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An Update on China's Variable Interest Entities: Navigating Regulations and Mitigating Risks for 2013

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For more than a decade, variable interest entities ("VIEs") have been used as investment vehicles for foreign companies to indirectly invest in China's restricted and prohibited industries as well as for Chinese domestic companies to acquire offshore financing or listing. For many years, Chinese regulatory authorities have turned a blind eye on the use of VIEs, fueling the growth of certain restricted and prohibited sectors, such as telecommunication, internet, and media – the most notable example being Sina's NASDAQ listing in 2000. Recent government actions, however, indicate the Chinese government's intention to crack down on VIEs, highlighting the unreliability of using such vehicles. This article will outline the background for VIEs, reasons for their employment, recent developments on VIEs, and actions foreign companies can take to mitigate their risks in light of China's current regulatory environment.

I. Background

A. What Are VIEs?

VIEs are investment vehicles used by foreign invested entities to control an operating company through a series of contractual arrangements, rather than through equity ownership. Under the VIE structure, the foreign investor establishes an offshore vehicle with a domestic partner to directly or indirectly own a wholly foreign-owned enterprise ("WFOE") in China. The domestic partner establishes a subsidiary operating company to apply for all the relevant operating licenses and permits.

VIE Agreements generally include:

- **A call option agreement –** which gives the WFOE the legal right to purchase the VIE at a set price
- **An equity pledge agreement –** which is used by VIE owners to pledge their equity as collateral
- **A loan agreement –** which transfers most shareholder rights from Chinese VIE shareholders to the WFOE
- **A power of attorney –** which gives a power of attorney to the WFOE
- **A technical service agreement –** which allows the WFOE to extract all of the VIE's profits

Through these contractual arrangements, the WFOE controls the operating company, allowing the foreign investor to obtain the operating company's economic benefits, as well as permitting the offshore vehicle to consolidate the WFOE's and operating company's financial statements. Furthermore, VIEs evade restrictions on foreign ownership precisely because there is no stock ownership.

B. Why Do Foreign Investors Use VIEs?

There are two main reasons why foreign investors use VIEs:

1. VIEs allow foreign investors to indirectly invest in restricted sectors.

Since the opening of China's market, private companies in China have had difficulty in getting access to capital and have looked to foreign investors as a source of funds. Unfortunately, Chinese companies need permission to list overseas and foreign companies are restricted from participating in certain domestic sectors. By necessity, VIEs are created to overcome these challenges. VIEs allow foreign investors to reap the economic benefits of investing in a restricted industry without having to obtain approvals for direct investment and permit domestic companies to access capital in such restricted industries. Using the VIE structure, many Chinese internet companies, including Sina, Baidu, Ctrip, Sohu, and Youku, have been able to list overseas.

2. VIEs circumvent the need to obtain approvals under M&A Rules for cross-border acquisitions.

People's Republic of China Provisions on the Merger or Acquisition of Enterprises in China by Foreign Investors ("M&A Rules") provides that where a company, enterprise, or natural person in China acquires an affiliated company in China in the name of its lawfully established or controlled overseas company, examination and approval procedures must go through the Ministry of Commerce of the People's Republic of China ("MOFCOM"). Approvals for cross-border affiliated acquisitions under the M&A Rules, however, are notoriously difficult to obtain. To circumvent these rules, VIEs have been used to avoid having to obtain MOFCOM approvals, on the basis that M&A Rules do not apply since VIEs do not involve any acquisition of a domestic company by a foreign investor, nor involve direct equity transfer.

C. What Are the Risks of Using VIEs?

While VIEs seem to be a popular choice, they present a number of regulatory, legal, and business risks.

1. Regulatory Risks

The main regulatory risk for VIEs is their lack of official approval from the Chinese authorities and avoidance of Chinese regulatory supervision. Although VIE agreements do not allow their foreign investors to directly own an equity stake in the operating company, the Chinese authorities might view such indirect ownership as a foreign investment in a restricted sector without obtaining all the necessary MOFCOM approvals. Investors have used VIEs to avoid restrictions from the China Securities Regulatory Commission ("CSRC") and to list on overseas securities exchanges. Such action is problematic because Chinese authorities cannot exercise regulatory control over such companies because they were formed in the Cayman Islands or other tax haven jurisdictions, even though their substantive operations are in China. While companies seemed to have tacit approval by government authorities in the past, they face risks that the authorities may require the VIE structures to be unwound, depending on current government policies (see Part II).

