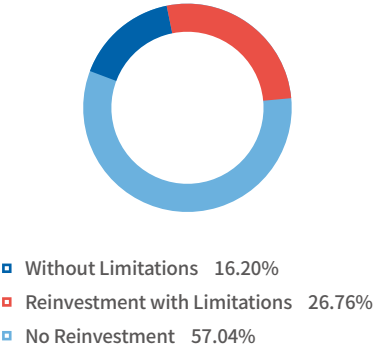




Reinvestment

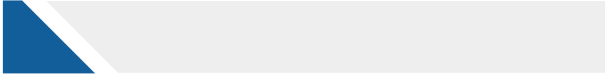
To improve capital efficiency and release more capital for portfolio investments, GPs typically consider whether reinvestment should be allowed at all. Investors, on the other hand, worry about whether the reinvestment would affect the timeliness of capital recycling and the certainty of investment returns. Over the years, more than 50% of the private funds, while permitting reinvestment, imposed restrictions on the reinvestment minimize risks associated with reinvestment, such as delayed exit and the risk of a new project posed to the entire funds. In 2022-2023, there were equal number of funds that restricted reinvestment by using fund profit only and reinvestment by using paid-in capital principal only, while around 20% of them set a cap on the amount of money for reinvestment.

Limitations on Reinvestment

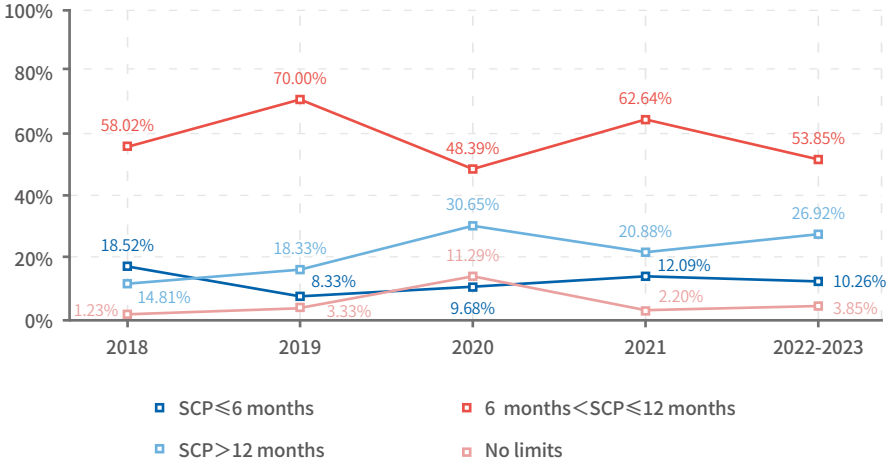
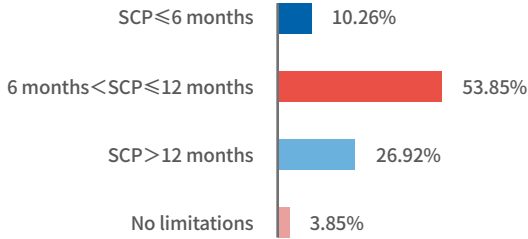


Subsequent Closings

Our data for the 2022-2023 period indicate that more than 50% of private funds adopted a subsequent closing mechanism, with over 80% of them allowing subsequent closings to occur within a six-month or longer period. A period longer than 12 months for subsequent fundraising closings increased slightly as compared to 2021. This seems to correlate to the collective sentiment of fund managers dealing with the challenges of the current fundraising market.

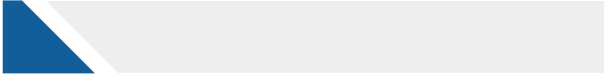


Subsequent Closing Period (“SCP”)

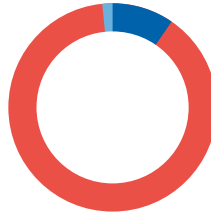


Investors admitted at subsequent closings are often required to pay a late admission fee to compensate the existing investors. During the 2022-2023 period, most of the late admission fee ranged between 5-10%, although funds with late admission fee less than 5% slightly increased compared to 2021. The method of calculation for the late admission fee varies. Some funds use the initial paid-in capital of a newly admitted investor as the basis of calculation, while some use the capital paid in advance by the existing investors as the basis for calculation. Given the variations, investors admitted at subsequent closings need to calculate with care the actual amount of the late admission fee under each formula.





