

# The Future of Chinese Foreign Investments: An Exploration of the Perils and Consequences of Investing in Variable Interest Entities

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## Abstract

*The Variable Interest Entity ('VIE') has long been a well-accepted structure for foreign investors within sectors that concern China's investment restrictions. They are also utilised as a means by which Chinese domestic entities can list overseas on capital markets internationally. From a regulatory perspective, despite there being no clear prohibition regarding the VIE structure in China, there has also been no specific endorsement of the VIE structure either. Consequently, the VIE structure has remained a grey area within the Chinese legal system. Though the VIE structure permits both foreign and domestic investors to circumvent governmental regulations and reviews, this simultaneously means that the VIE structure hazardously lacks the backing of the relevant authorities which presents a number of legal and regulatory risks. Thus the future of China's VIEs is based upon its anticipated creation of a genuinely level playing field and an improved rule-of-law environment for all market players; so as to render any VIE-type structure redundant and prevent further uncertainty from infiltrating the investment sector.*

## Introduction

The Variable Interest Entity ('VIE') is a well-established and widely utilised structure of investment employed throughout the foreign investment sector in China.<sup>1</sup> The structure entails a succession of contractual arrangements that hold the principal function of circumventing the investment restrictions that the Chinese government has placed upon foreign ownership in particular sectors of the market.<sup>2</sup> Consequently, the legal validity of VIEs has been a point of contention since its very inception. The Sina Corporation was the first

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<sup>1</sup> Z. Xianwu & B. Lihui, 'Variable Interest Entity Structure in China' (China Law Insight, February 2012) <[www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/](http://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/)> accessed 14/04/2014.

<sup>2</sup> D Barboza, 'A Loophole Poses Risks to Investors in Chinese Companies' (N.Y. Times, 23/01/2012) <<http://dealbook.nytimes.com/2012/01/23/a-loophole-poses-risks-to-investors-in-chinese-companies>> accessed 25/07/2015.

company to successfully investigate the uncertain environment surrounding the VIE, when it was publicly listed on the NASDAQ in 2000.<sup>3</sup> In general, the Chinese authorities approved the use of the structure and in consequence the structure has been broadly implemented throughout foreign investment in China.<sup>4</sup> This has aided, among other things, a number of the most renowned Chinese enterprises by facilitating their acquirement of foreign capital and finalising offshore listings, notwithstanding the legal restrictions.<sup>5</sup>

This is due to China's new leaders being encouraged to choose a path of economic liberalism, in order to evade slowing or blocking the development model. Such an approach is exemplified by recent declarations made by Party officials; for example President Xi, who pledged that China would dedicate itself to constructing a 'level playing field' for all market players.<sup>6</sup> Also, Premier Li introduced positive alterations to the restrictions placed upon foreign investments such as VIEs,<sup>7</sup> and the year 2012 was the first time China's banks extended a higher number of loans to private companies, than to state-owned enterprises (SOEs),<sup>8</sup> both of which are encouraging for parties to VIEs.

However, one must remain mindful that, in reality, these are comparatively small changes. The intermittent public quarrels between the different parties to the VIE arrangement and the unclear and often contradictory approaches of various regulatory bodies highlight the drawbacks that continue to plague the VIEs.<sup>9</sup> Furthermore, the enduring lack of clarity, transparency and equality between the parties to the VIE structure, evidence that sincere shifts in policy of greater proportions is required in order to truly impact the

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<sup>3</sup> R. Pearson, 'Looking at Chinese VIEs' (Forbes, 18/10/2012) <<http://www.forbes.com/sites/richardpearson/2012/10/18/looking-at-chinese-vies>> accessed 20/07/2015.

<sup>4</sup> *Ibid.*

<sup>5</sup> These include *Baidu, Sina Corp, Sohu.com, Netease, Tencent, Renren, Dangdang, New Oriental Education and Alibaba.*

<sup>6</sup> V. Ruan, 'Xi Jinping Pledges Level-Playing Field for Global Investors' (The South China Morning Post, April 2013) <<http://www.scmp.com/news/china/article/1210311/xi-jinping-pledges-level-playing-field-global-investors>> accessed 05/05/2014.

<sup>7</sup> D. Barboza & C. Buckley, 'China Plans to Reduce the State's Role in the Economy' (The New York Times, May 2013) <[https://www.google.com.hk/search?q=China+Plans+to+Reduce+the+State%E2%80%99s+Role+in+the+Economy,+the+New+York+Times&source=univ&tbm=nws&tbo=u&sa=X&ei=2LGkUd3jJeWXiQf4\\_4CADg&ved=0CC4QqAI&biw=1260&bih=620](https://www.google.com.hk/search?q=China+Plans+to+Reduce+the+State%E2%80%99s+Role+in+the+Economy,+the+New+York+Times&source=univ&tbm=nws&tbo=u&sa=X&ei=2LGkUd3jJeWXiQf4_4CADg&ved=0CC4QqAI&biw=1260&bih=620)> accessed 27/04/2014.

<sup>8</sup> 'Shadows Lengthen: Chinese Credit Rises. China's Credit Rating Falls' (The Economist, April 2013) <<http://www.economist.com.hk/news/china/21576134-chinese-credit-rises-chinas-credit-rating-falls-shadows-lengthen>> accessed 28/04/2014.

<sup>9</sup> M. N. Goldberger & L. Krabill, 'Fraud Prevalent in Reverse Merger Companies with Operations in China' (2011) *Ballard Spahr LLP* <[http://www.ballardspahr.com/AlertsPublications/Articles/2011-07-08\\_Fraud\\_Prevalent\\_in\\_Reverse\\_Merger\\_Companies\\_with\\_Operations\\_in\\_China](http://www.ballardspahr.com/AlertsPublications/Articles/2011-07-08_Fraud_Prevalent_in_Reverse_Merger_Companies_with_Operations_in_China)> accessed 27/07/2015.

perilous ambiguity rife within the structure.<sup>10</sup>

The urgency of the need for such change is demonstrated by the rising uncertainty felt by the relevant parties as they are forced to continue operating upon the basis of speculation, in spite of the minor improvements in leadership attitude.<sup>11</sup> This brings many to the conclusion that such legal ambiguity needs to be dealt with before China potentially jeopardises the confidence of foreign investors in its economic markets and loses the key competitive status it requires in order to attract and retain foreign investors.<sup>12</sup> This paper shall argue that in the thirty-five years since China began concerted efforts of economic reform, a status of limbo has formed around the VIE structure. In consequence this exposes the institutional challenges that confront the 'state capitalism' model of China, including attempts to both maintain and broaden the Party-state's level of control.<sup>13</sup> Henceforth, the future prospects of VIEs in China are dependent upon the way in which Chinese policy-makers decide to earnestly respond to these institutional challenges. This paper has six parts. Following this introduction, Part II introduces a general analysis of the origins and structure of the VIE, taking into consideration the reasons why the VIE structure was brought into existence. Part III will take a look at the horizontal risks associated with VIEs and the perilous nature of the VIE contract. Part IV will then explore the associated domestic vertical risks and regulatory measures, as well as case examples of selective enforcement, the core vertical risk currently plaguing VIEs. Part V will look at the offshore vertical risks related to the VIE structure, such as tax related issues and the potentially hazardous outcomes. Part VI concludes the paper by discussing the future of the VIE structure and the ways in which the VIE, as well as its surrounding factors of influence, could be altered by investors and the Chinese government in order to bring much needed clarification to this sector of investment.

## **II. General Analysis of the Origins and Structure of the VIE**

China operates in a self-defined 'socialist market economy' and is unitarily ruled by the Chinese Communist Party ('CCP'). Throughout the Maoist era (1949-78), foreign direct

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<sup>10</sup> V. Lo & X. Tian, *Law for Foreign Business and Investment in China* (Routledge, 2009) page 364.

<sup>11</sup> 'Legal Analysis on Recent Rulings Related to VIE Structure' (Han Kun Law Offices Memorandum, 8 July 2013) < [www.hankunlaw.com/backuser/picinfo/20137811354.pdf](http://www.hankunlaw.com/backuser/picinfo/20137811354.pdf) > accessed 15/04/2014.

