

# Legal Commentary

August 5, 2019



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## Private Equity Law

### Analyzing S Fund Participation in PE Fund Interest Secondaries

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Private equity funds in China have undergone more than a decade of exploration since first appearing at the end of the 20th century, and the regulatory system has gradually improved since 2014. Over these years, the first batch of private equity funds has entered their exit periods or reached fund term expiration, which has led to potential conflicts between some investors over the need to liquidate investments through withdrawal and fund management teams who need to extend their fund terms so as to maximize returns. In addition, the implementation of the *Guiding Opinions on Regulating the Asset Management Business of Financial Institutions* and their supporting rules have emphasized deleveraging, which has placed requirements on traditional private equity fund investors such as banks and wealth management firms to conform within a prescribed period. All of these factors have led to a thriving secondary market for private equity fund interests.

The private equity fund interest secondary market is a market for the purchase, sale, transfer and circulation of interests in private equity investment funds, such as partnership interests, and forms part of the private equity secondary market (“PE secondary market”). Broadly speaking, the secondary market includes markets for trading equity and other interests in non-listed companies. Accordingly, secondary private equity transactions (“**PE secondaries**”) can also be divided into two types, transactions involving direct transactions of private equity fund portfolio investments (secondary directs) and those involving private equity fund interests (secondary fund interests).

Secondary funds (“**S Funds**”) are professional secondary market investors that are particularly active in PE secondaries. In this article, we will analyze some practical issues involved in the S Fund participation in trading secondary fund interests.

## Transaction Sequence

Generally speaking, the sequence of transferring private equity fund interests includes negotiations between transaction parties, due diligence investigations, notification of existing investors in the target fund, exercise of rights of first refusal, negotiations and confirmation of the transaction documents, and payment at closing. PE secondaries focus more on the legal relationship between the buyer and the seller and lead to different areas of concern during the main stages of transactions compared to direct investments by limited partners to Fund, which focus on the legal relationship between the buyer and the fund or between the buyer and the general partner.

**Negotiations between transaction parties.** PE secondaries can generally be divided into two types of transactions, general partner (GP)-led transactions and seller-led transactions. In GP-led transactions, the fund management team needs to pay attention to their duties to existing limited partners in the fund. Specifically, the management team needs to notify existing limited partners of the progress of the transaction in a timely manner. In the case of multiple buyers (syndicated transactions), the management team should coordinate the bidding process. In seller-led transactions, the initial consent of the management team of the target fund needs to be obtained to facilitate the transaction since the private equity fund's partnership agreement<sup>1</sup> usually restricts the limited partner's right to freely transfer its partnership interest or the right to withdraw from the partnership.

As a buyer, an S Fund initially needs to understand the reasons for the transfer and whether there are time constraints on the transaction. If necessary, the S Fund may protect its interests by signing a letter of intent, which would usually stipulate an exclusivity period of a few months. The S Fund can control the pace of the transaction, make reasonable payment arrangements, and obtain better outcomes during negotiations by understanding the background information, such as whether the purpose of the transfer is to meet the seller's liquidity needs or to meet the requirements of the investment enterprise to adjust its LP structure, and whether the seller or the management team stipulates time limits for receiving the payment or completing the transaction.

**Due diligence.** The buyer's due diligence includes both the basic information of the target fund and the basic information of the target fund interest and the seller. When a PE secondary occurs, the target fund will generally have already completed its major investments, of which some have entered the exit period. In such cases, the due diligence should focus on the stage and actual situation of the fund. For example, if the target fund has already entered the exit period, only moderate effort is required with respect to the due diligence of matters within the investment period. Rather, the focus should be placed on the status of the target fund interest and the seller. With respect to the target fund interest, the buyer needs to know the basic condition of the interest, whether there is any breach of contract, the status of rights, whether there is any pledge and other circumstances that may affect the effectiveness of the disposal of the interest. With respect to the seller, the buyer needs to understand the seller's debt status to determine whether the target fund interest is subject to any risk of being frozen, pledged, or otherwise claimed by a third party before closing. Due diligence of target funds, target fund interests and sellers will help to eliminate risks

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<sup>1</sup> Below, target funds refer to limited partnership private funds since the most common organization form of private equity investment fund is a limited partnership.

and provide guidance for subsequent negotiations and the drafting of key transaction terms.

