

**VIE STRUCTURES IN CHINA:  
AN UPDATED OVERVIEW**

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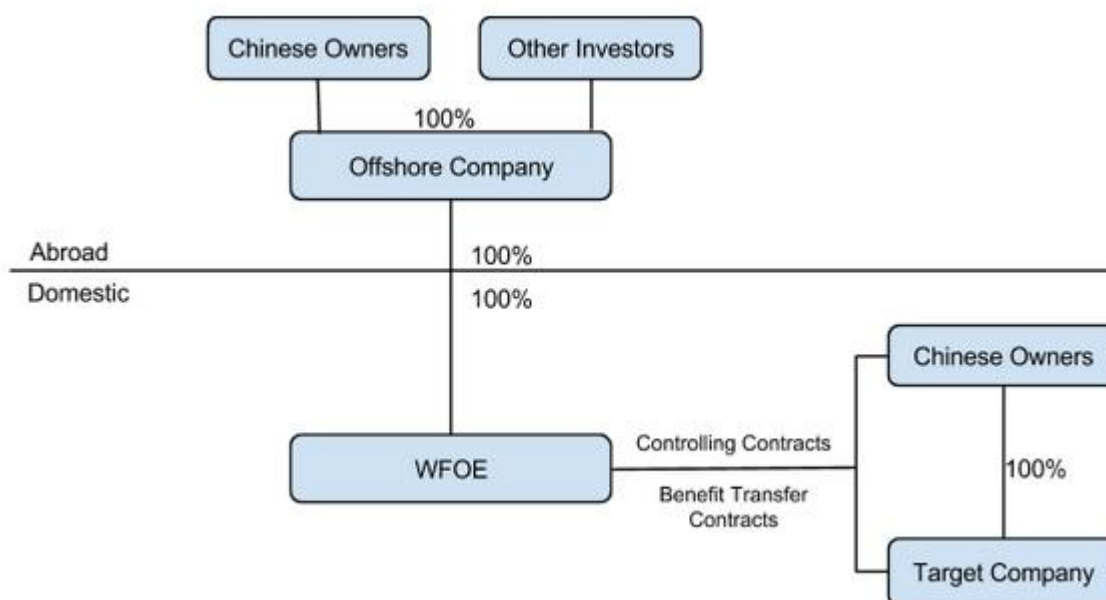
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## VIE Structures in China - an Updated Overview

### 1. Introduction

#### 1.1 Definition of a VIE Structure

Variable Interest Entity (VIE) is a term used by the United States Financial Accounting Standards Board (FASB) in the **FIN 46** statement to refer to an entity (the investee) in which “the investor holds a controlling interest that is not based on the majority of voting rights.”<sup>1</sup>



In a VIE structure, as the diagram shows, foreign investors can control and reap economic benefits from a subsidiary/subsidiaries (Target Company) through the ownership of a Wholly Foreign-Owned Entity (WFOE) which has certain controlling and benefits transfer contracts (VIE contracts) with the Target Company and the shareholders of the Target Company.

#### 1.2 Advantage of a VIE structure

In China, foreign direct investment has been classified into four categories: (1) encouraged; (2) permitted; (3) restricted; (4) prohibited. Different categories are subject to different levels of governmental review.<sup>2</sup>

<sup>1</sup> [http://en.wikipedia.org/wiki/Variable\\_interest\\_entity](http://en.wikipedia.org/wiki/Variable_interest_entity)

<sup>2</sup> Article 4, Provisions Guiding the Direction of Foreign Investment

Foreign investors must obtain certain approvals from the government for their investments in China. It can be difficult to obtain approval to enter certain industries, especially restricted industries, such as value-added telecommunication services, direct sales, mail order, and online sales. By using a VIE structure, foreign investors do not have to obtain PRC government approval for a foreign direct investment since they do not own the equity of the Target Company. However, they can still operate a Target Company and receive revenues from it.

### **1.3 Examples of VIE structures**

Currently Listed on NASDAQ or NYSE: Sohu, Netease, Ctrip, Baidu, Youku, Dangdang, Alibaba

Currently Listed on Hong Kong Stock Exchange (HKSE or HKEx): Tencent

Previously listed on HKEx: Alibaba.com (delisted in 2012)

## **2. Risks of a VIE structure**

### **2.1 Regulatory risks:**

The Alibaba prospectus states that “the Peoples' Republic of China government may not agree that these arrangements comply with PRC licensing, registration or other regulatory requirements, with existing policies or with requirements or policies that may be adopted in the future.”<sup>3</sup>

Other companies (and not just Alibaba) have taken note that there is a possibility that the PRC government may determine VIE structures to be illegal as it could be seen as a way of circumventing governmental review of foreign direct investment.

