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VIE Structures in China: What You Need to Know

by David Roberts and Thomas Hall*

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



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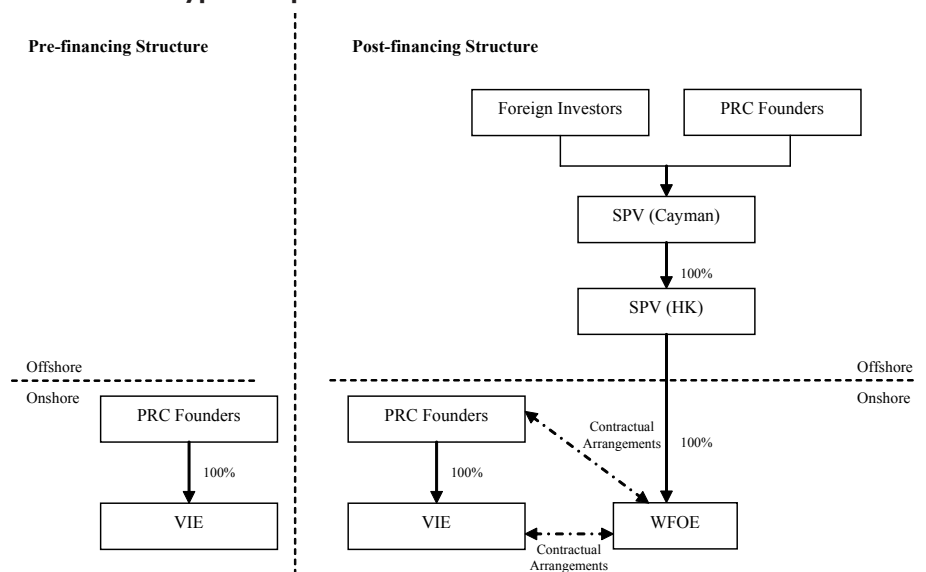
economic benefits of, the domestic company (“VIE”) through a series of contractual arrangements.¹ The VIE, whose shareholders of record would be PRC individuals or companies (typically with the founders retaining majority ownership), would hold those licenses and assets that cannot be legally owned by 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).

The following diagram illustrates a

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

Chart I — A typical captive structure



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:

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

1. Typically the contractual arrangements are entered into between the VIE and its shareholders and the WFOE. However, for accounting or other reasons, certain of the contractual arrangements may be entered into by an offshore entity rather than the WFOE.

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 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.

In 2009, the General Administration of Press and Publication (“GAPP”) became the first major PRC regulatory authority to issue specific rules prohibiting the use of VIEs in a restricted industry in which VIE structures had been used in numerous offshore listings. Together with the National Copyright Administration and National Office for Combating

Pornography and Illegal Publications, GAPP issued the Notice on Further Strengthening of the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Games (the “GAPP Notice”) in September 2009. The GAPP Notice provides, among other things, that foreign investors are not permitted to invest in online game operating businesses in China via wholly owned, equity joint venture or cooperative joint venture investments, and expressly prohibits foreign investors from gaining control over or participating in domestic online game operators through indirect means, such as establishing other joint venture companies or contractual or technical arrangements. However, we are not aware of any online game companies utilizing the VIE structure, including some that completed overseas listings following effectiveness of the GAPP Notice, being penalized or ordered to unwind their VIE structures. The generally cited reason for this is that GAPP and the other regulatory agencies that promulgated the GAPP Notice do not have general jurisdiction over regulating and approving corporate structure changes. Rather, these functions for online gaming companies would be conducted by the PRC Ministry of Culture and MOFCOM. Although there is still uncertainty with respect to the implementation of the GAPP Notice, most observers, including PRC law firms, believe GAPP is unlikely to directly interfere with the adoption of VIE structures by leveraging its power to approve the publication of online games before their launch on the Internet. Neither the Ministry of Culture nor MOFCOM have issued rules or indicated publicly that they intend to enforce the GAPP Notice to prohibit the use of VIEs by online gaming companies.

