O'Melveny & Myers Publishes Paper on VIE Structures in China: What You Need to Know

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Perhaps no topic is currently more hotly debated among the PRC foreign investment community than the "variable interest entity," or VIE, structure. Used for more than a decade by foreign-invested PRC companies operating in industries subject to restrictions on foreign investment, the structure has been adopted by many of China’s most well known offshore-listed companies. For several emerging industries in China, including Internet and private education, almost all major players have adopted VIE structures to attract foreign venture capital financing and complete offshore listings (primarily in the U.S. and Hong Kong).

However, recent instances of companies losing control of their VIEs (e.g., the Alipay VIE) and concerns over a potential regulatory clampdown on VIE structures have caused significant concern among investors. Steep declines in share prices of offshore-listed PRC companies in September 2011 were attributed, at least in part, to concerns about the VIE structure.

As a result, it is more important than ever that investors clearly understand how VIE structures work, why they are used, and the risks involved with investing in a company using a VIE structure. In the linked article, we discuss the basic characteristics and underlying rationale of the VIE structure, its expanded use in recent years, the regulatory history and recent regulatory scrutiny of the structure, the structural risks inherent in its use, and best practices for mitigating such risks.

The full report follows below. To request a hard copy of the report, please **click here**.

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For more than a decade, the captive or “Sina-model” structure (also commonly referred to as the “variable interest entity,” or VIE, structure, which is the term we use in this article) has been adopted by foreign-invested PRC companies operating in industries subject to restrictions on foreign investment. The structure has become commonplace and is used by many of China’s most well known offshore-listed companies, including Alibaba, Baidu, Dangdang, Focus Media, New Oriental, Sina and Tudou. For several emerging industries in China, including Internet and private education, almost all major players have adopted VIE structures to attract foreign venture capital financing and complete offshore listings.

However, recent instances of listed companies losing control of their VIEs (including the very public dispute between Jack Ma, the founder and CEO of Alibaba, and Alibaba’s other shareholders regarding the Alipay VIE) and concerns over a potential regulatory clampdown on VIE structures have caused significant concern among investors. Steep declines in share prices of offshore-listed PRC companies in September 2011 were attributed, at least in part, to concerns about the VIE structure.

As a result, it is more important than ever that investors clearly understand how VIE structures work, why they are used, and the risks involved with investing in a company using a VIE structure. In this article, we discuss the basic characteristics and underlying rationale of the VIE structure, its expanded use in recent years, the regulatory history and recent regulatory scrutiny of the structure, the structural risks inherent in its use and best practices for mitigating such risks.

Anatomy of the VIE Structure

VIE structures are typically adopted as part of an offshore restructuring of a PRC domestic company in preparation for venture capital or private equity financing and eventual listing on an offshore stock exchange. But unlike a straight-forward offshore “red-chip” restructuring where the offshore holding company would acquire the domestic company’s equity interest from its PRC resident founders, in a VIE structure the offshore holding company would form a new wholly owned subsidiary (“WFOE”) in China which would control, and receive the economic benefits of, the domestic company (“VIE”) through a series of contractual arrangements.[1] The VIE, whose shareholders of record would be PRC individuals or companies (typically with the founders retaining majority ownership), would hold those licenses and assets that cannot be legally owned by or transferred to the WFOE under PRC foreign investment restrictions. As a result of the contractual arrangements, the offshore holding company would be able to consolidate the financials of the VIE into the group's overall financial statements under applicable accounting standards (the term "variable interest entity" being a U.S. GAAP accounting term describing an entity consolidated in this way). *Please see the PDF for a diagram that illustrates a typical captive structure.*

The contractual arrangements include 1) agreements providing effective control over the VIE, and 2) agreements providing for the transfer of substantially all of the economic benefits of the VIE to the WFOE. A typical VIE structure will comprise the following agreements:

Agreements providing effective control over the VIE

1. Call Option Agreement — Under the call option agreement among the WFOE, the VIE and the VIE's shareholders, the VIE's shareholders grant an option for the WFOE or the WFOE's designee to purchase all or a portion of their equity interest in the VIE through one or a series of transactions. The purchase price is typically set as "the lowest permissible price under PRC law."

2. Equity Pledge Agreement — Under the equity pledge agreement among the WFOE, the VIE and the VIE's shareholders, the VIE's shareholders pledge their equity interest in the VIE to the WFOE as a guarantee of the performance of their and the VIE's obligations under other VIE structure agreements. The equity pledge agreement typically includes a power of attorney signed by each pledgor authorizing the WFOE's designee to handle the transfer of the pledged equity. It is important to note that under PRC law the equity pledge must be registered with the local Administration of Industry and Commerce to perfect the security interest.

3. Voting Rights Agreement or Proxy — Under the voting rights agreement among the WFOE, the VIE and the VIE's shareholders, the VIE's shareholders delegate their shareholder rights, including voting rights, inspection/information rights, signing rights and election rights, to the designee of the WFOE.

4. Loan Agreements — Under the loan agreements between the WFOE and each VIE shareholder, grants a loan to the shareholder to use for capitalization of the VIE. The loan agreement typically includes stringent covenants, limits on repayment methods and acceleration clauses designed to help in enforcing the VIE structure as a whole.

Agreements providing for the transfer of substantially all of the economic benefits of the VIE

1. Exclusive Service Agreement — Under the exclusive service

agreement between the WFOE and the VIE, the WFOE provides certain services to the VIE for a fee, typically determined by the WFOE with the intended result of shifting the VIE's operating profits to the WFOE. The scope of service varies depending on the industry, but typically includes consulting or strategic services and technical services.