### **2.2 Contractual risks:**

Contract Law of the PRC provides that a contract shall be null or void if an illegitimate motive is concealed under the guise of a legitimate act.<sup>4</sup> According to this clause, the contracts executed in a VIE structure could be null and void since its main purpose is to bypass governmental review of foreign direct investment that appears to violate Chinese law.

There have, however, been no rulings on these contracts in PRC courts. In the event that the Chinese owners breach any contracts, it is unclear whether the rights of the foreign investors under the contract will be protected by PRC courts or arbitral institutions.

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<sup>3</sup> Page 40, Alibaba's Prospectus of NYSE.

<sup>4</sup> Article 52, Contract Law of PRC

### 3. Chinese Authorities and VIE structures

#### 3.1 Government authorities and structures

It is apparent that the Chinese government has always paid attention to VIE structures as this has been mentioned in several regulations issued by the Chinese government, such as:

1. In October 2005, SAFE issued a *Notice of the State Administration of Foreign Exchange on the Administration of Foreign Exchange Involved in Financing and Return on Investment Conducted by Residents in China via Special-Purpose Companies* that included VIE structures in the scope of foreign exchange supervision.<sup>5</sup>
2. In September 2009, MOFCOM issued *Provisions of the Ministry of Commerce on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* stating, “No foreign investor is allowed to substantially avoid the M&A security review by using a VIE structure”.<sup>6</sup>

Despite its wide use, the legality of the VIE structure in China has long been uncertain. We may, however, gain insight into the government’s attitude towards the VIE structure from a recent case: Wal-Mart’s Acquisition of Yihaodian.

On August 12, 2012, after an eight-month merger review process, MOFCOM conditionally approved Wal-Mart’s acquisition of control of Shanghai Yishiduo E-Commerce Co., Ltd. Yihaodian, the largest online supermarket in China, is believed to be operated by Yishiduo E-Commerce Co., Ltd., under a VIE structure. MOFCOM imposed conditions confining the scope of the transaction to the online direct sales business of Yihaodian only, prohibiting Wal-Mart from providing network platform services to trading parties through Yihaodian, and expressly precluding Wal-Mart from offering value-added telecommunication services (a restricted industry) through Yihaodian via a VIE structure.<sup>7</sup>

This was the first time that MOFCOM had explicitly prohibited the use of a VIE structure. Although it is not an express declaration as to the illegality of the use of the VIE structure, it indicates MOFCOM’s negative attitude towards the use of VIE structures operating in a restricted sector.

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<sup>5</sup> Notice of the State Administration of Foreign Exchange on the Administration of Foreign Exchange Involved in Financing and Return on Investment Conducted by Residents in China via Special-Purpose Companies

<sup>6</sup> Provisions of the Ministry of Commerce on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

<sup>7</sup> Notice No.49, 2012, MOFCOM

### 3.2 Judicial authority and VIE structures

While there are no recent court judgements involving VIE structures, there was one notable case ruled by the Supreme Court in 2012 involving Minsheng Bank. It should be noted that while there were certain distinctions between the agreements in the Minsheng Bank case and those in a typical VIE structure, the Supreme Court ruling may reflect the judicial authority's attitudes towards these types of business operations.

In 1995, as foreign direct investment was restricted in the area of banking according to the laws and regulations at the time, Chinachem entered into a series of agreements with the SME Company authorizing SME to act as its proxy with respect to its shares in Minsheng Bank, including holding the shares in the bank on behalf of Chinachem, managing and exercising all the rights and interests associated with these shares, and filling in a director position on the board of Minsheng Bank. Meanwhile SME undertook voting rights associated with these shares following the instructions of Chinachem. Several years later, Chinachem had a dispute with SME over the ownership of the Minsheng Bank shares and related dividends.

The Supreme People's Court of the PRC in late 2012 ruled that the agreements between Chinachem and SME were invalid on the grounds that they established an entrustment relationship, which circumvented PRC laws and regulations on foreign investment in the financial industry and constituted "concealing illegal purpose under the guise of legitimate acts" according to article 52 of the Contract Law.<sup>8</sup>

China is not a case law country and judgements do not have the same precedent-setting effect that they do in case law jurisdictions. However, a risk still exists that foreign-controlled contracts may be ruled invalid by the courts.