In a seller-led transaction, the management team may show little willingness to cooperate in the due diligence. Due diligence of the operating status of the target fund is indispensable to facilitate the completion of the transaction. Comprehensive due diligence helps S Funds to reduce legal risk and design relevant terms of the transaction documents. In practice, some S Funds mainly take their own or related parties' direct investment sub-funds or their affiliated funds as investment targets in order to build mutual trust for the proposed transactions and provide convenience for the S Fund to indirectly obtain information on target funds.

The seller and the fund management team also need to conduct some preliminary due diligence investigations on the qualifications of potential buyers (including whether they are qualified investors and their financial qualifications) and whether they are suitable as investors in the fund (such as upper tier structures, source of funds, etc.).

**Notify existing investors in the target fund.** In many transactions, the parties to the transaction, including the target fund management team, wish to notify the existing investors (non-sellers) after the completion of the transaction, subject to restrictions of the transaction schedule. It should be noted that the Partnership Enterprise Law at Article 73 stipulates that a limited partner may transfer its interest in the limited partnership to a person other than a partner in accordance with the partnership agreement, provided that prior notice is provided to the other partners 30 days in advance. This 30-day-notice requirement should be regarded as a mandatory requirement, since there are no exceptions. Nevertheless, according to our case research, even though the validity of the transaction may not be affected due to the failure to observe the 30-day-notice requirement, the failure will result in a breach of contract on part of the seller. In practice, if the seller is unable to comply with the 30-day-notice requirement due to the transaction schedule but wishes to ensure the certainty or effectiveness of the transaction, the S Fund may consider prompting the target's fund management team to request other investors to sign a written letter to waive the 30-day-notice period requirement. Alternatively, if the transaction documents are required to be signed first, the parties may consider stipulating in the transaction documents the 30-day-notice period as a condition precedent to payment or to closing, etc.

**Exercising rights of first refusal.** Compared with the notice requirement, rights of first refusal of other partners is a substantial issue that requires more attention and cannot be easily circumvented. Under the Partnership Law, partners are entitled to a right of first refusal by default, which means that if a partner transfers an interest in the target fund, other partners have the right of first refusal to purchase the interest under the same conditions. However, the Partnership Law and its related regulations fail to further interpret the meaning of the "same conditions." With reference to judicial interpretation of the Company Law, same conditions "shall include the same number, price, payment method and term of the transferred interests." Therefore, a primary concern of S Funds should be to ensure the effective exercise or waiver of rights of first refusal. In addition, even in the case that other partners are not entitled to rights of first refusal, relevant documents are still required to be signed by all partners to complete the SAMR registration change. To ensure the completion of the private equity fund interest transfer transaction, the target fund management team and other partners should conduct negotiations in advance with respect to rights of first refusal.

**Negotiate to confirm transaction documents.** Partnership agreements are not usually the focus of negotiation in PE secondaries compared with traditional LP direct investment transactions, due to the particularities of the transaction stages and parties involved. Rather, the transfer agreement (or purchase agreement) will serve as the basis to determine the rights and obligations of the buyer and the seller. In some cases, an S Fund may also seek to negotiate and sign a side letter with the partnership agreement with the general partner and/or the fund manager. Where the seller has signed a side letter and is entitled to certain preferential rights thereunder, a focus of the negotiation will also be whether the S Fund, as the buyer, can directly assume the rights and obligations under the side letter or to what extent it will assume the rights and obligations.

In addition, if the target fund organizational documents stipulate that other existing investors are not entitled to a right of first refusal, the seller, buyer and the target fund management team can directly begin negotiating and drafting the transaction documents. If the existing investors of the target fund are entitled to rights of first refusal, the investors who intend to exercise their rights will also join the transaction negotiations. In the case of multiple proposed transferees, a bidding will be conducted depending on the circumstances in order to determine the terms of the transaction, and the parties will determine the terms of the transaction and finalize the transaction documents upon confirmation with the buyer.

