

The New Limited Partnership Fund Regime in Hong Kong - a Brief Comparison with the Cayman Islands Exempted Limited Partnership

Introduction

On 9 July 2020, the LegCo passed the Limited Partnership Fund Bill, establishing a limited partnership fund (“LPF”) regime which enables funds to be constituted and registered in Hong Kong in the form of limited partnerships. The new LPF Ordinance will come into effect on 31 August 2020.

The LPF Ordinance is welcomed by many as a much-needed step towards filling the gap in the legal framework in Hong Kong for the structuring of private equity funds. Prior to the introduction of the LPF Ordinance, managers seeking to set up a closed-ended private equity funds from Hong Kong would, as a matter of course, choose the Cayman Islands exempted limited partnership (“ELP”) as the fund vehicle. It was the de-facto choice as the Cayman Islands ELP was widely regarded as the “gold standard” in the private equity world, favoured by (especially institutional) investors, well supported by an established legal and administrative infrastructure in Hong Kong and throughout the region, and based on a reputable, widely accepted, common-law jurisprudence.

With the introduction of the LPF regime, managers now have a viable alternative for choice of fund vehicle. Hong Kong’s well established legal and financial infrastructure, equally well recognised common-law judicial system, simple and transparent tax regime, should, in theory, make it a serious rival to the ELP. The fact that managers regulated under Hong Kong laws can now also match the jurisdiction of the fund vehicle they are managing presents as an added bonus.

However, when faced with the choice, the first question on many managers’/sponsors’ minds will be – what is the difference between the two regimes, and importantly, how does the LPF stack up against the incumbent? In this article, we take a quick tour through both regimes on a side-by-side basis, and will point out some important differences and similarities between the two.

Cayman Islands vs. Hong Kong

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| Introduction | | |
| Key legislation | Exempted Limited Partnership Law (2018 Revision) (“ELP Law”) | Limited Partnership Fund Ordinance |
| Type of limited partnership | Exempted limited partnership | Limited Partnership Fund An LPF must satisfy the definition of “fund”, which is set out in full in section 3 of the Ordinance (section 15). |
| Legal status | An ELP does not have a separate legal personality. All letters, contracts, deeds, instruments or documents shall be entered into by or on behalf of a general partner (“GP”) (or any agent or delegate of the GP) on behalf of the ELP (section 14(2)). Legal proceedings by or against an ELP may be instituted by or against one or more of the GPs (section 33(1)). Any rights or property of every description of the ELP shall be held or deemed to be held by the GP(s) upon trust as an asset of the ELP (section 16(1)). | An LPF does not have a separate legal personality (section 15). |

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| Liabilities of general partners and limited partners | <p>In the event that the assets of the ELP are inadequate to satisfy the claims of its creditors, the GP(s) will be liable for all debts and obligations of the ELP (section 4(2)).</p> <p>Limited partners (“LPs”) shall not be liable for the debts or obligations of the ELP save as provided in the limited partnership agreement, provided that they do not take part in the conduct of the business of the ELP (see below) (section 4(2)).</p> | <p>The GP has unlimited liability for all the debts and obligations of the LPF (section 19(1)).</p> <p>However, if an LPF has an authorised representative (“AP”) (see below), the GP and the AP are jointly and severally liable for all the debts and obligations of the fund (section 19(3)).</p> <p>An LP is generally not liable for the debts and obligations of the fund beyond the amount of the partners’ agreed contribution. However, if an LP takes part in the management of the fund (see below), the LP and the GP in the fund (and the AP, if applicable) are jointly and severally liable for all the debts and obligations of the fund incurred while the LP so takes part in the management (sections 26(4),(5)).</p> |
| Establishment of a limited partnership | | |
| Number and eligibility of partners | <p>An ELP shall consist of one or more GPs and one or more LPs (section 4(2)).</p> <p>At least one GP shall either be an individual resident in the Cayman Islands, a company incorporated or registered as a foreign company in the Cayman Islands, an ELP, or a registered foreign limited partnership (section 4(4)).</p> | <p>An LPF shall consist of one GP and at least one LP (section 7).</p> <p>The GP shall either be a natural person who is at least 18 years old, a company or a limited partnership registered in Hong Kong, an LPF or a non-Hong Kong limited partnership (with or without legal personality) (section 7(1)(c)).</p> <p>An LP shall be a natural person or a corporation, a partnership of any kind, an incorporated body or any other entity (section 7(1)(d)).</p> |
| Main constitutional document | <p>The limited partnership agreement (the “LPA”)</p> <p>An LPA typically includes (but not limited to) the following matters:</p> <ul style="list-style-type: none"> • the powers, rights and obligations of the partners in the fund; • the admission of additional partners, and the retirement and withdrawal of existing partners in the fund; • the transfer of interests in the fund; • the organisation, management structure, governance and decision-making procedures of the fund; • the financial arrangements among the partners in the fund, e.g. the allocation and distribution of profits among the partners and capital contributions to the fund; • the investment scope and strategy of the fund; • the process to amend the LPA; and • events of termination of the fund and procedures upon such termination. | |