<sup>12</sup> S. Wei, 'Will the Door Open Wider in the Aftermath of Alibaba? - Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame' [2012] 42 *HKLJ* 561, page 582-583.

<sup>13</sup> *Ibid.*

investment in China was almost non-existent and historically, the anti-commercial traditions underlying Confucian ideology dominated and therefore merchants were assigned a low status.<sup>14</sup> In more recent times, throughout the nineteenth and twentieth centuries, China was exploited and colonised by the Western military and then forced to trade.<sup>15</sup> Consequently, intense hostility was felt toward the West, as well as a strong desire to recuperate autonomy over its trade and commerce sectors.<sup>16</sup> The demise of Mao Zedong proved to be a key turning point in the path to China's economic modernisation.<sup>17</sup> In 1978, with a view to commencing necessary economic reforms, the new CCP leadership, led by Deng Xiaoping, instigated a ground-breaking new 'Open-Door' policy.<sup>18</sup> This was introduced with the intention of utilising "market mechanisms and foreign resources" in order to stimulate economic growth.<sup>19</sup> For example, by the 1990s, economic reforms had accelerated to the point where the "conventional state planning system" was transformed into "a more market-oriented macro-economic regulation and control regime."<sup>20</sup> However, despite the new leaders of the CCP in the post-Mao era developing enduring and substantial policy alterations for economic reform, they did not go as far as to broadly reverse the objectives promulgated during the previous era.<sup>21</sup> In spite of progressive changes in policy, protectionist attitudes persisted in the shape of regulatory restrictions of investments from outside China throughout a number of different industries.<sup>22</sup> The contrasting treatment of Chinese and non-Chinese investments has proved to be a longstanding policy instituted by the CCP and is viewed as likely to persist into the

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<sup>14</sup> X. Zhang, 'Historical Attitudes and Implications for Path Dependence: FDI Development and Institutional Changes in China' [2004] *Erim. Rep. Series Res. In MGMT*, page 11.

<sup>15</sup> G. Finch, 'Modern Chinese Constitutionalism: Reflections of Economic Change' [2007] *Williamette J. INT'L L. & DISP. RESOL.*, page 77.

<sup>16</sup> A. Berger, *The Politics of China's Investment Treaty-Making Program in 'The Politics of International Economics Law'* (Tomer Broude, 2011).

<sup>17</sup> M. Elliot, 'Thirty Years After Deng: The Man Who Changed China', *TIME*, 10/12/2008 <<http://content.time.com/time/world/article/0,8599,1865539,00.html>> accessed 27/07/2015.

<sup>18</sup> A. E. Csordas, 'Funding Entrepreneurial Ventures in China: Proposals to More Effectively Regulate Chinese Foreign Private Issuers' [2012] 38 *Brook. J. INT'L. L.*, page 373.

<sup>19</sup> W. I. Friedman, Alumni Article, 'One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market' [2002] 27 *Brook. J. INT'L. L.*, page 477.

<sup>20</sup> S. Wei, 'Dark Past, Grey Present or Bright Future? –Foreign Investors' Access to China's Telecommunications Industry and a Political Economy Analysis of Recent Industrial Policy Moves' [2012] *J. World INV. & Trade*, page 513.

<sup>21</sup> D. Schindelheim, 'Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for foreign Investors Part of China's Economic Development Plan?' [2012] 21 *Cardozo J. INT'L & COMP. L.*, page 198.

<sup>22</sup> S. Wei, 'Will the Door Open Wider in the Aftermath of Alibaba? – Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame' [2012] 42 *H.K.L.J.*, page 561.

foreseeable future.<sup>23</sup> Furthermore, it is believed by some that the CCP may be considering a return to a more protectionist regime, propelled by a growing sense of nationalist pride and a drive to retain homegrown Chinese companies under governmental control.<sup>24</sup>

Since its proliferation in 1995, the centrepiece of the CCP's FDI policy has been the Catalogue for the Guidance of Foreign Investment Industries (the 'Catalogue').<sup>25</sup> The present version of the Catalogue explicitly assigns three categories to more than four hundred industry sectors; the categories are designated as either 'encouraged', 'restricted', or 'prohibited'.<sup>26</sup> In sectors not specifically listed in the catalogue, non-Chinese investments are deemed 'permitted' and those investments situated in the 'restricted' category necessitate government approval.<sup>27</sup> Finally, the category that is of greatest relevance to this article is the 'prohibited' category of investments, which are technically banned under Chinese law.<sup>28</sup> Notably, the value-added telecommunications (VAT) services and the Internet sector, where the VIE structure is used most prevalently, are categorised as 'prohibited' and disallow non-Chinese ownership.<sup>29</sup>

However, as the Chinese saying goes, "*The law is strong, but the outlaws are ten times stronger.*"<sup>30</sup> It is clear that China's VIEs have been brought into existence as a result of the present special market conditions and investment regulations that have amalgamated within the Chinese economy. In spite of the intrinsic risky aspects of the VIE structure, many market players submit that, in view of the restrictions enforced against them by PRC regulations and laws, the VIE structure is the best available option to help them accomplish their commercial goals. Essentially, the VIE structure comprises a series of contracts that are entered into

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<sup>23</sup> H. Huang, 'The Regulation of Foreign Investment in Post-WTO China: a Political Economy Analysis' [2009] 23 *COLUM. J. Asian L.*, page 185.

<sup>24</sup> V. Bath, 'Foreign Investment, the National Interest and National Security – Foreign Direct Investment in Australia and China' [2012] 34 *Sydney L. REV.*, page 32.

<sup>25</sup> L. Wanqiang, 'Chinese Foreign Investment Laws: A Review from the Perspective of Policy-oriented Jurisprudence' [2011] 19 *Asia PAC. L. REV.*, page 35.

<sup>26</sup> J. G. Sasser, 'China Risk factor Hiding in Plain View: A Brief Analysis of Variable Interest Entities (VIEs) Under Chinese Law' [November 2012] *TENN. Corp. news!*. Available at: <<http://www.frostbrowntodd.com/resources-1527.html>> accessed 25/07/2015.

<sup>27</sup> n. 21.

<sup>28</sup> C. Chen, 'The Evolution and Main Features of China's FDI Laws and Policies' (2011) in: *Foreign Direct Investment in China: Location Determinants, Investor differences and Economic Impacts*, page 60.

<sup>29</sup> S. Dickinson, 'VIEs in China. The End of a Flawed Strategy' (China L. Blog, 10/10/2011) <[http://www.chinalawblog.com/2011/10/vies\\_in\\_china\\_the\\_end\\_of\\_a\\_flawed\\_strategy.html](http://www.chinalawblog.com/2011/10/vies_in_china_the_end_of_a_flawed_strategy.html)> accessed 25/07/2015.

<sup>30</sup> W. Zhong, 'Dark Days for China's Whistleblowers' (Asia Times, 26/03/2009) <<http://www.atimes.com/atimes/China/KC26Ad01.html>> accessed 27/07/2015.

between a completely foreign-owned company (WFOE), a Chinese domestic company (VIE) and Chinese individuals who have possession of the VIE. A foreign parent company that directly or indirectly owns the WFOE is, in addition, instituted in what is usually a tax haven by the same Chinese persons that possess the VIE. The foreign investors customarily include venture capitalists (VC) and private equity (PE) firms and China's contractual arrangements intend to grant the foreign parent company de facto control of the VIE in question.<sup>31</sup> It is referred to as a 'variable interest' due to the fact that the controlling interest held by the foreign parent company in the VIE is not founded on the majority of voting rights, but rather on contracts. This type of contractual control does not meet the requirements of equity ownership in form; however substantively, it aims to achieve the same effect.<sup>32</sup> Though the concept of the VIE originated from accounting principles in the US, it is a structure of investment that is heavily entrenched with Chinese characteristics. The US General Accepted Accounting Principles require the reporting entity to consolidate the VIE's financials, providing that the reporting entity is the VIE's primary beneficiary.<sup>33</sup> This type of legislation in the US intends to prevent off-balance-sheet liabilities that may be hidden within the special purpose entities (SPE) of the reporting company and may otherwise go undetected, causing systemic risks.<sup>34</sup>

China's VIEs are distinctive due to the fact that they do not seek to hide liabilities in the VIE, instead Chinese domestic businesses and foreign investors aim to gain SPE regulation in order to consolidate the financials of the VIE as a type of asset on their balance sheet.<sup>35</sup> This is conducted with a view to attracting public investors from the international capital market, while simultaneously bypassing the investment restrictions of China.<sup>36</sup> Thus, from the standpoint of Chinese domestic companies, the dominant incentive to adopt the VIE structure

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<sup>31</sup> R. Lee, 'Understanding the VIE Structure: Necessary Elements for Success and the Legal Risks Involved' (Clients & Friends Memo, August 2011), <[www.martindale.com/members/Article\\_Atachment.aspx?od=296452&id=1328574&filename=asr-1328576.Understanding.pdf](http://www.martindale.com/members/Article_Atachment.aspx?od=296452&id=1328574&filename=asr-1328576.Understanding.pdf)> accessed 13/03/2014.