**Payment at closing and transfer of fund interests.** Please refer to the analysis in the following sections 2 and 3 for issues related to closing.

## Closing Date

As mentioned above, the transfer of private equity fund interests is generally not a simple “payment at delivery” transaction, and completion of the transfer process usually takes time. Determining the closing and payment dates is critical to reducing transaction risk in S Fund secondaries. The closing date usually refers to the date when the rights and obligations are transferred under the transaction, while the payment date only refers to the date when the consideration is paid for the transfer. The closing date and the payment date do not necessarily coincide, but there is a close relationship between them.

The closing date typically coincides with the signing date of the target fund interest transfer agreement, the signing date of the target fund partnership agreement, or the payment date of the transfer price. For S Funds, the earlier the closing date, the earlier the transfer of rights and obligations will be completed. However, in practice, parties rarely take the signing date of the target fund interest transfer agreement as the closing date. In most cases, parties will regard the signing date of the target fund partnership agreement as the closing date for the convenience of administration. Since the transfer consideration is generally agreed in the target fund interest transfer agreement, if the closing date is later than the signing date, one issue to be mindful of is that the target fund could make income distributions or certain other payments during the interim period which would affect the pricing of the target fund interest. In such cases, the S Fund will need to set in the target fund interest transfer agreement a mechanism for adjusting the transfer consideration or a mechanism for adjusting and reserving the capital contribution and income distribution.

Postponing the closing date will result in a longer transition period. Thus, another concern during

negotiations of the transaction documents is how to stipulate the seller's good-faith management obligations and further maintain the stability of the interest during the transition period.

## **Closing Arrangements**

The payment date may also be set later than the signing date of the target fund interest transfer agreement and the signing date of the target fund partnership agreement, such as the date of completion of the SAMR registration change. S Funds are subject to lower transaction risk the later the payment date is delayed. However, the determination of the payment date is also subject to negotiations between the parties, especially the seller's funding needs. If the seller is in urgent need of liquidity, it usually prefers a buyer who can pay the consideration within a shorter period (but may make concessions for the amount of transfer consideration). However, if the seller transfers the target fund interest only for the purpose of adjusting asset allocations, it will be more concerned about the amount of the transfer price and be less demanding for the timing of payments. S Funds therefore need to pay attention to the reasons for the seller's transfer of the target fund interest in the due diligence process.

In addition to the payment date, S Funds are closely concerned with the method of payment. Parties to the transaction can negotiate the method of payment, either a one-time payment or in installments, as well as the payment schedule. One-time payments are the best choice for sellers, while buyers usually prefer installment payments in order to reduce transaction risk and facilitate liquidity. In the case of installment payments, the payment of each installment will ordinarily be due at the completion of milestone events in the transfer process, which include the signing date of the target fund interest transfer agreement, the signing date of the target fund partnership agreement, or the date of completion of the business change.

During the transaction, in order to align the buyer and seller's demands, the parties may consider opening an escrow account or the third-party fund custody account if they intend to advance the payment schedule while ensuring security of the funds. Specifically, the buyer will pay the purchase price to an escrow account or a custody account upon satisfaction of preliminary conditions, which will be paid to the seller upon satisfaction of all conditions. The opening of a third-party custody account is relatively complicated since it involves a party other than the parties to the transaction and may require execution of an additional agreement between the parties. Therefore, use of an escrow account is more common in practice. In such cases, the parties will jointly select an escrow bank and open an escrow account under the name of either the buyer or the seller. The payment in the escrow account will be confirmed by both the buyer and the seller and transfer instructions need to be provided.

## **Termination Mechanisms**

As mentioned above, for complex transactions, a series of conditions precedent to closing will be stipulated in the target fund interest transfer agreement, and the closing may take place only if all preconditions have been met. This means the transaction may fail due to a failure in the satisfaction of closing conditions even if a target fund interest transfer agreement has been signed. Therefore, the target fund interest transfer agreement usually stipulates a specific termination mechanism that entitles the parties to terminate the agreement if the closing fails due to a major default.