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| Registration | <p>The registration of an ELP shall be effected by payment of a registration fee to the Registrar of Companies, and by filing with the Registrar of Companies a statement, containing information set out in section 9(1), signed by or on behalf of a GP.</p> <p>The Registrar of Companies shall issue a certificate of registration, which is conclusive evidence of the formation and registration of an ELP (sections 9(5), (7)).</p> | <p>An application for the registration of a fund as an LPF must be made to the Registrar of Companies by a Hong Kong law firm or a solicitor admitted to practise Hong Kong law on behalf of the proposed GP (section 11).</p> <p>The Registrar of Companies, on registering a fund as an LPF, must issue a certificate of registration to the fund (section 12).</p> |
| Registered office | An ELP must have a registered office in the Cayman Islands for the service of process and to which all notices and communications may be addressed (section 6(2)). | An LPF must have a registered office in Hong Kong to which communications and notices may be sent (section 18). |
| Confidentiality | <p>The Registrar of Companies shall maintain a record of each ELP and all the statements filed in relation to the ELP, which are open for public inspection (section 9(2)).</p> <p>On payment of a fee, any person may request a certified copy of the certificate of registration, a certificate of good standing or a copy of or extract from any registered statement filed with the Registrar of Companies in relation to the ELP (section 12(1)).</p> | <p>The Companies Registry must maintain a register for each LPF containing all documents registered with and certificates issued by the Registry (section 47). The Registry must also establish and maintain an index of the names of every LPF (section 50).</p> <p>Records under section 29 of the Ordinance in respect of an LPF must not be made available for public inspection (section 30(1)). Such records include the register of partners, financial statements of the fund, and documents and records of each transaction carried out by the fund (section 29(1)).</p> |
| Operating a limited partnership | | |
| General partners | <p>A GP is responsible for the management of the ELP.</p> <p>A GP may, without derogation from his position as such, also take an interest as an LP in the ELP (section 4(2)).</p> <p>A GP shall act at all times in good faith, and subject to any express provisions in the LPA to the contrary, in the interests of the ELP (section 19(1)).</p> | <p>The GP has ultimate responsibility for the management and control of the fund (section 19(2)).</p> <p>However, if an LPF has an AR (see below), both the GP and the AR have ultimate responsibility for the management and control of the fund (section 19(3)).</p> |
| Limited partners | <p>An LP shall not take part in the conduct of the business of an ELP in its capacity as a LP (section 14(1)).</p> <p>An LP does not, subject to any express provisions of the LPA to the contrary, any fiduciary duty to the ELP or any other partner (section 19(2)).</p> | <p>An LP does not have day-to-day management rights or control over the assets held by the fund (sections 26(1),(3)).</p> <p>An LP does not owe any fiduciary duty to the GP or any other LP in the fund (section 26(2)).</p> |