<sup>32</sup> Z. Wang, 'US-listed Chinese Firms in Credibility Crisis: Who Are They? Where Are They?' (2012) *Columbia University Journal* <<http://ssr.com/abstract=2177450>> accessed 24/07/2015.

<sup>33</sup> Financial Accounting Standards Board Interpretation No. 46: Consolidation of Variable Interest Entities.

<sup>34</sup> J. Steel, 'Variable Interest Entities (VIEs), Qihoo 360 and China' (Hedge Fund Consulting and Short Equity Research, May 2012 < [www.shortzilla.com/variable-interest-entities-vie-qihoo-360-and-china](http://www.shortzilla.com/variable-interest-entities-vie-qihoo-360-and-china)> accessed 25/03/2014.

<sup>35</sup> See: Z. Wang, n.29, for examples of the public listings typically used.

<sup>36</sup> *Ibid.*

is to obtain foreign capital.<sup>37</sup>

Furthermore, banks in China often lack incentive to lend funds to private enterprises due to ideological concerns, government interference in relation to bank lending and the presence of the local government's explicit or implicit guarantees for loans to SOEs.<sup>38</sup> Moreover established stock markets in the early 1990s in areas such as Shanghai and Shenzhen were almost exclusively utilised for the reform of the SOEs.<sup>39</sup> Therefore private entrepreneurs were, for a long period, forced to predominantly depend upon self-financing, in view of their restricted access to bank loans and domestic stock markets.<sup>40</sup> At the end of 1999, the private sector was contributing 27% of GDP, however it only accounted for 1% of lending from banks and 1% of listed companies on the domestic stock exchanges.<sup>41</sup> This situation is worsened by the burdensome process of approval and the complete ban taken against seeking foreign capital in overseas markets.<sup>42</sup> This, in effect, compels private enterprises in China to turn to more creative ways of obtaining capital, the most controversial of which is VIEs, which consistently draw headlines around the world.<sup>43</sup> A survey carried out in 2011 found that 42% of the 230 US-listed Chinese companies were utilising the VIE structure and the majority alluded to the restraints placed on offshore listings as the primary reason for their adopting the VIE structure.<sup>44</sup>

A policy that appears to have inadvertently promoted the status of VIEs in foreign investment in China was promulgated by the Provisions for the Acquisition of Domestic Enterprises by Foreign Investors (M&A Rules) in 2006.<sup>45</sup> It is provided by Article 11 that in a context where a domestic company merges its affiliated domestic company in the name of a

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<sup>37</sup> P. Gillis, 'Variable Interest Entities in China' (Forensic Asia, September 2012) <[www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf](http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf)> accessed 23/04/2014.

<sup>38</sup> S. Lubman, *The Evolution of Law Reform in China: An Uncertain Path* (Cheltenham, Edward Elgar Publishing, 2012) page xxvii—xxix.

<sup>39</sup> N. Gregory, S. Tenev & D. Wagle, *China's Emerging Private Enterprises: Prospects for the New Century* (International Finance Corporation, 2000) page 66.

<sup>40</sup> *Ibid.*

<sup>41</sup> N. Gregory & S. Tenev, 'The Financing of Private Enterprise in China' (2001) 38 *Finance & Development* page 1 <[www.imf.org/external/pubs/ft/fandd/2001/03/gregory.htm](http://www.imf.org/external/pubs/ft/fandd/2001/03/gregory.htm)> accessed 25/04/2014.

<sup>42</sup> n. 29.

<sup>43</sup> n. 36.

<sup>44</sup> P. Gillis, 'Statistics on VIE Usage' (China Accounting Blog, April 2011) <[www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html](http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html)> accessed 15/04/2014.

<sup>45</sup> S. Luk, 'Certain Recent Entrepreneurial Responses to China's Mergers and Acquisitions Rules' (Bloomberg Finance LP) <[www.winston.com/sitefiles/publications/d251d3badfe41705f62637cd143eeda3.pdf](http://www.winston.com/sitefiles/publications/d251d3badfe41705f62637cd143eeda3.pdf)> accessed 17/04/2014.

controlled overseas company, it is necessary for it to attain approval from the Ministry of Commerce (MOFCOM). As a result, this makes it particularly difficult to employ an offshore financing technique known as round-trip investments.<sup>46</sup> In contrast, the VIE structure, which employs contractual control instead of share ownership control and thus poses the best alternative in order to avoid prompting the commencement of the “*clumsy, burdensome, uncertain, time-consuming and costly approval process*”.<sup>47</sup> In consequence, the VIE structure has seen a substantial expansion in usage within more traditional asset-based industries. If the VIE structure and its associated risks continue to remain a theoretical and unlikely occurrence, then this trend looks set to further increase.

### **III. Horizontal Risks of VIEs: the Perilous Nature of the VIE Contract**

The crucial component of a VIE structure is composed of two wide categories of contractual arrangements between the VIE and the WFOE: the profit-extraction mechanism and the control mechanism.<sup>48</sup> The former primarily concentrates upon the cash flow of the group and holds a significant function in extending a loan to Chinese partners in order to capitalise the VIE, as well as channel the profits of the VIE into the foreign parent company via the WFOE. The loan agreement is entered into between the WFOE and their Chinese partners who will then reimburse the loan using the dividends attained from the VIE. An exclusive consulting or technical service agreement will also be concluded between the VIE and WFOE, and the services proffered will vary by industry or company. Consequently, all of the profits of the VIE can be directed to the WFOE and serve as payment for the provision of service.<sup>49</sup> In reality, companies are inclined to complement the technical service agreement with additional contractual arrangements, such as a trademark licensing contract, in return for royalty fees.<sup>50</sup> Thus, the foreign parent company is concurrent with the VIE’s commercial performance.<sup>51</sup>

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<sup>46</sup> D. Chase, ‘VIE Structure in China Faces Scrutiny’ (Clifford Chance Client Briefing, October 2011) <[www.cliffordchance.com/publicationviews/publications/2011/10/vie\\_structure\\_inchinafacesscrutiny.html](http://www.cliffordchance.com/publicationviews/publications/2011/10/vie_structure_inchinafacesscrutiny.html)> accessed 09/04/2014.

<sup>47</sup> n. 9.

<sup>48</sup> D. Schindelheim, ‘Variable Interest Entity Structures in the People’s Republic of China: Is Uncertainty for Foreign Investors Part of China’s Economic Plan?’ (2012) 21 *Cardozo J. Int’l & Comp. L.* 195, page 230-232.

<sup>49</sup> *Ibid.*

<sup>50</sup> n. 36.

<sup>51</sup> D. Roberts & T. Hall, ‘VIE Structures in China: What You Need to Know’ (O’Melveny & Myers Research Report, October 2011) <[www.omm.com/files/Uploads/Documents/VIE%20Structures%20in%20China%20-%20What%20You%20Need%20to%20Know.pdf](http://www.omm.com/files/Uploads/Documents/VIE%20Structures%20in%20China%20-%20What%20You%20Need%20to%20Know.pdf)> accessed 26/05/2014.