2. Asset Licensing Agreement — Under the asset licensing agreement between the WFOE and VIE, the WFOE licenses certain assets, typically including intellectual property, to the VIE for royalty fees. The agreement usually allows the WFOE to terminate the license at any time. Such right of termination gives the WFOE additional control over the VIE if operation of the VIE relies on the assets that are the subject of the license.

Captive structures were initially used primarily for "asset-light" companies where the VIE only holds certain key permits and licenses, but substantially all major assets (e.g., property or equipment) are held by the WFOE. Investors were relatively comfortable that the downside risks of relying on contractual arrangements to control, consolidate and obtain the economic benefits of the VIE were limited in the case of an asset-light business. However, as discussed below, due to PRC regulatory restrictions on straight-forward red-chip restructurings and as investors and overseas regulators became more accustomed to the use of VIE structures, the structure has been increasingly adopted by asset-heavy companies in recent years.

Notwithstanding its widespread use by high-profile companies, there are a number of significant negative effects of adopting a VIE structure. As discussed in greater detail below, these principally include the risk that the structure will be declared invalid by PRC regulators or that the contractual arrangements will be unenforceable or otherwise insufficient to retain control over the VIE. In addition, the arrangements for transferring the VIE's profit to the WFOE are inefficient from a tax perspective. For example, the profit transfers are subject to business tax, thereby resulting in double taxation of that revenue (once when received by the VIE and once when transferred to the WFOE), and may face transfer pricing challenges from the PRC tax authorities.

Expanded Use of the VIE Structure

Sina was one of the first companies to use the VIE structure to attract foreign investment and complete its listing on Nasdaq in 2000 (hence the name "Sina-model" structure). As an Internet company, Sina and its investors adopted a VIE structure in response to PRC regulatory restrictions on foreign investment in Internet-related businesses in China. Although the structure was not officially or publicly blessed by the PRC government, Sina and the other early Chinese Internet companies, including Sohu and Netease, were able to obtain enough unofficial comfort from the PRC Ministry of Information Industry ("MII") (now known as the Ministry of

Industry and Information Technology, or “MIIT”) that they were able to successfully complete their initial public offerings and stock exchange listings in the United States using the structure.

As venture capital and private equity financings in China increased during the last decade, the VIE structure became more and more commonplace. However, given the obvious regulatory risks involved, investors and companies were initially cautious in using the structure in new industries. From 2001 to 2006, the structure was primarily used by companies in new technology or emerging industries where private companies predominated, including online games, advertising and private education. As more companies adopting the structure listed in the United States (and on the Hong Kong Stock Exchange, beginning with Alibaba in 2005) without any noticeable PRC regulatory backlash, investors and other market participants gradually became more comfortable with the structure.

Following the enactment of the Regulations on Mergers and Acquisition of Domestic Companies by Foreign Investors (the “M&A Rules”) in September 2006, the VIE structure became even more prominent. Under the M&A Rules, approval by the central-level PRC Ministry of Commerce (“MOFCOM”) is required for all traditional red-chip restructurings. Since the promulgation of the M&A Rules, almost no such offshore restructurings have been approved by MOFCOM.

However, in the years following the issuance of the M&A Rules, PRC law firms and market participants became comfortable that acquiring control of a domestic company through the use of VIE structures, at least as long as the VIE operates in an industry subject to foreign investment restrictions, does not trigger the central MOFCOM approval requirement under the M&A Rules. With VIE structures having been accepted by investors and without major regulatory crackdowns on its use, the conditions were set for a dramatic expansion in their use. PRC companies in an increasing number of industries adopted the structure for their pre-IPO offshore restructurings, including in traditional and asset-heavy industries such as seed production, coal trading, auto retailing and dredging services. This expansion into more traditional and asset-heavy industries, where the companies are more likely to compete directly with large state-owned enterprises and attract the attention of PRC regulators, has apparently been a significant factor in the recent increase in PRC regulatory scrutiny of the VIE structure.

Increasing Regulatory Scrutiny

Although the structure has never formally been blessed by any PRC regulatory body, its tacit acceptance by key regulators including MOFCOM, the PRC State Administration of Foreign Exchange (“SAFE”) and MIIT has been crucial to its continued prevalence. However, the structure has consistently been dogged by concerns that PRC regulatory authorities will one day clamp down on its use, determining it to be a violation in principle of relevant PRC foreign investment restrictions and the M&A Rules. In fact, there have been several attempts by individual PRC regulators to restrict or curtail the use of VIE structures. Some of these have been designed to prohibit its use for certain industries, while others have been designed to circumscribe its use, thus implicitly accepting the VIE structure within the prescribed parameters.

The first attempt to explicitly circumscribe use of the VIE structure was the Circular on Strengthening the Administration of Foreign Investment in and Operation of Value-added Telecommunications Businesses (the “MII Circular”) issued by the MII in July 2006. The MII Circular requires that certain key assets – including trademarks, domain names and servers – required to conduct the business of any value-added telecommunications provider (which includes Internet companies) be held by the company holding the value-added telecommunications service provider license or its shareholders, and not be leased or licensed from a third party. In effect, this meant that in a VIE structure the VIE needed to hold these key assets and could not lease or license them from the WFOE. The MII Circular has been widely viewed as targeting foreign Internet companies, such as Google, trying to invest in restricted sectors in China through use of the VIE structure. By requiring the VIE to hold key assets, MII was attempting to ensure that that the VIE was not merely a shell company holding only the key operating licenses. Although the MII Circular enhanced risks associated with the VIE structure by increasing the potential damage if the WFOE lost control of the VIE, it also may be viewed as implicitly acknowledging the use of the VIE structure in the value-added telecommunications sector.