While the GAPP Notice did not end up having a significant impact on how investors viewed the VIE structure, another attempt by an industry regulator to prohibit use of the VIE structure had

a much greater impact. A number of reports have suggested that the People's Bank of China (the "PBOC") is not permitting the use of VIE structures by entities applying for third-party payment service licenses, which the PBOC began accepting applications for in late 2010. Although the relevant PBOC regulations do not refer to VIE structures, reports have indicated that license applicants have been required to indicate whether they have any indirect foreign controlling interest and that PBOC would not grant licenses if there was such foreign controlling interest. It is based on this unpublished rule that Alibaba's Jack Ma stated he had no choice but to unwind the Alipay VIE (discussed further below). However, the basis of this reported prohibition is unclear given that other online payment services, some reportedly using a VIE structure, were able to obtain the license. In the aftermath of the Alipay incident, there have been media reports that the PBOC is investigating whether other licenses being held through VIE structures should be revoked.

Buddha Steel, Inc.'s withdrawn IPO in March 2011 showed the ability of local governmental authorities to prohibit the use of VIEs. Buddha Steel abruptly canceled its proposed public offering in the United States, citing that the company "was advised by local governmental authorities in Hebei Province that [its VIE structure contractual control arrangements] contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy." The limited information announced by Buddha Steel and its relatively low profile as a small steel maker that had become a U.S. reporting company through a reverse merger has made

it difficult to gauge the importance of the apparent disapproval of its use of the VIE structure. Some market participants have viewed Buddha Steel's announcement as a sign that PRC regulatory authorities are drawing a line at use of VIE structures in certain asset-heavy and core traditional industries, in this case steel production.

More recently, in August 2011 MOFCOM released the Measures on Security Review Mechanism for Merger & Acquisition of Domestic Enterprises by Foreign Investors (the "National Security Review Measures"), which specifically state in Article 9 that VIE structures, along with other forms of indirect control, cannot be used to avoid the national security review. As a practical matter, many transactions utilizing VIE structures are unlikely to implicate core national security concerns and therefore would likely not be subject to the national security review.² However, the National Security Review Measures were initially met with concern that the explicit reference to VIE structures portended a move by MOFCOM to clarify that use of VIE structures is in fact a form of acquisition for purposes of the M&A Rules, which would then trigger central MOFCOM approval for the establishment of any VIE structure in a red-chip restructuring. On the other hand, given that the national security review mechanism specifically targets acquisitions that would be deemed sensitive to China's national security interests, it is hardly a surprise that MOFCOM would explicitly disallow indirect structures such as VIE structures to avoid the review. In fact, as with the MII Notice, the explicit reference to VIE structures further confirms that MOFCOM is fully aware of the use of such structures.

2. The National Security Review Measures and related legislation do not clearly state all industries in which an acquisition would trigger the national security review. As a result, there remains some uncertainty as to what industries are covered, including whether it may cover Internet content providers.

As long as MOFCOM does not issue rules folding VIE structures within the M&A Rules framework, the absence of such inclusion may be read as a tacit acknowledgment and acceptance of VIE structures.

However, there have been some indications that major regulatory authorities (including the China Securities Regulatory Commission (the “CSRC”)) are in fact contemplating a more general prohibition of the VIE structure. In early September 2011, rumors surfaced of a report produced within the CSRC recommending the prohibition of VIE structures, with a grandfathering exemption for companies that have already listed overseas. Although a purported copy of the report has been viewed by many industry professionals and was published in the PRC media, the circumstances around the report remain controversial. For example, it is unclear whether the copy of the report that surfaced was only a draft, and whether a final version of the report was in fact published and delivered to the State Council. The report also caught the attention of the international media, resulting in numerous articles that have significantly heightened concern about not only VIE structures but the overall foreign investment climate in China.

The report provides a number of reasons for supporting tighter regulation of VIE structures, including concerns about national security (in particular in relation to the Internet industry and asset-heavy industries) and the desire to have China’s leading companies in emerging industries list onshore in China instead of overseas. At the same time, the report is cautious in stressing that any change in policy should carefully consider the possible negative effects of a clampdown on VIEs, including causing market disorder and leaving some private Chinese companies without options to raise funds given the inability of many of them to meet the listing requirements on domestic stock exchanges and the

relative lack of flexibility in China’s current corporate law. In the end, the report probably represents the view of a number of regulatory officials that the use of the VIE structure should be more tightly regulated. However, to what extent the State Council, MOFCOM or the CSRC would follow the policy recommendations in the report is unclear, and more recent market chatter has indicated a comprehensive clampdown on the use of VIEs may be unlikely, at least in the near term.