In regard to the control mechanism, typically contracts will involve an equity pledge agreement, a call option agreement and a power of attorney.<sup>52</sup> The role of the equity pledge is to act as the security for full compliance under the VIE by the Chinese partners holding other obligations under the VIE contracts.<sup>53</sup> The call option, provides the WFOE with sole discretion in deciding whether to acquire the VIE at the set price imposed by the WFOE. The power of attorney bestows normal shareholder rights to the WFOE, such as the attendance of shareholders' meetings and voting rights.<sup>54</sup> These contractual arrangements have the effect of securing de facto control for foreign investors over the VIE as if they were the shareholders of it, while simultaneously circumventing the restrictions placed on foreign equity ownership by China.<sup>55</sup>

However, the VIE structure's chief advantage is also one of its weaknesses. In form it complies with the investment restriction on foreign ownership, however in substance it is non-compliant.<sup>56</sup> In practice, for example, it is doubtful that the WFOE could successfully exercise the call option or acquire the VIE's equity under the equity pledge agreement as the VIE structure is typically utilised in an industry where foreign equity ownership is disallowed.<sup>57</sup> The enforceability of these VIE contracts has so far not been directly tested and remains principally unsettled. However, it is in danger of being pronounced illegal or invalid for public policy related reasons, in pursuance of Art 52 of the PRC Contract Law.<sup>58</sup> If this is accurate then a high level of damage could be incurred by foreign investors as the majority of the time, the offshore listed company encompasses no real assets apart from the contractual control it exercises over the domestic VIE. Therefore in effect, foreign investors are simply investing in that underlying contractual control.<sup>59</sup> When business is prosperous and runs smoothly, then it becomes a win-win situation that suits both the domestic company's desire for capital and the foreign investors' want for access to the Chinese market.<sup>60</sup> However, when prosperity begins to slow and disputes erupt between the beneficial and legal owners of the VIE, the

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<sup>52</sup> n. 29.

<sup>53</sup> n. 34.

<sup>54</sup> *Ibid.*

<sup>55</sup> P. Gillis, 'Statistics on VIE Usage' (China Accounting Blog, 11/04/2011)

<<http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html>> accessed 23/07/2015.

<sup>56</sup> n. 9.

<sup>57</sup> n. 29.

<sup>58</sup> n. 19, page 581.

<sup>59</sup> *Ibid.*

<sup>60</sup> n. 29.

precarious underlying contractual basis of the VIE structure becomes exposed. Regrettably, almost all foreign investors are confronted with these types of walk-outs from their Chinese partners. Often they opt to avoid the process of formal adjudication in China as they fear their own original infringement of the investment restrictions will be called into question. Thus, engagement in private negotiations is frequently resorted to with the Chinese partners.

This article would like to highlight that such private settlements are of particular concern for the foreign investor because it is this party that is situated in a substantially disadvantageous position during the negotiations. It is this factor that Wickersham and Taft propose as the key factor which differentiates this form of bargaining from other sectors of the legal sphere, which similarly act 'in the shadow of the law'.<sup>61</sup> This is because the VIE arrangement signifies a clear and unarguable infringement of Chinese investment restrictions. However, such collusion between the two parties poses far less of a problem for the Chinese company because it is they who hold the rights to the contract on paper.<sup>62</sup> Therefore if, the Chinese authorities endeavoured to terminate the VIE and penalise those involved, or the contractual foundation of the VIE collapsed due to manipulation by the Chinese non-government parties; the consequences would impact the party of foreign investors to a significantly greater extent.<sup>63</sup> The most well-known example of investors losing control over a China-domiciled company as a result of its Chinese owner disregarding the VIE agreement, is the Yahoo- Alibaba dispute in 2011, which shall be comprehensively analysed forthwith.<sup>64</sup>

#### Case Analysis: The Alibaba Dispute and the Chinachem Case

The Alibaba Dispute involved the two parties, *Alibaba Group* and *Yahoo! Inc.* Jack Ma, the Executive Chairman of *Alibaba*, terminated unilaterally the VIE structure and departed with *Alipay*, the core asset of the VIE. This left *Yahoo!* with no alternative but to participate in

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<sup>61</sup> W. Wickersham & M. Taft, 'Understanding the VIE Structure: Necessary Elements for Success, and the Legal Risks Involved' (Cadwalader, 10/08/2011)

<<http://www.cadwalader.com/uploads/cfmemos/a6415b1795be964c293f513215.pdf>> accessed 23/07/2015.

<sup>62</sup> n. 48.

<sup>63</sup> S. M. Davidoff, 'Fraud Heightens Jeopardy of Investing in Chinese Companies' (N.Y. times, 24/04/2015)

<<http://dealbook.nytimes.com/2012/04/24/fraud-heightens-jeopardy-of-investing-in-chinese-companies>> accessed 23/07/2015.

<sup>64</sup> E. M. Rusli, 'Yahoo and Alibaba Resolve Dispute Over Aliplay' (N.Y. Times, 29/07/2011)

<<http://dealbook.nytimes.com/2011/07/29/yahoo-and-alibaba-resolve-alipay-dispute>> accessed 10/07/2015.

private negotiations with Jack Ma in order to try and recuperate as much of its investment as possible. Ultimately, *Yahoo!* was forced to relinquish its beneficial interest in the VIE and tackle class action lawsuits from US public investors.<sup>65</sup> The VIE structure was ultimately abandoned by the parties, though the resulting compensation agreement allowed *Yahoo!* to still enjoy the economic benefits of *Alipay* before and after its IPO, or any other event of liquidity. However, the loss and controversy that ensued is a prime illustration of the key need for clarification in this sector and the detrimental results the lack of uncertainty can cause.

The most recently publicised decision of the Supreme People's Court fortunately came closer to judicially clarifying this topic. It involved the foreign investor Nina Wong's Hong Kong company *Chinachem Financial Services (Chinachem)*, which fought in the courts over a shareholding dispute for twelve years. However, it was met with a negative response by the region's highest judicial authority.<sup>66</sup> The dispute was founded upon a series of loan and entrustment agreements, which it entered into along with *China Small and Medium Enterprise Investment Development (China SME)*. This was in order to invest in *China Minsheng Banking Corporation*, which was a section of the financial services that was off-limits to foreign investors.<sup>67</sup> As the relationship between *Chinachem* and *ChinaSME* deteriorated, China SME sought to leave the situation along with the shares it held in *Minsheng*, on the behalf of *Chinachem*. This proxy arrangement was deemed unenforceable by the Supreme People's Court based upon the grounds that, the intentions of the arrangement involved the circumvention of China's investment restrictions and thus were invalid as they constituted "*concealing illegal intentions with a lawful form.*"<sup>68</sup>

This case immediately alarmed China's VIEs, primarily because the rationale underlying this contractual arrangement is remarkably similar to their own actions of bypassing foreign investment restrictions imposed by the relevant Chinese authorities. It seems to indicate a clear precedent of the courts' ability to resort to Article 52 of the PRC Contract Law in order to tackle contradicting VIE contracts.<sup>69</sup> However, it is important to note

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<sup>65</sup> G. Yongqiang, 'Yahoo Sued for Alipay Transfer' (Caixin Online, August 2011) <<http://english.caixin.com/2011-06-08/100267371.html>> accessed 02/05/2014.

<sup>66</sup> Civil Suit Judgment of the Supreme People's Court: *Chinachem Financial Services v China SME* (2002).

<sup>67</sup> *Ibid.*

<sup>68</sup> See para. 3, Art 52, PRC Contract Law.

<sup>69</sup> D. Harris, 'Crouching Tiger, Hidden Fraud. Clear Speaking on VIEs' (China Law Blog, 16/07/2011) <[http://www.chinalawblog.com/2011/07/crouching\\_tiger\\_hidden\\_fraud\\_clear\\_speaking\\_on\\_vies.html](http://www.chinalawblog.com/2011/07/crouching_tiger_hidden_fraud_clear_speaking_on_vies.html)> accessed 24/07/2015.

that the proxy arrangement viewed in the case involving *Chinachem* predates the surfacing of the current VIE structure and was a rather more crude form of foreign control in comparison to current VIEs. For example, VIE contracts now comprise a power of attorney, rather than the entrustment agreement utilised in *Chinachem*.<sup>70</sup> Also, in the former, Chinese partners who held equity interests in the VIE are simply granted the rights associated with these interests to the WFOE in order to act as its proxy, which is allowed under PRC law.<sup>71</sup> In comparison, the latter specifically provided that *China SME*, though they were registered owners of the shares in *Minsheng*, only held them on the behalf of *Chinachem*. The specific provision that *Chinachem* was the actual owner of the *Minsheng* shares in the entrustment agreement displays a more obvious type of noncompliance with Chinese legal restrictions.