The most common cause for termination of an agreement is a major breach by either party. With respect to the buyer, its willingness to purchase the target fund interest depends to a large extent on the truthfulness and accuracy of the representations and warranties of the seller and target fund management team. The biggest concern of the seller is to ensure payment of the transfer consideration by the buyer. Transaction security is a common concern for both the buyer and seller. Therefore, both the buyer and seller may terminate the agreement in the case of a major breach. However, the right of termination is also subject to certain restrictions to prevent abuse, such as limiting the exercise of rights to the occurrence of certain consequences of a breach, or granting the party in default a reasonable grace period and remedial period. Another common provision relates to the buyer's right of termination in the event that the target fund's interest is subject to any significant adverse changes before the closing.

In addition, the parties to the transaction may also stipulate a long stop date in the target fund interest transfer agreement. The purpose of the provision is to prevent unlimited delay of the transaction if the conditions precedent to closing cannot be reached and therefore protect the seller's right to subsequent disposal of the target fund interests and the buyer's right to obtain a refund. The long stop date is determined by considering various factors such as the actual progress of the transaction. The long stop date, if too late, may cause the parties to miss the best opportunity to complete the transaction; conversely, if it is too early, the long stop date may disrupt the normal order of the transaction. Certain exceptions should be considered in order to determine the long stop date. For example, if the parties stipulate the SAMR registration change as one condition precedent to closing, changes in SAMR policy as well as other objective factors should be excluded.

## **Brief Tax Analysis<sup>2</sup>**

In practice, S Funds may require a certain percentage discount on the price of the target fund interest even though the market may inherently assign a discount to the interest. In such cases, the tax authorities may request a tax adjustment, especially when the fair market value of the interest exceeds book value, since discounted transfers may not generate any tax revenue. This means that the seller not only has to bear the loss of the income due to the discount, but may also have to bear an additional tax burden. In practice, the seller and the buyer may stipulate in the agreement how to distribute the tax burden between them.

Therefore, S Funds may consider conducting the transfer in the form of causing the seller to withdraw or reduce its capital contribution and have the buyer enter the fund. As far as we know, the tax authorities are less likely to request tax adjustments in practice in the case of withdrawals.

If a tax adjustment is proposed when transferring a target fund interest, the S Fund can assert that the tax adjustment does not conform to the basic principles of the Law on Enterprise Income Tax by claiming that the seller and buyer are not related in any way and by considering the particularity of the S Fund, the business environment and factors resulting in the discount. Even if the fund interest is transferred at a discount, it is still very difficult to determine the fair market value of the private equity fund interest in practice. On March 30, 2018, the Asset Management Association of China promulgated the Guidelines

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<sup>2</sup> At present, secondaries also include private equity fund unit transactions in foreign secondary markets, as well as overseas S Fund withdrawals from domestic fund and interest transfers. The tax issues related thereto should be analyzed by comprehensively considering various factors which are not detailed in this article.

for the Valuation of Non-listed Equity Investment of Private Equity Funds (for Trial Implementation), which proposes five methods to evaluate non-listed equities and emphasizes that valuations should take substance over form. In fact, the basis for tax adjustments still awaits to be clarified considering that the valuation of private equity fund interests in PE secondaries may be the sum of the fair value of the market of the invested enterprises, and different invested enterprises are subject to different valuation methods.

## **Conclusion**

The private equity secondary market has gradually improved with the development of the domestic primary market. In addition to the issues mentioned above, there are still many details to be explored in the practice of private equity fund interest secondaries, such as the difference in the transaction procedures when dominated by different parties, the focus of transaction negotiations when the seller is in default, the bidding mechanism in case of multiple buyers, and special provisions in the fund documents of S Funds. It is foreseeable that as the private equity fund interest secondary market gradually matures, secondaries will become more complicated and S Funds will play a more important role in the market.

## ***Important Announcement***

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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