Late Admission Fee Rate



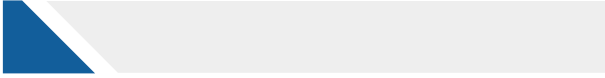
- Fixed Rate ≤ 5% 9.68%
- 5% < Fixed Rate ≤ 10% 88.71%
- At GP's discretion 1.61%

Capital Contribution Default

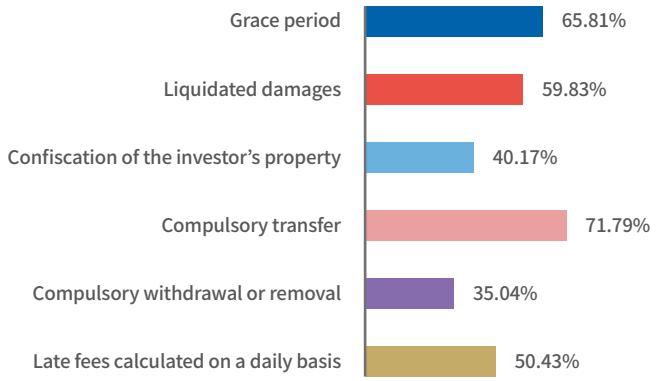
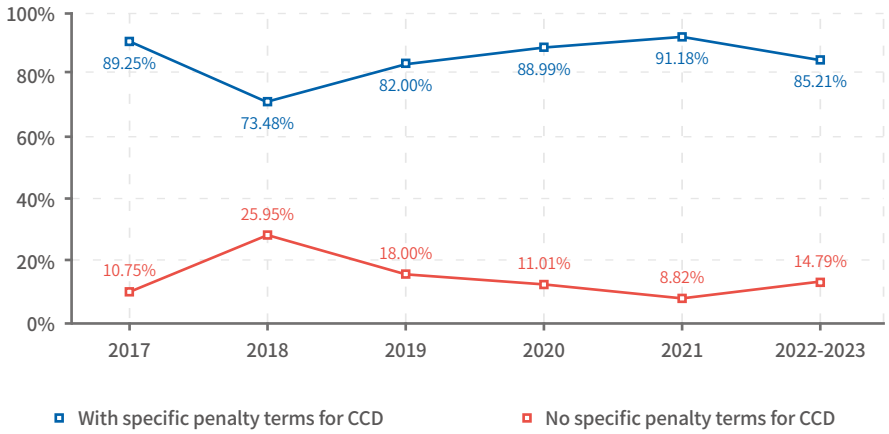
Timely and full payment of capital contributions significantly impact on the daily operation and investment activities of private funds. Fund documentation often contains detailed clauses to penalize failures to make capital contributions either on time or in full. Remedies for failures of capital contribution are often tailored to deal with different categories of investors, their payment ability and the investment schedule of the funds. Common remedies include grace period, liquidated damages, forfeiture of investor's partnership interest, compulsory transfer or withdrawal, and per diem fees for late payment.

During the 2022-2023 period, 85.21% of private equity funds included specific penalties for failures to make capital contributions. However, the number of funds without such penalties nearly doubled, from 8.82% in 2021 to 14.97%. This change seems to reflect the slowdown of the fundraising market in the past two years: (i) fund managers, facing the current fundraising difficulties and the shortage of market liquidity, yielded to their relationship with investors and curtailed their own expectations about the ability of the investors to make capital contributions, and (ii) government guide funds and state-owned capital investors which had low acceptance for typical default penalties of private funds has gradually made their presence felt and voice heard.