Secondly, the chief way in which VIEs can channel profits to the WFOE is via an exclusive consulting or technical service agreement, which is a legitimate way in which to direct profits through share dividends.<sup>72</sup> This further demonstrates the illegal objectives that *China SME* encompassed by merely acting as the trustee of *Chinachem* by buying shares in *Minsheng* and consequently violating the legal restrictions.<sup>73</sup> To conclude, as the illegal intentions viewed in the *Chinachem* case were significantly more obvious in regard to its entrustment agreement than the VIE structure, then it is reasonably clear why the Supreme People's Court invalidated them without hesitation. More significantly, in view of the fact that China is not a common law jurisdiction, it does not treat preceding cases as binding authorities or even precedents; this makes the future status of VIEs even more difficult to predict.

In sum, these incidences display the potential consequences of misaligned interests between the Chinese owners and the foreign investors.<sup>74</sup> They are also a prime example of the unarguable bias of risk weighed against foreign investors in the VIE structure, which far outweighs those implicitly assumed when participating in various other tentatively illicit arrangements.<sup>75</sup> In particular because the foreign investors of the VIE have very limited legal

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<sup>70</sup> n. 3.

<sup>71</sup> *Ibid.*

<sup>72</sup> S. Abrams, 'The VIE Meta-Narrative: Illegal vs. Invalid' (China Hearsay Blog, 13/10/2011) <<http://www.chinahearsay.com/the-vie-meta-narrative>> accessed 05/07/2015.

<sup>73</sup> *Ibid.*

<sup>74</sup> R. Lewis, 'Foreign Investors in China Using the Variable Interest Entity Structure' (Lawyer, 11/11/2011) <<http://www.thelawyer.com/foreign-investors-in-china-using-the-variable-interest-entity-structure/1010207.article>> accessed 24/07/2015.

<sup>75</sup> I. Ng, 'The Dark Cloud Over the Variable Interest Entity' (The Corporate Treasurer, 18/07/2013) <<http://www.thelawyer.com/foreign-investors-in-china-using-the-variable-interest-entity-structure/1010207.article>> accessed 18/07/2015.

recourse when disputes materialise over their control of the relevant company.<sup>76</sup> For example, it is likely that if the VIE fails, by means of either managerial rift, Chinese government decree, or other governmental or operational decision, then it shall be exceedingly difficult for a foreign investor to utilise judicial means in order to recuperate their investment losses.<sup>77</sup> Henceforth, the investors may have no better alternative than to accept an inadequate remedy of the Chinese party's choosing, as viewed in the *Yahoo-Alibaba* case.<sup>78</sup> This peril is intensified by the following domestic and offshore risks associated with VIEs in addition.

#### IV. Domestic Vertical Risks of VIEs

##### Regulatory Uncertainty

Regulatory uncertainty is the primary vertical risk factor of concern for the participants of Chinese VIEs. Though *Sina* obtained an approving opinion from the Ministry of Information Industry, wherein the company structure as well as its pre-IPO restructuring were Recognised in 2000, Chinese regulators have not since formally verified the legality of the VIE structure.<sup>79</sup> The questionable internal report prepared by the China Securities Regulatory Commission (CSRC) in September considered a general prohibition of the VIE structure; however, this turned out to be a mere research project by a low-rank official.<sup>80</sup> Although it did instigate an unsettling feeling amongst market participants, reminding them of Beijing's prior invalidation of the Chinese-Chinese-Foreign (CCF) structure in 1998.<sup>81</sup> Despite this leaked report, no general prohibition of VIEs ever transpired; however, the stock prices of companies who utilised VIEs saw a sharp decline due to the surrounding speculation generated by the

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<sup>76</sup> D. Harris, 'Everything You Always Wanted to Know about China VIEs. The Transcript' (China Law Blog, 23/11/2011) <[http://www.chinalawblog.com/2011/11/everything\\_you\\_always\\_wanted\\_to\\_know\\_about\\_china\\_vies\\_the\\_transcript.html](http://www.chinalawblog.com/2011/11/everything_you_always_wanted_to_know_about_china_vies_the_transcript.html)> accessed 28/07/2015.

<sup>77</sup> D. Aubin, 'Investor Risk Lurks in Legal Structure of China IPOs-Lawyers' (Reuters, 02/11/2013) <<http://www.reuters.com/article/2013/06/23/china-investments-idUSL2NOEMPD20130623>> accessed 14/07/2015.

<sup>78</sup> Z. Zianwu & B. Lihui, 'Variable Interest Entity Structure in China' (King & Wood Mallesons, February 2013) <<http://www.lexology.com/library/detail.aspx?g=a9d30374-f27f-4be7-8468-2a772ee84cf>> accessed 14/07/2015.

<sup>79</sup> D. Roberts & T. Hall, 'VIE Structures in China: What You Need to Know' (O'Melveny & Myers Research Report, October 2011) <[www.omm.com/files/Uploads/Documents/VIE%20Structures%20in%20China%20-%20What%20You%20Need%20to%20Know.pdf](http://www.omm.com/files/Uploads/Documents/VIE%20Structures%20in%20China%20-%20What%20You%20Need%20to%20Know.pdf)> accessed 24/04/2014.

<sup>80</sup> S. Aldred & D. Durfee, 'Exclusive: China's Company Structure under Threat' (Reuters, September 2011) <[www.reuters.com/article/2011/09/18/us-chinain-investment-idUSTRE78H0SP20110918](http://www.reuters.com/article/2011/09/18/us-chinain-investment-idUSTRE78H0SP20110918)> accessed 27/04/2014.

<sup>81</sup> n. 18.

report.<sup>82</sup>

In spite of the absence of a general ban, there remain regulatory measures that have the potential to restrict the use of VIEs.<sup>83</sup> The issues that foreign investors often encounter, regarding both the regulation of VIEs, as well as the business activities in China as a whole, centre upon the notably general style within which rules are drafted. Therefore they provide little indication as to their specific scope of implementation. An example of this is the circular published in July 2006 by the Ministry of Industry and Information Technology (MIIT Circular) on the topic of fortifying the administration of foreign investment in the VAT services sector.<sup>84</sup> It gives a subtle indication of the potential for concentrated efforts to be instigated against unsanctioned VIEs in the VAT industry.<sup>85</sup> Though the provision seems to include language that seeks to wholly outlaw VIEs in this sector, it can also be inferred as a mere restriction on the use of VIEs. This includes the requirement for the Chinese company to possess the intellectual property it utilises and refrain from leasing, transferring or selling the VAT licence. The majority of VIEs conform to the latter rule, particularly because the Chinese domestic entity is typically one that functions the business in pursuance to the licence it holds and does not involve the transferral of the licence to the WFOE.<sup>86</sup> This type of interpretative and uncertain approach is not satisfactory, predominantly because it may undermine the foundations of predictability and certainty that a free market economy is built upon and consequently increase the potential for selective enforcement or regulatory inconsistency.<sup>87</sup>

In regard to the covert circumvention by VIEs of MOFCOM's scrutiny of foreign M&A activities in China, there are also substantial vertical risks present. In view of Article 11 of the M&A Rules omitting to specifically reference the VIE or agreement-based control, foreign investors and Chinese companies avoid the associated foreign M&A approval process by way

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<sup>82</sup> n. 29.

<sup>83</sup> C. Spring, 'China VIE Structure for Foreign Investment under Attack from Multiple Directions: Will It Emerge (Relatively) Unscathed or Is Its Very Survival Threatened?' (Hogan Lovells China Alert, January 2012) <[www.legal500.com/assets/images/stories/firmdevs/hogan\\_lovellis\\_client\\_note.pdf](http://www.legal500.com/assets/images/stories/firmdevs/hogan_lovellis_client_note.pdf)> accessed 14/05/2014.