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| Limited Partners (cont'd) | <p>An LP may lose the benefit of limited liability if it engages in the conduct of the business of the ELP with persons who are not partners in the ELP. In such circumstances, in the event of insolvency, the LP shall be liable for all debts and obligations of that ELP during the period that he participates in the conduct of the business as though it were a GP. However, it shall only be liable in such circumstances to a person who transacted business with the ELP during the relevant period with actual knowledge of such participation and who reasonably believed the LP to be a GP (section 20(1)).</p> <p>The ELP Law provides a non-exhaustive list of activities which an LP may undertake without being deemed to take part in the conduct of the business of an ELP. These activities include, for instance, consulting with and advising a GP regarding the business of the ELP, and calling, requesting, attending or participating in any meeting of the partners (section 20(2)).</p> | <p>An LP may lose the benefit of limited liability if it takes part in the management of the fund. In such circumstances, the LP and the GP in the fund (and the AP, if applicable) are jointly and severally liable for all the debts and obligations of the fund incurred while the LP so takes part in the management (sections 26(4),(5)).</p> <p>The LPF Ordinance sets out a non-exhaustive list in Schedule 2 of permitted activities which are not regarded management of a fund (section 27). These activities include, for instance, acting as an agent, member, contractor, officer or employee of the fund, and serving on a board or committee of the fund.</p> |
| Contributions | <p>The contribution required of an LP is set out in the LPA or any side letter.</p> <p>Contribution can be in the form of cash, property, services or other assets, but it does not include any moneys lent by a limited partner to the ELP (section 2).</p> <p>If an LP receives a payment representing a return of any part of his contribution at the time where the ELP is insolvent (provided that the LP has actual knowledge of such insolvency), the LP shall be liable to the ELP for the amount of the payment for a period of 6 months commencing on the date of payment to the extent that the repayment is necessary to discharge a debt or obligation of the ELP (section 34(1)).</p> | <p>An LP, under an LPA, agrees to make contributions (whether in the form of property, services or otherwise) valued at a stated amount to the fund.</p> <p>Withdrawal of capital contributions from an LPF is permitted if the fund remains solvent following such withdrawal (section 17).</p> |
| Distributions to partners | <p>A partner's right to share in the profits and capital of the ELP is set out in the LPA or any side letter.</p> | <p>An LP has the right to participate in the income and profits arising from the management of the assets and transactions of the fund (section 26(1)).</p> <p>Distribution of profits and assets of the fund to partners, are permitted if the fund remains solvent following such distribution (section 17).</p> |
| Dealings with partnership interest | <p>A partnership interest is transferable in whole or in part, subject to provisions in the LPA (section 32(1)).</p> <p>With the written consent of the GP, an LP may transfer or grant a security interest in the whole or part of its LP interest (section 32(6)).</p> <p>With the written consent of any other GP, a GP may transfer or grant a security interest in the whole or part of his GP interest (section 32(7)).</p> | <p>Partners in the LPF may determine in the LPA the transfer of interests in the fund by the LP (section 16(2)).</p> |

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| Appointment of investment manager | - | The GP must appoint either a Hong Kong resident who is at least 18 years old or a company registered in Hong Kong as an investment manager to carry out the day-to-day investment management functions of the LPF. A GP can also act as an investment manager (sections 20(1), (2)). |
| Appointment of auditor | - | The GP must appoint a person, who is independent of the GP and the IM, as an auditor to carry out audits of the financial statements of the LPF (sections 21(1), (3)). |
| Appointment of authorised representative | - | If the GP is another LPF or a non-Hong Kong limited partnership without a legal personality, the GP must appoint a Hong Kong resident who is at least 18 years old or a company registered in Hong Kong as the authorised representative of the fund to be responsible for the management and control of the fund (sections 23(1)-(3)). |
| Appointment of responsible person | - | The GP must appoint a person (either an authorised institution, a licensed corporation, an accounting professional or a legal professional) as a responsible person to carry out anti-money laundering (“AML”) and counter-terrorist measures (sections 33(1)-(2)). |
| Custody of assets | - | The GP must also ensure that there are proper custody arrangements for the assets of the fund (section 22). |
| Taxation | <p>Neither the ELP nor the partners are subject to any form of direct taxation in the Cayman Islands.</p> <p>On application by a GP, an ELP can request an undertaking from the Government that, for a period of not exceeding 50 years from the date of the undertaking, no form of taxation will apply to the ELP or to any partner thereof in respect of the operations or assets of the ELP or the partnership interest (sections 38(1), (2)).</p> | <p>An LPF meeting the definition of “fund” under section 20AM of the Inland Revenue Ordinance (Cap. 112) may enjoy profits tax exemptions (subject to certain exemption conditions).</p> <p>In respect of stamp duty, an interest in an LPF does not fall within the definition of “stock” under section 2 of the Stamp Duty Ordinance (Cap. 117) and, therefore, is not chargeable with stamp duty when contributed, transferred or withdrawn.</p> |
| Failure to perform LPA obligations/ breaches of LPA provisions | If an LPA contains default provisions which set out the remedies or consequences to which a partner will be subject where it fails to perform its obligations under the LPA, or otherwise breaches the LPA, such remedies or consequences shall not be unenforceable solely because they are penal in nature (section 25(1)). | - |