Capital Contribution Default (“CCD”)

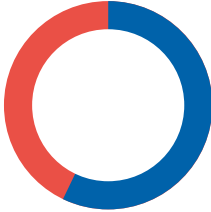


There have been notable changes in the remedies in the past two years even for funds that provided for default penalties. For the grace period, nearly 57.14% of the funds in 2022-2023 allowed GPs to grant the grace period, which was almost twice of 28.92% in 2021. The length of the grace period was usually five to ten days. For the forfeiture of partnership interest, 55.32% of the funds in the 2022-2023 period, as compared to 43.37 in 2021, allowed to forfeit 50% to 100% partnership interest of the investors failing to make capital contributions. For the funds that required compulsory transfer of partnership interest for failures to make capital contributions, 43.37% of them did not intervene in the transfer price, which was significantly higher than the 28.36% of 2021. For the liquidated damages or the late payment fee arrangements, 20% and 8.47% of the funds used methods other than per diem interest to calculate, respectively, the liquidated damages and late payment fee in 2022-2023, a significant increase in both cases.



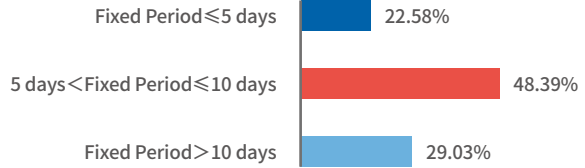
Penalty Terms for Capital Contribution Default

Grace Period

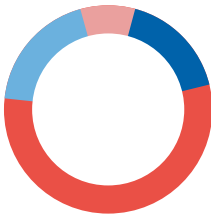


- At GP's discretion 57.14%
- Specified by clause 42.86%

Term of Grace Period

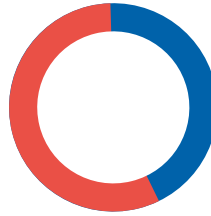


Default Forfeit Rate



- Fixed Rate ≤ 50% 17.02%
- 50% < Fixed Rate ≤ 100% 55.32%
- Variable Rate 19.15%
- Others 8.51%

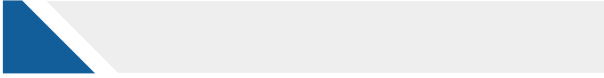
Compulsory Transfer Price



- No intervention in the transfer price 43.37%
- Intervention in the transfer price 56.63%

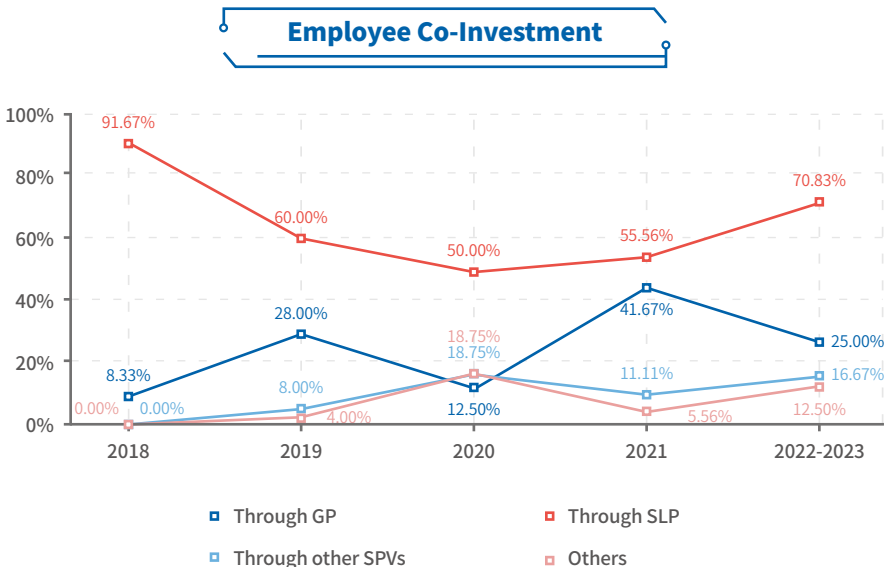
Employee Co-investment

Employee co-investment allows the fund manager and its employees to jointly invest in the private fund under its own management or the portfolios of such private funds. For one thing, it is designed to align the interest of the management team with the fund and improve the capability and diligence of the fund manager of its management of the fund. For another, it provides employees of the fund with an opportunity to share the benefit of the fund's investment and maximize the professional skills of the employees. As such, more and more fund managers have made considerable efforts to structure the co-investment regime in recent years.