<sup>84</sup> *Ibid.*

<sup>85</sup> L. Determann & A. Marson, 'Internet Business Law in China for US Companies' [April 2009] *The Computer & Internet Lawyer* 26 page 2 <[www.bakermckenzie.com/files/webinars/eyeonchina110211/China%20Internet%20Biz%20Law%2026%20C&IL%2013%\["2009\].pdf](http://www.bakermckenzie.com/files/webinars/eyeonchina110211/China%20Internet%20Biz%20Law%2026%20C&IL%2013%[)> accessed 04/05/2014.

<sup>86</sup> *Ibid.*

<sup>87</sup> *Ibid.*

of a VIE structure.<sup>88</sup> Nevertheless, the provision of Article 11 seems to widen the scope of MOFCOM's power by putting forward that "*parties thereto shall not evade... by any other means*".<sup>89</sup> It is unfortunate that this ambiguously drafted term fails to provide guidance as to whether the use of VIEs is permitted to circumvent the M&A approval process.

Furthermore, for the reason of guiding foreign M&As, as well as safeguarding national security, the Provisions for the Implementation of the System for Security Review of Acquisitions of Domestic Enterprises by Foreign Investors (National Security Review) was promulgated by MOFCOM in 2011.<sup>90</sup> Article 9 states that if the proposed activity can be incorporated within the scope of the merger and acquisition security review, then it is requisite for an application to be filed with MOFCOM.<sup>91</sup> The overall provision and guidance of Article 9 is far more clear than that of Article 11 of the M&A Rules, particularly because it specifically refers to "agreement-based control", which targets the VIE structure in a direct manner.<sup>92</sup> Nonetheless, the national security review's scope is restricted to national defence security issues, as well as national economic security issues and does not appear to invalidate the actual VIE structure.<sup>93</sup> Once these regulatory measures have been reviewed, one can distinguish an increasing trend of scrutiny of VIEs by China's regulators.<sup>94</sup> Therefore, although it is doubtful that a complete ban will be introduced in the near future, it is possible that industry-wide constraints may be introduced in certain sectors.

### Selective Enforcement

The second feature of the domestic vertical risks in regard to VIEs is regulatory inconsistency, also known as 'selective enforcement'.<sup>95</sup> Selective enforcement occurs when law enforcers derail the specified route of regulation or digress from the principle or objective established

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<sup>88</sup> P. Huang, 'A Primer on China's New Cross-Border M&A Rules' in *Doing Business in China: Resolving the Challenges in Today's Environment* (Skadden, 2011).

<sup>89</sup> *Ibid.* page 13.

<sup>90</sup> MOFCOM, 'Announcement No. 53 of 2011 of the Ministry of Commerce of the People's Republic of China Concerning the Provisions of the Ministry of Commerce for the Implementation of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors' (2011) <<http://english.mofcom.gov.cn/article/policyrelease/aaa/201112/20111207869355.shtml>> accessed 25/07/2015.

<sup>91</sup> *Ibid.*

<sup>92</sup> n. 85.

<sup>93</sup> n. 87.

<sup>94</sup> *Ibid.*

<sup>95</sup> n. 9.

by the regulation in question.<sup>96</sup> Instead, they enforce regulations and execute laws by discretion, treating the same issues with different attitudes.<sup>97</sup> Such a discretionary approach to law enforcement is practiced across many different sectors and many deem it is unfortunately showing signs of further proliferating throughout many sectors of Chinese law.<sup>98</sup> This growing pattern of selective policy implementation is detrimental to China's future economic development. For example, it is warned by K. J. O'Brien, an esteemed political scientist and prolific writer on Chinese social policy execution, that such an approach by Chinese authorities can turn a well-liked central policy promoting economic growth, into a harmful 'local policy' that may increase extraction levels and justify wasteful investment.<sup>99</sup> However, this article would like to highlight that the selective enforcement of this particular sector is of greater concern than others areas of the economy affected by this approach. This is predominantly due to the lack of published and specific criteria available to foreign investors as well as the aforementioned uncertainty emitted by the Chinese court decisions. This is naturally a legitimate concern for investors and adds an additional element of insecurity, in combination with the aforementioned domestic risks and unequal standing within the Chinese jurisdiction.

The VIE of *Sina* was endorsed by the Ministry of Information Industry in order to list it on NASDAQ.<sup>100</sup> However, other VIEs have not been granted such preferential treatment and there is currently no official explanation as to what the distinguishing features were of Sina's VIE. A Delaware Corporation, *Buddha Steel*, was compelled to withdraw its IPO application with the US Securities and Exchanges Commission (SEC) as local authorities in the Hebei Province abruptly invalidated its VIE on the grounds of public policy.<sup>101</sup> This occurred while more than one hundred other companies employing VIEs had been successfully listed offshore with no invalidation from either the local or central government.<sup>102</sup> According to some, this is believed to be a unique action that should not trigger angst regarding the legality

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<sup>96</sup> D. Chen, 'Selective Enforcement of Regulation' (2011) *China Journal of Accounting Research*, Vol. 4, page 9.

<sup>97</sup> *Ibid.*

<sup>98</sup> M. Lipsky, *Street-Level Bureaucracy* (Basic Books, New York, 1989) page 48-49.

<sup>99</sup> 'Selective Policy Implementation in Rural China' (1999) *Comparative Politics*, Vol. 31, No. 2, page. 167.

<sup>100</sup> F. Zhou & B. Zhang, 'VIE Structure – a long untold story' (Financial Worldwide, January 2014) <<http://www.financierworldwide.com/vie-structure-a-long-untold-story/#.VbjCWvIViko>> accessed 24/07/2015.

<sup>101</sup> n. 20.

<sup>102</sup> *Ibid.*

of the VIE structure in general.<sup>103</sup> However, it should be noted that it is precisely this sort of selective enforcement that generates the greatest risks for foreign investors. If there are sufficient differences between *Buddha Steel's* VIE and *Sina's* VIE in order to warrant diverse treatment, then such differences should be clearly explained so that participants of the market can plan in accordance, in order to avoid a similar fate.<sup>104</sup> Unfortunately, this has not occurred and so foreign investors are still in uncertain territory as they try to guess the reasoning for the invalidation of *Buddha Steel*. This is particularly harmful because it undermines the rule of law and promulgates a return to the model of 'rule-by-law', where law is a tool only utilised by public officials in order to govern the country.<sup>105</sup> Additionally, the *Buddha Steel* case alludes to the possible conflict of policy between local and central governments, which adds a further layer of vertical risks that foreign investors must maintain awareness of.<sup>106</sup>

#### V. Offshore Vertical Risks of VIEs

##### Invalidation and De-Listing of the Company

In light of VIEs being predominantly used by Chinese companies to gain access to international capital markets, vertical risks inevitably arise from the offshore jurisdictions in which the company is listed. The primary risk associated with this is of being de-listed from that particular offshore market, therefore as the majority of foreign investors are investing in the contractual control of the VIE then it is of the highest importance that the actual contractual arrangement itself fulfils the necessity for consolidation.<sup>107</sup> This should be in accordance with the relevant accounting principles, as well as be enforceable within the Chinese jurisdiction; thus, in turn, lowering the chance of invalidation by China's regulators. In the alternative, foreign investors will stand to suffer substantial losses because the foreign listed company often does not have an operation of its own, in consequence it relies upon channelled profits

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<sup>103</sup> T. Shoemith, 'PRC Challenge to Variable Interest Entity Structures?' (Pillsbury Winthrop Shaw Pittman LLP Client Alert, March 2011) <[www.pillsburylaw.com/publications/prc-challenge-to-variable-interest-entity-structures](http://www.pillsburylaw.com/publications/prc-challenge-to-variable-interest-entity-structures)> accessed 24/04/2014.

<sup>104</sup> *Ibid.*

<sup>105</sup> J. Waldron, 'The Concept and the Rule of Law' [2008] 43 *Georgia Law Review* 1, page 24.

<sup>106</sup> B. Rooij, 'From Support to Pressure: The Dynamics of Social and Governmental Influences on Financial Law' (2013) *Regulation & Governance*, Vol. 7, No. 3.