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| Termination of a limited partnership | | |
| Winding up and dissolution | <p>Most LPAs contain provisions prescribing the automatic winding up and dissolution of the ELP upon the occurrence of a particular event. In the absence of such provisions, an ELP shall continue in existence until wound up and dissolved by a resolution of all GPs and a two-thirds majority of LPs (section 36(1)).</p> <p>A partner, creditor or liquidator may also apply to the court for an order for dissolution on just and equitable principles (section 36(3)(g)).</p> <p>Except to the extent where such provisions are not consistent with the ELP Law, Part V of the Companies Law and the Companies Winding Up Rules 2018 are deemed to apply to the winding up and dissolution of an ELP (section 36(3)).</p> | <p>An LPF may be dissolved in accordance with the LPA (section 70(1)).</p> <p>An LPF can also be dissolved without a court order when certain default events occur in relation to the GP (or the AR, if applicable) of the LPF and that the GP or the AR is not replaced within 30 days after the date of the occurrence of such default events. These events include where the GP (or the AR, if applicable) is bankrupt, dissolved, dead, wound up, or ceases to be the GP (or the AR, as the case may be) (sections 70(1), (2)).</p> <p>An LPF can also be dissolved with a court order on application by a partner or a creditor, for instance, where a partner wilfully or persistently commits a breach of the LPA (section 71(1)).</p> |

It is clear from the above comparison that the ELP and LPF share many similar characteristics. It would be fair to say, in fact, that the LPF is, by and large, a clone of the ELP.

Here are some of my initial thoughts around key differences and similarities between the two regimes.

Liabilities of the GP

The ELP Law is clearly worded to provide that GP(s) will only have unlimited liability for debts and obligations of the fund to the extent those liabilities cannot be satisfied out of the assets of the fund. The LPF Ordinance, on the other hand, does not impose this limit on liability – the GP is liable for all debts and obligations of fund and there is no statutory recourse to the assets of the fund as a first step.

In practice, of course, we would expect that in drafting the limited partnership agreement (LPA), the GP would ensure there are indemnity provisions allowing it to satisfy debts and obligations out of the assets of the fund, and this would be the case regardless of whether we are dealing with an LPF or an ELP. Conceptually, however, a GP should prefer to have the benefit of a statutory right to the assets of the fund as a first resort (which the ELP provides, and which the LPF does not seem to contemplate). After all, without such a statutory right, the GP can only rely on an indemnity provision (which is a contractual right), and that provision can be subject to challenge by the courts, or negotiated down by investors. In addition, indemnities are often limited by exclusions (for example, they would normally not cover acts amount to “gross negligence” or malfeasance).

Co-GPs

The ELP law contemplates that an ELP may appoint more than one GP (which is a common arrangement among PRC managers, where funds are often structured with “co-GPs”. For example, one of the GPs will be from a fund house undertaking actual investment discretion, while the other GP will have investor connections for fund raising purposes, but may only undertake administrative functions in the fund). The LPF Ordinance, however, only permits one GP for the fund, which may be a structural limitation for some managers.

Fiduciary duties

The ELP Law specifically provides that a GP of the fund “shall act at all times in good faith, and subject to any express provisions in the LPA to the contrary, in the interests of the ELP” (section 19(1)). Before the ELP Law came into force, a GP was under an absolute duty to act in good faith in the interests of the ELP. This duty could not be restricted, limited, or varied by the terms of LPA. As a practical issue, this often raised issues of conflicts of interest for the GP, especially where it acted as GP to more than one ELP, where it co-invested with other ELPs, where it caused the ELP to invest in portfolio companies in which it or its associates (including its principals) also had interests, where there was self dealing in securities, or where there was unequal treatment of LPs (e.g. by way of side letters etc). With the modification of this duty under the revised ELP Law, the GP’s fiduciary duty may now be modified under the LPA. Specifically, it may now stipulate the circumstances in which the GP may act in the interest of a party other than the ELP, which should, as a practical matter, make it easier for the GP to manage interests that compete against the interests of the ELP. However, the GP remains under an absolute duty to act in good faith on matters concerning the ELP, and where the LPA is silent, then the default position remains that the GP must act in good faith and in the interests of the ELP as a whole.

The LPF, on the other hand, appears to be largely silent on the standard, the scope and extent of duties owed by the GP (other than a reference to the fact that the scope of the GP’s fiduciary duties may be contractually amended as between the parties (see section 16 of the LPF Ordinance), and the fact that the rules of equity and common law will continue to generally apply to the LPF (section 92 of the LPF Ordinance)).

Given this, it would appear that there is much more flexibility for the GP of an LPF to negotiate and modify the scope and extent of its fiduciary duties (as compared to the GP of an ELP). At a minimum, the GP of an ELP remains subject to an absolute duty to act in good faith on matters concerning the ELP, whereas it would seem that the GP of an LPF has the ability to contract out of this. In addition, the LPF Ordinance is silent on what the default position should be where there is no provision in the LPA or contractual agreement to the contrary (but the logical assumption would be that all of the fiduciary duties that a GP would be subjected to under the rules of equity and common law would continue to apply).