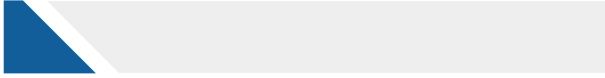


The co-investment falls into two categories: fund co-investment and project co-investment. As the name implies, the fund co-investment refers to employees of a fund directly or indirectly making money available to the fund which invests in projects with monies from other investors. Under the project co-investment regime, the employees and the fund will jointly invest in a project using their separate sources of capital. Since there are specific legal requirements regarding the domestic target company’s registered capital, the number of shares and how many such shares are capable of being owned by the employees, the fund co-investment regime is more prevalent in RMB-denominated funds.

The co-investment can be further categorized into direct and indirect co-investment. The main difference is whether employees of the fund manager can make capital contribution directly to the fund or indirectly through an SPV. Considering such factors as the limitation on the number of investors in limited partnership funds, the ease of changing company registration, changes of the employees who will participate in the co-investment and their respective investment amount, the direct co-investment regime is rarely used in practice. It is common for employees to indirectly invest in a fund through the GP, special limited partner (“SLP”) or other specialized investment vehicles outside the fund. In 2022-2023, the percentage of management teams indirectly co-investing in funds through SLP reached a new high to 70.83%. Meanwhile, the indirect co-investment through GP, other specialized investment vehicles outside the fund, or other forms were 25%, 16.67% and 12.5% respectively.⁴



⁴ A fund may utilize multiple forms of co-investment simultaneously, resulting in the total proportion of various co-investment forms exceeding 100%.



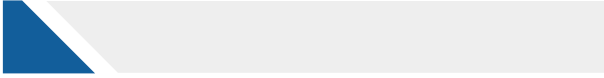
Key Person

Key persons often refer to the founders of managers/GPs, core members of the management team or other individuals who have significant influence over the operation, formulation and execution of investment strategies of the funds. For any given fund, there could be one or more key persons. Investors require the key-person provision because they are keen on the continuous involvement of certain individuals in the operation and management of the fund. Investors often require key persons to devote sufficient time and attention to the operation and management of the fund-related entities including the fund, the fund manager and the GP, and restrict key persons from participating in fundraising, establishment or management of other funds or serving as key persons in other funds before the expiry of the investment period or before the capital utilization rate of the fund has met the target.

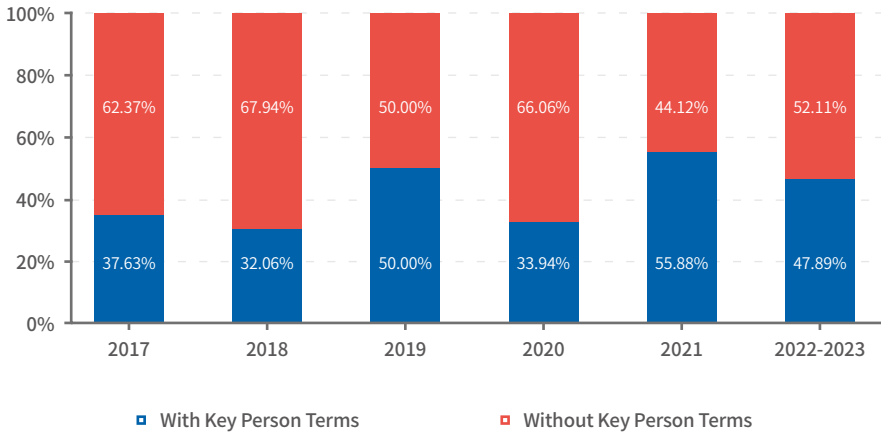
Single-project funds, in contrast to blind pool funds, usually require much less time and effort from the management team because of their specific investment targets and typically do not include a key person provision. In addition, fund managers backed by institutions such as state-owned enterprises, insurance companies and securities firms, given the characteristic of their internal operation and management, may also shy away from the key person provision to avoid tying specific individuals to the fund.