### 3.3 Arbitral institutions and VIE structures

From 2010 to 2011, the China International Economic and Trade Arbitration Commission ("CIETAC") Shanghai ruled on two cases involving the VIE arrangement of an online game operating company, stating that the VIE agreements were void on the grounds that such an arrangement violated the mandatory provisions of administrative regulations that prohibit foreign investors from investing in the online game operation business, and constituted "concealing illegal intentions with a lawful form".<sup>9</sup>

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<sup>8</sup> 2002, 4th Civil Court, Final, No.30.

<sup>9</sup> Page 90, Dec 2012/ Jan 2013, China Business Law Journal

It should be noted that online gaming operations is one of a few industries where there are rules explicitly prohibiting foreign investors from controlling and participating in the business indirectly through contractual or technical support arrangements.<sup>10</sup> There are, however, no such specific rules for most other industries. Thus, it is still uncertain whether the arbitral institution would have the same opinion toward VIE structures used in other industries and whether other arbitral institutions may hold a different opinion with respect to the same case.

#### 4. Future Legal Development of VIE Structures

On January 19, 2015, China's Ministry of Commerce (MOFCOM) issued a Foreign Investment Law draft ("Draft") and also an "Illustration of the Draft" ("Illustration") for public comment.<sup>11</sup>

Under the Draft, foreign-invested enterprises ("FIEs") shall be determined to be foreign investors.<sup>12</sup> In addition, foreign investors controlling a domestic enterprise or holding the rights and interests of a domestic enterprise through contracts, trusts and other means shall be determined to be a foreign investment.<sup>13</sup> Where a foreign investor prescribed in the Draft is controlled by a Chinese investor, the foreign investor may, when applying for market entry licensing for an investment in China included in the scope of the list of restricted investments, submit supporting materials to have its investment deemed as such by the Chinese investor.<sup>14</sup>

According to the Draft, control of a Target Company (domestic enterprise) by foreign investors (FIE) through a VIE structure, and controlling through contracts, would be determined to be a foreign investment that shall be subject to governmental review and obtain official approval. If an Offshore Company is controlled by Chinese investors, however, it might be deemed as an investment by a Chinese investor upon application.

The Draft does not set forth any rules with respect to the companies that already use VIE structures to operate industries in restricted or prohibited categories. The illustration does state three possibilities when the Draft takes effect:<sup>15</sup>

- 1) Investors could keep operating businesses through VIE structures after declaring to the government authority that the VIE is actually controlled by Chinese investors.

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<sup>10</sup> Article 4, Xin Chu Lian [2009] No. 13

<sup>11</sup> <http://www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtml>

<sup>12</sup> Article 11, the Draft of Foreign Investment Law

<sup>13</sup> Article 15, the Draft of Foreign Investment Law

<sup>14</sup> Article 45, the Draft of Foreign Investment Law

<sup>15</sup> Article 3, Illustration of the Draft of Foreign Investment Law

- 2) Investors file an application with the government authority to apply for determination whether a VIE structure is controlled by Chinese investors. The investor could keep operating the business through a VIE structure if the government official determines it is controlled by Chinese investors.
- 3) Investors file an application with the government authority to apply for permission to use a VIE structure, and the government authority would determine this based on factors such as who is the actual controlling party.

## 5. Conclusion

As discussed above, VIE structures have been a gray area in the Chinese legal system. Even though the Chinese government holds a negative attitude towards VIE structures, there is no clear prohibition against the use of a VIE structure in most industries in China, except for a few industries such as online gaming. There has also been no express endorsement of VIE structures either. Several domestic companies have been using VIE structures to raise funds abroad, and this includes companies that have been listed in overseas stock exchanges.

The Foreign Investment Law, if enacted, would change this situation as investments through VIE structures would then be treated the same as regular foreign investments and be subject to governmental review. Existing VIE structures would not escape and would fall within the three aforementioned scenarios.

Though new VIEs might be subject to strict governmental review after the Foreign Investment Law takes effect, the Chinese government would likely not apply the law retroactively as many well-known companies listed in overseas stock exchanges have chosen to operate using this model. Retroactive application of the law would potentially harm these companies and have a negative effect on the market and economy. The Chinese government will likely seek an approach such an exemption or special rule that will allow these companies to continuing operating as they do now.

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