<sup>107</sup> S. Dickinson, 'VIEs in China. The End of a Flawed Strategy' (China Law Blog, October 2011) <[http://www.chinalawblog.com/2011/10/vies\\_in\\_china\\_the\\_end\\_of\\_a\\_flawed\\_strategy.html](http://www.chinalawblog.com/2011/10/vies_in_china_the_end_of_a_flawed_strategy.html)> accessed 27/04/2014.

originating from the VIE in order to pay dividends to foreign investors.<sup>108</sup> The horizontal risks and domestic vertical risks may widen their scope of impact onto offshore territory and it is the duty of the offshore securities to ensure satisfactory disclosure of these sorts of risks is made and potential accounting fraud is prevented.

#### Taxation Issues

In regard to accounting principles in the US, in pursuance of FASB Interpretation No. 46, the reporting company is permitted to consolidate another entity only if it possesses the right to receive the anticipated residual returns of the entity.<sup>109</sup> This could pose specific problems for VIEs utilised in asset-heavy industries, in contrast to those which are asset-light, because foreign investors may be compelled to put the entirety of their operations into the VIE. Internet-related companies are diverse because they can place additional operations, such as advertising and programming, into the WFOE while the VIE only holds the section of the operations off-limits to the WFOE.<sup>110</sup> This means that for the WFOEs of certain companies, such as *Baidu* and *Sina*, only rely on the VIE for some of their profit-making activities, while the private educational services, *New Oriental Education* and *Technology Inc*, might have to entirely rely upon its VIE for profits.<sup>111</sup> This makes a significant impact upon the tax sector of the enterprise in question.

In reality, despite there being a profit-extraction mechanism in place, Gillis highlights that the majority of VIEs in asset-heavy industries do not seem to extend the service fee or royalty fee payment to the WFOE due to fears over the potential for adverse tax implications.<sup>112</sup> If the VIE conveys profits to the WFOE, it shall incur the usual business tax set at 5 per cent on service payments.<sup>113</sup> This is the associated cost of utilising VIEs, as such costs would not be incurred if the operations were carried out in the WFOE. Further, the higher the payment amount to the WFOE, the higher the level of business tax charged. There may also

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<sup>108</sup> *Ibid.*

<sup>109</sup> 'FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities' (FASB News Release, January 2013) <<http://www.fasb.org/news/nr011703.shtml>> accessed 29/04/2014.

<sup>110</sup> *Ibid.*

<sup>111</sup> P. Gillis & M. Lowry, 'Son of Enron: Investors Weigh the Risks of Chinese Variable Interest Entities' (2014) *Journal of Applied Corporate Finance*, Vol. 26, Issue 3 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2513042](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2513042)> accessed 22/07/2015.

<sup>112</sup> *Ibid.*

<sup>113</sup> n. 106.

be a transfer pricing adjustment associated, as the tax authorities in China may not allow a reduction to the VIE for the entirety or part of its fee payment to the WFOE in calculating the income tax of the VIE.<sup>114</sup> Particularly due to the questionable nature of the action, wherein a company pays the entirety of its earnings for services, to another company. In view of the fact that the standard rate of corporate income tax in China is 25 per cent, the VIE may be required to pay a much higher level of income tax as a result of the transfer pricing adjustment.<sup>115</sup> If the tax authorities have made the adjustment to the transfer price, then they may permit the WFOE to decrease its reported income when calculating its income tax, however the tax authorities may equally choose not to do this.<sup>116</sup> Thus, the adverse tax implications associated with the transferral of profits from the VIE to the WFOE may, in effect, diminish the economic viability of the VIE structure.<sup>117</sup> This is the foremost reason for why the VIE may choose to retain its profits instead of channelling them into a foreign parent company. This poses a concern for SEC, because the necessitation for consolidation may not have been originally satisfied. For example, in the case of *New Oriental Education*, 97 per cent of the revenues it had generated remained within the VIE; this raises the question of whether the revenue, in reality, belongs to the US-listed parent company and triggers investigation by the SEC.<sup>118</sup> However, an answer to this cannot be given without prior direct clarification from the Chinese government.

#### **VI. The Future of the VIE Structure**

The perils faced by China's VIEs are a microcosm of the broader institutional challenges that foreign investors are faced with when they perform business in China. It seems that the only way to improve the uncertain situation, making it more agreeable for both the investors and the Chinese government, is to specifically identify these institutional challenges. Then adjustments should be devised for both parties, so that the VIE structure is brought out of the murky waters currently surrounding it. In light of this, the author shall, at the end of this section, propose that VIEs should be fully legalised in order to begin to counteract the issues

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<sup>114</sup> n. 104.

<sup>115</sup> See Art 4, Enterprise Income Tax Law of the People's Republic of China.

<sup>116</sup> n. 106.

<sup>117</sup> n. 29.

<sup>118</sup> P. Gillis, 'SEC v EDU--the End of VIEs?' (China Accounting Blog, July 2012)

<<http://www.chinaaccountingblog.com/weblog/sec-v-edu-???the-end-of-vies.html>> accessed 28/03/2014.

associated with their uncertain status.

### Future Changes on the Part of the Chinese Government

#### *Greater Transparency*

In accordance with the annual Business Confidence Survey carried out by the European Chamber of Commerce, the greatest obstacle for market players in China is, “*the discretionary enforcement of broadly drafted laws and regulations*”.<sup>119</sup> This was well exhibited in the conditional approval made by MOFCOM of *Wal-Mart’s* acquisition of the controlling stakes in *Niuhai*, which holds a VIE arrangement with *Yishiduo*.<sup>120</sup> One of the attached conditions for this acquisition included that, Wal-Mart must expressly prohibit the use of the VIE structure in order to participate in *Yishiduo’s* VAT business.<sup>121</sup> Chin and a number of others argue that this is the clearest message proffered by MOFCOM in regard to the use of VIEs.<sup>122</sup> Nonetheless, the “*mushy and unclear*” language utilised by MOFCOM triggered additional bouts of speculation.<sup>123</sup>

The complexity of the case can be viewed in the overlapping nature of the competition law issues regarding foreign M&As and the restrictions placed on market access to foreign ownership in the VAT sector. Abrams put forward that the presence of the VIE within the case is just incidental to the competition law issue of market concentration.<sup>124</sup> While others argue that this signifies one of the first moves toward outlawing VIEs; particularly when one takes into account the problematic market definition adopted by MOFCOM.<sup>125</sup> Further, it is important to note that MOFCOM did not specifically invalidate the structure itself, thus

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<sup>119</sup> The Business Confidence Survey 2012 <<http://www.eurochamber.com.cn/en/publications-business-confidence-survey-2012>>.

<sup>120</sup> M. Williams, ‘Wal-Mart in China: Will the Regulatory System Ensnare the American Leviathan’ (2007) *Connecticut Law Review*, Vol. 39, Issue 4 <<http://heinonline.org/HOL/LandingPage?handle=hein.journals/conlr39&div=42&id=&page=>> accessed 14/07/2015.

<sup>121</sup> MOFCOM’s Announcement No. 49 (2012) <<http://fldj.mofcom.gov.cn/aarticle/ztxx/201208/20120808284410.html>>.

<sup>122</sup> Y. Chin, ‘The Chinese MOFCOM Enforces Telecoms Regulations in AML Merger Review (Wal-Mart/Yihaodian)’ (2013) *E-Competitions*, No. 51263 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2260474](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2260474)> accessed 02/07/2015.

<sup>123</sup> S. Abrams, ‘Wal-Mart, Yihaodian and the Mystery of the VIE’ (China Hearsay, August 2012) <<http://www.chinahearsay.com/wal-mart-yihaodian-and-the-mystery-of-thevie/>> accessed 24/04/2014.