The uncertainty regarding implementation of the National Security Review Measures and whether the PRC government will implement further restrictions on the use of VIE structures has led some PRC law firms to be more cautious when issuing opinions on the legality of the structure. At this point, however, we understand that most PRC law firms have continued issuing standard opinions in industries where use of the VIE structure is common, pending any further developments or indications from the regulatory authorities.

Structural Risks — Cautionary Tales

Although the VIE contractual arrangements are crafted to remove any risk of the WFOE losing control of the VIE or its assets, enforcement of the contracts in practice would likely be difficult. Even if they ultimately can be enforced under PRC law against a renegade VIE, irreparable damage to the company may be incurred before enforcement is effected.

While losing control of a VIE has always been a significant risk with the VIE structure, high profile instances of lost VIEs have been rare, at least until recently. The first high profile test of the structure occurred in 2001 at none other than the company that pioneered the structure, Sina, when one of Sina.com’s founders and controlling shareholder of Sina’s VIE was removed

from his position at the company. He eventually accepted a settlement and sold his shares in the VIE without significant disruption to Sina's business. In the end, the founder's decision not to attempt to keep control of the VIE was likely instrumental in maintaining investor confidence in the integrity of the structure.

In April 2008, concerns that Agria Corporation, a PRC seed producer that completed an IPO on Nasdaq in November 2007, was losing control of its VIE caused its stock price to plummet, leading to class action lawsuits. Agria announced the resignation of its chief operating officer and director who was also the founder, sole director and legal representative of Agria's VIE operating entity, due to a dispute with Agria's board and its controlling shareholder. According to reports, the COO, who held no shares in the offshore parent company, was disgruntled at not having received certain compensation for services to the company (including a significant shareholding in the offshore parent company) that he believed was owed and promised to him and his management team by the controlling shareholder. The parties eventually reached a settlement whereby the COO and other members of management of the VIE received a significant amount of shares in the offshore parent as well as cash compensation for services rendered to the company. As with Sina in 2002, a potential disaster was averted through a negotiated settlement, but Agria serves as an important lesson of the risks when the person controlling the VIE does not have a significant shareholding interest, or any interest at all, in the offshore company, which is often referred to as a "sufficient alignment of interests" with the offshore listed company.

Although Sina and Agria eventually retained their VIEs intact, two recent examples have shown how a VIE can be lost, possibly for good. In August 2010 GigaMedia Limited, a Taiwan-based Nasdaq-listed online game

company, announced that it was in a dispute with its former China head and founder of a PRC-based online game business they acquired. The founder's company had been acquired in 2007 through the acquisition of an offshore holding vehicle where the onshore VIE structure was already in place. GigaMedia apparently left the founder in the key positions controlling both the WFOE and VIEs. In early 2010 GigaMedia decided to remove him as head of its China operations, but he did not cooperate and retained control of the company seal, financial chops and other key registration documentation. Without control over such documentation, GigaMedia was unable to effect control over the WFOE or VIEs, or to even register the shareholder resolutions at the WFOE level to remove him from his positions. GigaMedia has brought a series of legal actions against the individual (and he has reciprocated with legal actions of his own) both inside and outside of China in an attempt to regain control of GigaMedia's China operations. Notably, GigaMedia's problem establishing its control is not specific to the VIE structure, as the founder has also successfully (although perhaps temporarily) usurped control of the WFOE. It is actually more of a cautionary tale of the general risks when investing in a PRC-based company, especially one with a strong founder or business partner. However, many market observers have used GigaMedia as a prime example of the risks of a VIE structure. In addition, even if GigaMedia successfully retakes control of the WFOE, it may have a significantly more difficult time effecting control over the VIEs through enforcement of the contractual control arrangements. GigaMedia has already had to announce the deconsolidation of the financial results of the PRC-based business pending resolution of the above dispute.

The most high profile recent example of loss of control over a VIE involves the Alipay VIE. Jack Ma successfully severed

Alibaba's VIE arrangements with Alipay, Alibaba's affiliated online payment service provider, considered a crown jewel of the Alibaba Group. Mr. Ma signed off for the termination of the VIE arrangements in his capacity as authorized signatory for each of the WFOE and the VIE, stating that he had no choice but to do so as the PBOC would not grant Alipay the required third-party payment service license if it remained foreign-controlled. The ensuing public dispute between Mr. Ma and Alibaba Group's other major shareholders, Yahoo! and Softbank, eventually led to a settlement whereby Alibaba Group could indirectly gain from future appreciation in value of Alipay but retained no control over Alipay.