More than 50% of the private equity funds formed in 2022-2023 did not include key person provisions in the deal documentation, representing a significant increase compared to 2021. This change correlated with the increase of single-project funds in 2022-2023 and the active involvement of fund managers backed by state-owned enterprises, insurance companies and securities firms.



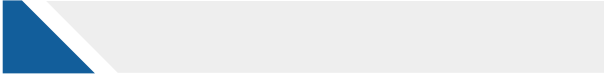


Key Person Terms Inclusion

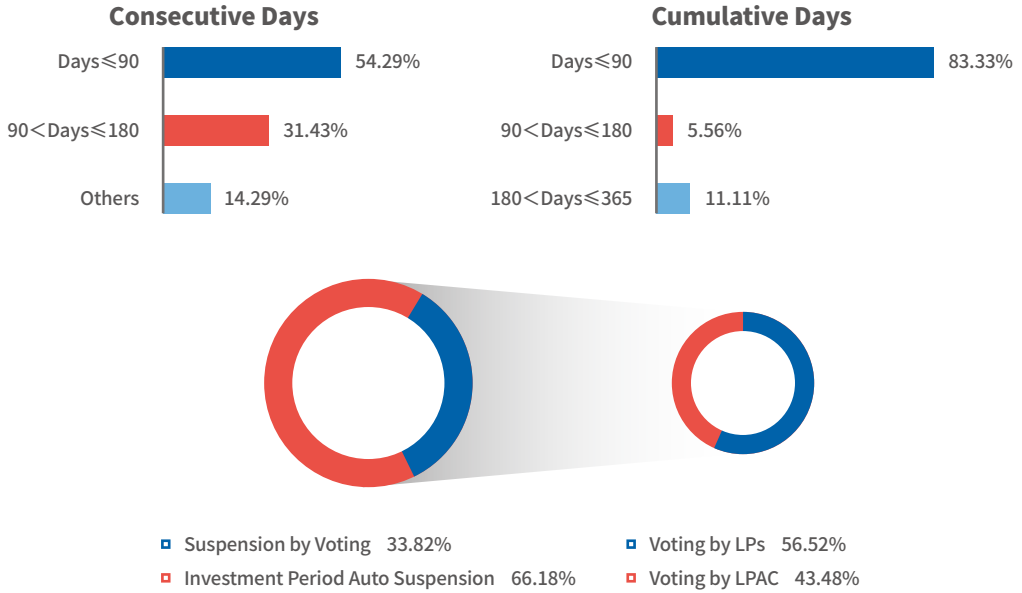


During the investment period, “key person event” may be triggered if one or more key persons cease to provide agreed services to the fund, the fund manager, the GP or other entities, consecutively or cumulatively, for a specified time, or if the key person deceases or becomes incapacitated. The fund contract usually stipulates that If any of the above situations occurs, the investment period will be suspended either automatically or upon an affirmative vote by a certain percentage of investors or the advisory committee. During the suspension of the investment period, the fund will be prohibited from making any new investment until the key person event is cured, such as the decision-making body of the fund (the partners’ meeting or the advisory committee) agreeing to the replacement of the key persons. Otherwise, the investment period of the fund will be terminated permanently. The management fee during the suspension period is usually reduced according to an existing agreement.