<sup>124</sup> *Ibid.*

<sup>125</sup> S. Ning, H. Yin & H. Wu, ‘MOFCOM Approved Wal-Mart’s Acquisition of Controlling Stake in Yihaodian But Said No to VIE Structure’ (King & Wood Publication, August 2012) <<http://fldj.mofcom.gov.cn/aarticle/ztxx/201208/20120808284410.html>> accessed 20/04/2014.

allowing speculation to continue to grow. Evidently, this indicates that Chinese regulators are aware of the existence of VIEs in China and their possible circumvention of Chinese regulations. In view of this, it should be stressed that these types of laws and regulations based upon inconsistent informalities, undermine the stability of the business environment that is required by a free modern economy in order to function and may slow China's efforts toward achieving economic reform.<sup>126</sup> The aforementioned instances of restriction can amalgamate into a force that can thoroughly shake the confidence of the market.<sup>127</sup> In consequence, the regulatory uncertainty, lack of transparency and inconsistency may ultimately harm the investment environment and potentially the broader interests of the Party-state, such as China's economic advancement.

### *Greater Equality*

The absence of a level-playing field and general market access has long posed a significant problem for foreign investment in China. The utilisation of the VIE structure is both a creative and rational choice by foreign investors and Chinese private entrepreneurs under the special market conditions of China. China has experienced economic reforms for three and a half decades and is now positioned at a crossroads between economic liberalism and economic nationalism.<sup>128</sup> The regimen is consistently faced with the dilemma of choosing between the continued rigid restrictions upon the facets of a free market economy and the development of a private sector in socialist China.<sup>129</sup>

Foreign investment and private entrepreneurship are promoted to the extent that they will help to serve the interests of the Party-State. Although the drawback associated with this model is that the likely result of inefficient allocation and utilisation of capital and damage to productivity and innovation levels.<sup>130</sup> Particularly now that the preliminary period of China's economic reform and associated large investment projects prescribed by the State have begun to fade from the development agenda.<sup>131</sup> As a result, the Chinese government's

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<sup>126</sup> n. 115.

<sup>127</sup> *Ibid.*

<sup>128</sup> n. 9, page 582-583.

<sup>129</sup> J. Garrick, *Law, Wealth and Power in China: Commercial Law Reforms in Context* (Routledge, 2011) page 159-161.

<sup>130</sup> *Ibid.*

<sup>131</sup> 'European Business in China Position Paper 2012/2013', <[http://www.cbichina.org.cn/cbichina/upload/fckeditor/2012%20EUCCC%20Position%20Paper\\_Executive\\_EN.pdf](http://www.cbichina.org.cn/cbichina/upload/fckeditor/2012%20EUCCC%20Position%20Paper_Executive_EN.pdf)> accessed 26/04/2014.

habitual bias against private enterprises and foreign investors is in urgent need of change and the promotion of fair and healthy market competition needs to be advanced.<sup>132</sup> It is generally conceded that the ten-year Internet industry boom in China can be accredited to the employment of VIEs, which present a practicable alternative for the funding of Chinese private companies lacking in capital.<sup>133</sup> This leads one to the conclusion that, if the Chinese government allowed foreign investors equal access to the market and means of gaining capital then it could raise the likelihood of this positive trend continuing and decrease the need for companies to use less orthodox structures.

#### *Legalisation of VIEs*

In light of the uncertainty and unpredictability currently associated with the VIE structure, this paper contends that China should take concerted steps toward specifically legalising VIEs. Such a move would signify an important advancement toward structuring a level- paying field for participants within the market and emit an inviting message to potential foreign investors into China. China's SOEs do not require the employment of VIEs primarily because domestic stock markets and bank lending are readily available to them and the approval process is far more straightforward for them to list offshore.<sup>134</sup> Garrick points out that, comparatively, China's private companies endure a harsh situation in their capital- starved state and have no alternative but to resort to creative ways in order to survive and continue to develop.<sup>135</sup> Therefore, if China is truly concerned about retaining control over certain sensitive sectors, then it could establish a multiple share structure and include some classes of shares whereby the voting rights are only issued to Chinese nationals.<sup>136</sup> This would, at the very least, provide a suitable compromise in comparison to the precarious limbo status VIEs are currently situated within.

#### *Future Changes on the Part of Investors*

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<sup>132</sup> *Ibid.*

<sup>133</sup> 'Without VIEs, There Would Not Have Been the Golden Ten Years for China's Internet Industry' (Nanfang Daily, June 2011) <[http://epaper.nfdaily.cn/html/2011-06/23/content\\_6976516.htm](http://epaper.nfdaily.cn/html/2011-06/23/content_6976516.htm)> accessed 24/04/2014.

<sup>134</sup> n. 29.

<sup>135</sup> n. 127.

<sup>136</sup> *Ibid.*

*The Multi-Jurisdictional Captive Company*

A potential replacement for the VIE structure has begun to surface, known as the Multi-Jurisdictional Captive Company (MJCC), which asserts that it provides better legal protection to foreign investors.<sup>137</sup> The chief distinguishing feature of the MJCC structure is a custodian arrangement, which places shares in the VIE as a neutral third party, rather than with the Chinese founders of the VIE.<sup>138</sup> It will function in a similar manner to an escrow account held by a bank and aims to tackle the horizontal risk of a rogue Chinese shareholder walking away from the VIE after a conflict of interest between the Chinese and foreign parties. However, it fails to address the fundamental problem of legality as it is uncertain whether all of the contractual arrangements, including the new custodian agreement, would be enforceable within a Chinese court.<sup>139</sup> Thus it seems like the MJCC structure will not be in proper use by companies in the near future, as it will take time for it to become a workable alternative. However, it is certainly something that investors and the Chinese government should keep in mind if a practicable compromise cannot be reached regarding the VIE structure.

*Improvement of Corporate Governance*

A second alteration that could be made by the investing party, is to exert stronger corporate governance controls over the operating company and the WFOE. This may help to mitigate the risk of the operating company or any of its subsidiaries being transferred out of the structure of the VIE agreement.<sup>140</sup> Furthermore, foreign investors should ensure that the necessary ancillary documents are in order so that control can be taken of the operating company under the VIE agreement if it becomes necessary to do so.<sup>141</sup> These protectionist controls could be furthered by diversifying the shareholding and the board of directors of the VIE. This would maximise the alignment of interests between the beneficial and legal owners of the VIE, which would then minimise the likelihood of conflict and subsequent court involvement.<sup>142</sup>

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<sup>137</sup> T. Burroughs, 'China's VIEs: A Political Football' (Asia Venture Capital Journal, April 2013) <<http://www.avcj.com/avcj/analysis/2263609/chinas-vies-a-political-football>> accessed 01/05/2014.

<sup>138</sup> *Ibid.*

<sup>139</sup> *Ibid.*

<sup>140</sup> n. 18.

<sup>141</sup> *Ibid.*

<sup>142</sup> n. 9.

It is interesting to note that Gillis proposes, if a proportion of these measures were implemented then the VIE structure may even be rendered obsolete, as the conditions of China's market would be such, that illegal measures would not need to be resorted to in order to gain access and compete equally within the market.<sup>143</sup> This process will be assisted if the Chinese government chooses to follow the school of economic liberalism, over nationalism.<sup>144</sup> In the meantime it is believed to be unlikely that China will completely invalidate VIEs due to their wide usage within key businesses, as well as its employment within multiple Chinese national champion companies.<sup>145</sup>

### Concluding Remarks

This article has positioned the intrinsic hazards associated with VIEs, including the vertical and horizontal risks, within the broader context of foreign investment in China so that one can more easily appreciate the greater legal and business environment and the encumbering institutional challenges that China is currently faced with. As viewed in the path of development from the CCF structure to the VIE and on to the new MJCC structure, market participants have a tendency to bend the rules to fit their own objectives. Thus, a satisfactory resolution for the VIE problem cannot be found via a simple and straightforward alteration to the structure itself. Therefore, it is highly likely that market participants shall develop new methods by which to work around any ban introduced on VIEs. The core of the subject ultimately centres upon how China chooses to respond to the root of the issue, the investment restrictions placed on foreign ownership in certain sectors of the market, that gives rise to the utilisation of the VIE structure. Simultaneously, the associated institutional challenges should be addressed in order to evoke effective economic reform. A truly level playing field, as well as a better rule-of-law environment will inevitably benefit China in the long term and potentially render any VIE-type structure redundant to market players in future.

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<sup>143</sup> n. 29.

<sup>144</sup> *Ibid.*

<sup>145</sup> *Ibid.*