2. Legal Risks – Enforceability of VIE Agreements

For foreign companies who use VIE structures to invest in restricted sectors, they face possible risks that their contractual arrangements will not be respected by either the Chinese shareholder of the VIE or by PRC courts. A feared scenario would be that the Chinese shareholder of the VIE would take the VIE and refuse to acknowledge the VIE agreement. The VIE structure depends on

the enforceability of the contracts between the WFOE and the VIE – if those contracts are breached, public shareholders would lose their investment in the VIE. The most famous example highlighting this issue is the *Yahoo-Alibaba* (2010) case. In that case, the dispute arose when Jack Ma, CEO of Alibaba transferred the ownership of Alipay (China’s leading online payment processor) under a VIE structure to a domestic company controlled by Mr. Ma. Alipay was a WFOE wholly owned by Alibaba Group, a Cayman Island company that was owned by Yahoo, Softbank, and Mr. Ma. When People’s Bank of China regulators decided that Alipay could not obtain the required license if the online payment company had foreign ownership (whether through equity or VIE), this resulted in the dismantling of the VIE and Yahoo’s loss of Alipay. Mr. Ma, on the other hand, obtained full ownership of Alipay. The *Yahoo-Alibaba* case serves as a reminder that VIE agreements are not guaranteed to be enforceable.

3. Business Risks – PRC Shareholder Nominee for Foreign Companies

One of the main business risks that foreign companies face is the lack of trustworthy PRC shareholder nominees for their operating companies. While domestic companies can find trustworthy shareholder nominees for VIEs (e.g. through relatives or close friends), foreign companies usually have difficulty securing PRC nominees due to lack of ties, which becomes problematic if the partnership between the domestic company and foreign company dissolves.

II. Recent Developments (2009-2012)

Recent government actions also indicate a trend towards stricter regulation of VIEs.

Governmental and Legislative Actions against VIEs

1. Notice on Internet Games (2009)

In 2009, the State Commission Office for Public Sector Reform, along with two regulators, published a notice on animation and internet games (“Notice”). The Notice states that foreign investors may not control or participate in a domestic business that is engaged in online gaming by entering into contractual arrangements, establishing a joint venture company, or offering technical support. The Notice indicates Chinese authorities’ awareness of VIEs and their intention to regulate the use of VIEs.

2. National Security Review (2011)

In 2011, MOFCOM issued provisions that banned the adoption of “control through contracts” arrangements to evade national security review requirements for foreign investment in certain key sectors that would otherwise be subject to review. The issuance of these provisions is a direct attack by MOFCOM on VIEs since VIEs are known to use “control through contracts.”

3. CSRC Report (2011)

In 2011, CSRC purportedly issued a report that requested the State Council to push MOFCOM to impose stricter regulations on the use of VIEs (especially in areas like the internet) and to encourage Chinese companies to list at home. While the report is only “unofficial” and its suggestions would require the collaborative efforts of multiple government agencies, it has led to a decline in the price of companies using the VIE structure and signals stricter government control on use of VIEs.

4. Circular 45 (2012)

In 2012, the CSRC issued a new circular on application for overseas listing by PRC enterprises (“Circular 45”). Effective on January 1, 2013, Circular 45 states that joint stock companies

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incorporated under the *Company Law of the People's Republic of China* that meet the listing requirements effective in the intended regions may file applications with the CSRC for issuing shares and listing overseas. CSRC, however, will reject an issuer's application if one of its shareholders invested in the issuer through a VIE structure. Circular 45, though relaxes the requirements for domestic enterprises to issue shares and list overseas, but also makes the VIE structure more impracticable from commercial and legal perspectives.

III. Recommendations

With a trend towards stricter government control of VIEs and increasing risks for its use, foreign companies can take several steps to mitigate their risks. First, foreign companies can "control the chop." This is important because the company chop definitively represents the company's actions and is needed to enter into contracts and to register for government approvals. By securing the necessary company seals, the foreign company can retain control over its business in the operating company in case of disputes. Second, foreign companies can install trusted persons at key positions of the Chinese operating companies. While this is not a foolproof solution, such a move would provide some security that there are personnel whose interest is solely for the foreign companies. Lastly, foreign companies can shift their assets and businesses to the WFOE whenever possible. Particularly for non-restricted sectors, foreign companies can expand their businesses and acquire assets through the WFOE to ensure more direct ownership of the assets by the foreign investor. By taking these precautions, foreign companies will be better prepared in dealing with the risks and uncertainty surrounding VIEs.

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