These examples highlight the practical risks associated with the VIE structure — a strong personality holding control of the VIE who has an incentive, or at least not enough disincentives, to run away with the VIE. Combined with PRC legal norms that emphasize the concept of “legal representative”³ and possession of the company seals and corporate registration documentation, the risk of a disgruntled person with controlling power over the VIE attempting to abscond with its assets is higher than in many jurisdictions. This is in particular true in the sensitive instance where the company is trying to remove the person controlling the VIE from his positions at the VIE and the company, as was the case with Sina and GigaMedia. In the case of Agria, the problem derived from too much concentration of control at the VIE level, as well as insufficient alignment of interests insofar as the senior management of the VIE lacked significant shareholding interest in the ultimate listed company. Alibaba perhaps represents the most worrisome case in that it was apparently triggered by a government policy, or a perception of a government policy, that would have caused the VIE to lose its

business anyway if the structure were not unwound.

A further potential concern with VIE structures was highlighted during the recent initial public offering of online video service provider Tudou and the highly publicized divorce proceedings of Tudou's founder, Gary Wang. In the months leading up to the IPO, the ex-wife of Mr. Wang, who holds 95% of the equity interests in Tudou's VIE, initiated a lawsuit against him in connection with their divorce, seeking the division of the equity interest in the VIE held by Mr. Wang, arguing that it formed part of the community property during their marriage. As Mr. Wang's ex-wife was not a party to the VIE contractual arrangements, this lawsuit raised uncertainty about the ownership of a large portion of the VIE and the ability of the contractual arrangements to cover that interest. Mr. Wang eventually reached a settlement with his ex-wife under which she dropped her claims to that property, but not until after it became a significant distraction to the IPO process and resulted in fairly unusual risk factor disclosure in the prospectus for the offering.

Best Practices for Mitigating the Structural Risks

The cautionary tales discussed above are of course by no means the only examples of VIE structure blow-ups. Many private companies have had similar problems. In the end, the VIE structure is an inherently risky corporate structure that should only be used when there are no other less risky options available. But there are also a number of things that can be done to help mitigate the risk.

The most important mitigating actions that can be taken to reduce the risk of losing control of the VIE are to limit the ability of any single person to usurp

3. In PRC corporate law, the “legal representative” of a company is a natural person appointed to perform duties and attend legal proceedings on a company's behalf in accordance with relevant laws and the constitutional documents of the company. Any documents executed by a legal representative affixing a company seal are deemed legal, valid and binding against the company.

control and to disincentivize anyone with such ability from doing so. Several steps can be taken to achieve these goals, including:

- *Diversify shareholding of the VIE* — One option is to ensure no member of management has the power to single-handedly control the VIE, whether by himself or in conjunction with others over whom he has significant influence. The ideal practice would be to have four or more shareholders with different interests and constituencies, including professionals associated with institutional shareholders of the offshore holding company, with each holding under 33% of the VIE's total equity interest. Another possibility is to have several non-executive personnel from the WFOE or VIE act as shareholders of the VIE, assuming there is no concern that such personnel would be subject to the control of a single individual, such as the company's founder. Although these non-executive personnel would presumably not have a significant interest in the offshore holding company, as long as each of their individual equity interests in the VIE was relatively small, their inability to actually run the VIE or influence others to jointly act to the detriment of the offshore holding company should significantly diminish the risk of them attempting to usurp control of the VIE.
- *Carefully consider proper board composition and who should act as legal representative of the VIE* — Although under PRC law the shareholders are the highest decision making body in a domestic company, in practice the board and the legal representative of a company control day-to-day operations and may be difficult to remove if the shareholders are deadlocked or cannot access the VIE's corporate seals and other key registration documents. Some VIEs have only a single executive director, oftentimes the founder. While this may be convenient from an administrative perspective, it enhances the risks of the VIE structure. The VIE's board should match the board of the WFOE, which ideally should include a diverse group of individuals who have shareholding in the offshore holding company and are unlikely to collude to undermine the VIE structure. One option is for at least half the board to comprise representatives of major offshore shareholders. It may also be advisable not to permit the founder or someone likely to collude with the founder to act as legal representative of both the WFOE and the VIE. Finally, the company seal and other registration documents should be maintained by non-executive personnel.
- *Maximize alignment of interests between persons controlling the VIE and those of the offshore holding company* — To disincentivize the persons controlling the VIE from attempting to breach the VIE arrangements, it is important to ensure they have a sufficient stake in the success of the offshore holding company. The alignment of interest is typically a stronger disincentive if the offshore holding company is already listed, since the value of the offshore shareholding to the founder will likely be greater in that case and the negative effects of dissolving the VIE structure would be more public and perhaps entail greater legal and reputational risk. Although the Alipay incident shows that alignment of interests may not be a sufficient disincentive by itself, it is interesting to consider whether Jack Ma would have severed the VIE ties if Alibaba Group were a publicly listed company.
- *Ensure the VIE structure contractual arrangements are in order and enforceable* — The