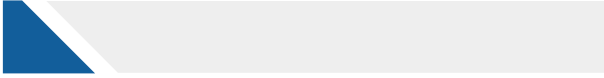


Key Person Event

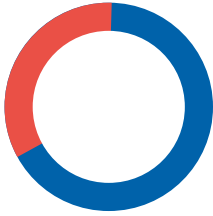


Removal of GP

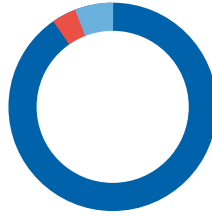
The GP removal mechanism is a protective measure for limited partners under extreme circumstances, but the trigger events are often limited. According to our data for 2022-2023, 66.9% of private equity funds provided for the GP removal mechanism. The trigger event for GP removal was predominantly based on an “at fault” approach (90.36%), while 3.61% adopted a “no-fault” approach, and 6.02% adopted both “at fault” and “no-fault” removal approaches simultaneously. Moreover, nearly 70% of private equity funds in 2022-2023 required either litigation or arbitration as a prerequisite to the at-fault removal. This requirement is usually combined with a vote by certain number of limited partners to initiate the litigation or arbitration and the GP can only be removed upon a final judgment or arbitral award finding that the GP was indeed at fault.



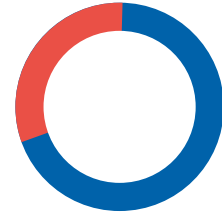
Removal of GP



- With GP Removal 66.90%
- Without GP Removal 33.10%



- Fault Removal 90.36%
- No-Fault Removal 3.61%
- Fault Removal & No-Fault Removal 6.02%

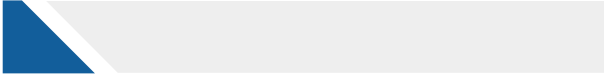


- Arbitration/Litigation Precondition 69.23%
- No Arbitration/Litigation Precondition 30.77%

Side Letters/Unilateral Agreements

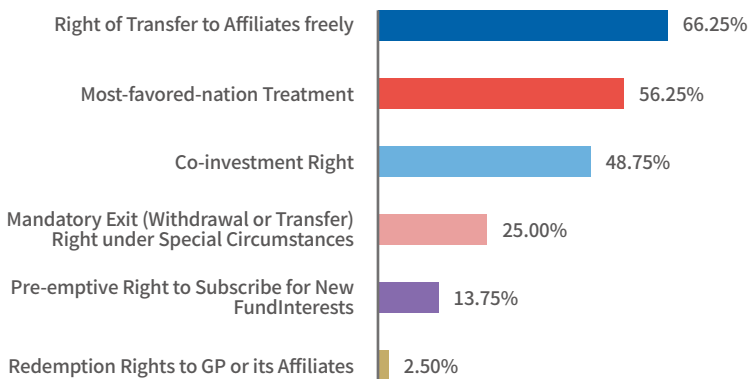
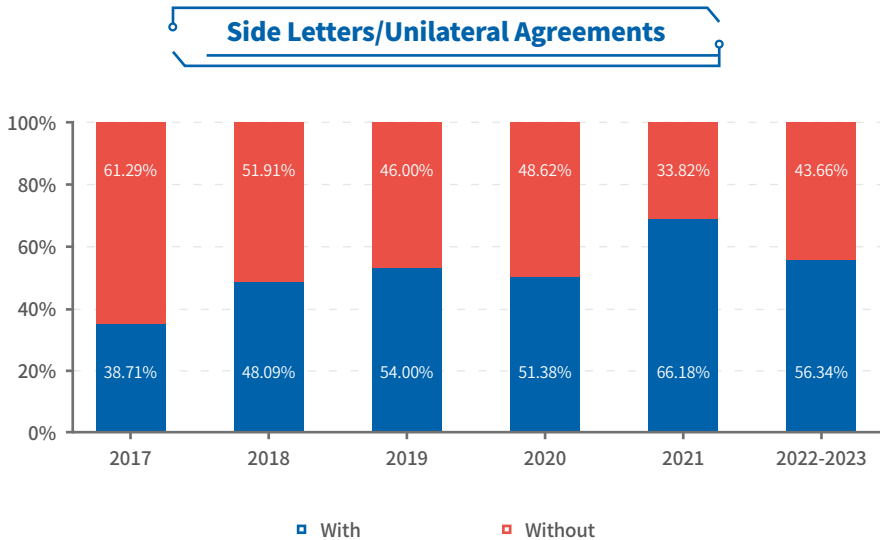
Side letters or unilateral agreements are separate agreements between investors and the GP/fund manager. They usually provide that the GP/fund manager will have the sole discretion to decide on specific requests of the investors. Common provisions in side letters/unilateral agreements include, but are not limited to, sequencing of contributions, waiver of liability for breach of contract under certain circumstances, co-investment rights (i.e., sharing of investment opportunities), local investment requirements, additional investment restrictions, veto rights on specific matters, appointments to the advisory committee, transfers of partnership interests to affiliates without any restriction, special disclosure requirements, fee cap or waiver requests, and most-favored-nation treatment clauses.