Unenforceability of penalties

LPAs would generally contain default provisions which prescribe the actions to be taken where an LP fails to perform certain obligations, or otherwise breaches the LPA. The most common of these would provide that where an LP fails to meet a capital call, for example, it would have its capital commitment reduced or forfeited. The ELP Law specifically confirms that these remedies / consequences in the LPA will not be unenforceable solely because they amount to “penalties” under the common law. This reduces the risk that these provisions in the LPA would be subject to challenge in the Cayman courts.

The LPF Ordinance, on the other hand, appears to be silent on this issue, which leaves open the possibility that any of these remedy or default provisions may be challenged in a Hong Kong court (and struck out as being unenforceable for going beyond a reasonable assessment or measure of the loss suffered).

Confidentiality of records

In the Cayman Islands, a record of each ELP and all statements filed regarding the ELP, which are kept at the Registrar of Companies, are open for public inspection. These include, among others, name of the ELP, nature and principal place of business, term of partnership (if any), and the full name and address of each GP.

In Hong Kong, the public can access the LPF register maintained by the Companies Registry, which will contain all documents registered with and certificates issued by the Registry. These will necessarily include certain specified forms e.g. the Annual Return which an LPF is required to file with the Registry, although it is still uncertain at this stage what information will need to be provided to the Registry in these specified forms. It is, however, worth mentioning that the LPF Ordinance explicitly provides that certain records must not be made available for public inspection. These include, among others, audited financial statements, register of partners (i.e. identity of partners), AML documents and the controller of each of the partners in the LPF.

In practice, there is probably not much difference between the two regimes when it comes to disclosure of information. Importantly, the identity of LPs, their controllers, and audited financial statements of the fund, are matters that may be kept confidential under both regimes.

AML obligations

It is worth noting that there is an additional obligation under the LPF Ordinance for the GP to appoint a responsible person to carry out AML and counter-terrorist measures. Such responsible person can either be an authorised institution, a licensed corporation, an accounting professional, or a legal professional. The Ordinance further requires AML records and documents of an LPF to be kept at its registered office (which, however, cannot be made available for public inspection).

Although the appointment of such responsible person is not required in the Cayman Islands, in practice, an ELP will still be subject to various AML obligations, for instance, under the Proceeds of Crime Law and the Anti-Money Laundering Regulations. In particular, an ELP is required under these laws to appoint experienced and skilled risk and compliance professionals to the roles of AML Compliance Officer, Money Laundering Reporting Officer and Deputy Money Laundering Reporting Officer.

Appointment of auditor and proper custody of assets

Under the LPF Ordinance, the GP must appoint an auditor. While there is no such explicit requirement under the ELP Law, an ELP is still required under the recently enacted Private Funds Law 2020 to have its accounts audited and signed-off annually by an auditor approved by the Cayman Islands Monetary Authority, or it will be subject to a fine of US\$24,390. Practically, therefore, there should be no difference between the two regimes.

As for custody, the LPF Ordinance specifically imposes a duty on the GP to ensure proper custody arrangements for the assets of the LPF (either by way of appointment of a third party custodian or self-custody). Although the ELP law makes no mention of custody of assets, an ELP will still be required under the Private Funds Law 2020 to appoint a custodian. There is, again, limited practical difference between the two regimes.

Conclusion

Notwithstanding that the LPF appears to be directly modelled upon the Cayman ELP regime, there are some material differences between the two. Of note is the fact that the GP of an LPF does not have any statutory recourse to the assets of the fund as a first resort when it comes to determining the scope of its liabilities, and must rely instead on contractual indemnities to protect its position.

The LPF also appears to be more restrictive when it comes to the ability of appointing co-GPs to a fund. On the other hand, the ability to modify any of the fiduciary duties that the GP would normally be subject to is a distinct advantage of the LPF over the ELP regime (which makes the duty to act in good faith an absolute one not capable of contractual modification). Finally, the fact that certain default provisions in the LPA of an LPF may remain subject to challenge in the Hong Kong courts for being penalties would add more uncertainty to the operation of an LPF – particularly during periods of economic downturn when LPs may have financial difficulties meeting drawdown obligations, and when parties generally tend to be more litigious.

On the balance, the LPF regime will certainly be attractive to a Hong Kong based fund sponsor, given that the centralisation of a fund's management, operation and domicile will reduce the cost of having to engage additional professionals and service providers for regulatory compliance in multiple jurisdictions (the legal fees and disbursements savings from using an LPF as opposed to an ELP are not insubstantial). This will be important for managers/sponsors who are looking to launch smaller sized funds, where the AUM limits will make cost considerations at the forefront of the decision process.

For all other managers/sponsors, the central question they face when proposing a different structure to investors will continue to be asked: "Why not Cayman?"

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