VIE control documentation should be thoroughly reviewed by counsel and compared against best practices. If possible, signed resignation documents should be procured from the directors and legal representative of the VIE ahead of time. Spousal consents should be procured to mitigate the risk of a spouse of one of the VIE shareholders claiming an interest in that equity. Finally, ensure that the share pledges entered into with the VIE shareholders have been properly registered with the appropriate authorities. Although ability to enforce the VIE contracts is not certain even if everything is properly in place, it would be very unfortunate to discover after the fact that correctable weaknesses in the arrangements prevented their enforcement.

- *Explore whether collapsing the structure and reverting to a traditional parent subsidiary structure is an option* — As China's industry sector restrictions and guidelines on foreign investment evolve, investors should regularly review whether certain companies they are invested in have the ability to unwind their VIE structures. One example frequently cited is the advertising sector, which has been open to foreign investment for many years, but required foreign investors to meet certain prudential requirements that PRC-based advertising companies had difficulty meeting. Over time, some of these businesses may eventually meet the necessary requirements for 100% ownership of the business, making the unwinding of the VIE structure a realistic restructuring possibility.

In addition to minimizing the risk of losing control of the VIE, it is important to also minimize the overall importance of the VIE in the corporate structure. This helps limit the damage if the VIE were lost and also reduces the incentive the VIE controlling persons may have to run off with the VIE. To the extent permissible under PRC law, assets and revenue should be held by the WFOE to reduce risk and the requirement to shift profit from the VIE to the WFOE. If a large portion of revenues must be collected by the VIE, ensure regular implementation of the revenue-transferring contractual arrangements.⁴

In the end, even the most fully vetted VIE structure still faces structural risks, but ensuring the VIE holds as few key assets as possible is the best way to mitigate damage in a worst-case scenario.

Conclusion

Notwithstanding the risks, VIE structures remain an important facet of investing in PRC-based companies and will likely remain so for years to come. Numerous companies have existed for many years, some for more than a decade, utilizing the structure and many have become household names in China and abroad. Optimistically, one can hope the recent attention-grabbing headlines regarding VIEs will lead the PRC government to seek consensus among the numerous affected parties and adopt a well-thought out approach to VIEs. This approach may result in some form of formal recognition of VIE structures, at least in industries where they have provided, and continue to provide, a platform for early stage companies to received much-needed funding and

4. Our understanding is that it has become quite commonplace for profitable VIEs to regularly make payments under the service agreements between the WFOE and VIE and that in many cases auditors are pushing for companies to effectuate these payments.

support from sophisticated foreign investors. By formally recognizing the structure, the PRC government could pave the way for offshore listed PRC companies using the structure to complete dual listings on the much-anticipated international board of the Shanghai Stock Exchange, giving PRC investors an opportunity to invest these companies. Formal recognition of the structure may also help reduce its structural risks by decreasing the risk that PRC courts would find the VIE contractual arrangements unenforceable on public policy grounds. On the other hand, it is also possible that the VIE structure will be increasingly discouraged or even prohibited in the future, or that its current existence in the gray area of PRC laws will continue indefinitely. Until the PRC government provides greater clarification on the treatment of VIE structures, all market participants involved in their use should remain vigilant regarding their inherent risks and uncertainties.

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