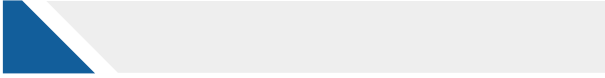
Government investors often demand inclusion of the following terms in a side letter: (1) making capital contribution to the fund only after private investors of the fund have made their capital contribution; (2) mitigation of default liability for overdue capital contribution caused by the applicable laws and regulations or regulatory requirements; (3) capital commitments of such government investors not exceeding a certain percentage; (4) local investment requirements; (5) compliance or policy-driven investment restrictions; (6) recommendations for investment opportunities; (7) right of withdrawal under specific circumstances; and (8) special disclosure requirements.



Investors backed by insurance companies often have different priorities. They often want to include the right to appoint advisory committee members, continuous compliance commitments by the GP and the fund manager, recommendations for co-investment opportunities, additional investment and related-party transaction restrictions and special disclosure requirements. Asset management products investors often demand default liability pass-through, term duration mismatches, and restrictions on multi-layered investment schemes.

In 2022-2023, most funds continued to utilize side letters/unilateral agreements. The chart below shows some common provisions of side letters/unilateral agreements and their percentages.

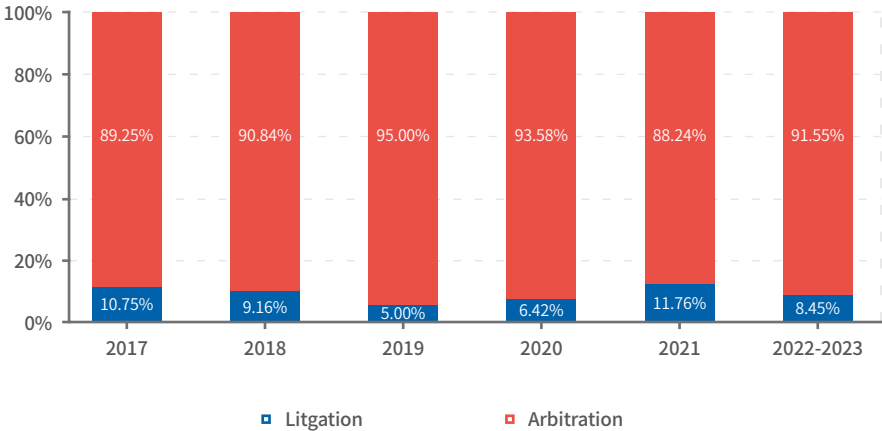




Dispute Resolution

In the private equity fund industry, arbitration has been the predominant mechanism to resolve disputes with only slight fluctuation over the years according to our data. In 2022-2023, 91.55% of the funds chose arbitration to resolve disputes and only 8.45% chose litigation. Compared with litigation, arbitration is faster in procedure, better protecting confidentiality and more flexible with the choice of jurisdiction. Specifically, since the arbitral award is final and binding on the parties and theoretically is conclusive notwithstanding the availability of post-award remedies such as an appeal to courts for the annulment or non-enforcement of the arbitral award, the arbitration is overwhelmingly favored by financial institutions because they are more time-sensitive than others. Secondly, since the awards are not publicly disclosed, arbitration is better at the protection of commercial information of private equity funds. Thirdly, since arbitration tribunals are formed by agreement of the parties, it helps the parties involved to select people experience and knowledge in the private equity fund field to serve on the tribunals. Possibly driven by the reasons set out above, the vast majority of private equity funds prefer arbitration as their forum for dispute resolution. Some investors, particularly those backed by state-owned enterprises, may prefer litigation as the dispute resolution mechanism.

Dispute Resolution



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