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Article 3

Chinese Style VIEs: Continuing to Sneak under Smog

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Chinese Style VIEs: Continuing to Sneak under Smog?

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The VIE (Variable Interest Entity) is a business structure that is comprised of a series of contractual arrangements that enable relevant parties to obtain a degree of control over, as well as a substantial economic interest in, certain companies without having to directly own their shares. For about fifteen years, by virtue of the VIE structure and its accounting treatment in the U.S. or Hong Kong, many China-based enterprises were successfully listed overseas, thus circumventing Chinese regulatory control on foreign equity ownership and investment restrictions in specific industries such as internet or education. In recent years, however, serious doubts arose about the validity and viability of the Chinese-styled VIE. Court judgments, arbitration awards, and administrative decisions from different sectors and levels have continued to pose challenges to the practice of creating Chinese-style VIEs. The egregious breach of contracts and the chaotic battles over control have also caused foreign investors to suffer, eliciting concern from the SEC and HKEx. This Article reviews the structure, origin, and logic of the VIE, and analyzes the evolution and dynamics of such practice. An argument can be made that China's best interests would be served by ending the murky situation surrounding the VIE; stopping this self-enforced vicious spiral by realigning the interests of the parties involved. One proposal suggests that a collective and coordinated regulatory framework that is characterized as less restrictive, more transparent, better defined, and more user friendly, should be set up for the VIE practice; this proposal should be initiated by the State Council and MOFCOM in particular. Moreover, international cooperation should be strengthened to better protect investors and deter opportunistic misbehavior.

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Introduction

Listed companies are the most visible business organizations, particularly those in the cross-border setting. Until early 2011, almost half of the 230 Mainland Chinese companies listed on U.S. stock exchanges used the Variable Interest Entity (VIE) structure.[1] In the period that followed, many companies continued to go public using the VIE structure even under unfavorable circumstances; these companies include such as Vipshop Holdings (NYSE: VIPS) in 2012, Autohome Inc. (NYSE: ATHM) and Qunar.com (NASDAQ: QUNR) in 2013, and JD.com (NASDAQ: JD) in 2014.[2] In fact, for more than a decade, the VIE scheme materially bypassed the Chinese government's foreign equity investment restrictions by grafting into American accounting treatments and by operating through contractual arrangements instead of direct equity ownership.[3] In more recent years, however,

1. Fredrik Öqvist, *Statistics on VIE Usage*, China Acct. Blog (Apr. 11, 2011), http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html.

2. *Vipshop Celebrates Completion of IPO and First Day of Trading on the NYSE*, NYSE (Mar. 23, 2012), http://www1.nyse.com/press/1332499674039.html; *Autohome Inc. Announces Pricing of Initial Public Offering*, Autohome Inc. (Dec. 10, 2013), http://ir.autohome.com.cn/phoenix.zhtml?c=250722&p=irol-newsArticle_print&ID=1883777; Qunar Cayman Islands Limited, *Qunar Announces Pricing of Initial Public Offering*, Globe Newswire (Nov. 1, 2013), http://globenewswire.com/news-release/2013/11/01/585921/10055716/en/Qunar-announces-Pricing-of-Initial-Public-Offering.html; Katie Roof, *China's JD.com Rallies in Nasdaq Debut*, Fox Business (May 22, 2014), http://www.foxbusiness.com/industries/2014/05/22/china-jdcom-set-for-nasdaq-debut/.

3. *See* Xu Ping, *Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge*, China Law Insight (Oct. 20, 2011), http://www.chinalawinsight.com/2011/10/articles/corporate/foreign-investment/variable-interest-entity-vie-structure-for-foreign-investment-in-the-prc-may-face-challenge/ (detailing how the VIE

doubts have accumulated over the validity and viability of the VIE, and some scholars have reported fierce battles with respect to control over VIEs.[4] This Article aims to delve deeper into the VIE phenomenon and calls for the relevant parties to realign their interests and engineer a healthy and equitable investment regulatory mechanism.

Part I briefly describes the concept and accounting treatments of the VIE in the U.S. and the rise and exuberance of the VIE in China. The creative and even odd combination of these two foreshadows the current predicament of the VIE structure. Part II introduces the parties and components of the Chinese-styled VIE, which work together to serve the purpose of the VIE structure. The three parts that follow detail the factors contributing to the ongoing trouble encumbering the VIE in China. Part III explores the unfavorable regulatory interventions stemming from different authorities, including the Ministry of Commerce (MOFCOM) and the China Securities Regulatory Commission (CSRC) as well as regional governments. Part IV presents briefs on representative cases like Giga Media, Anbow Education, Alibaba, and New Oriental Education to demonstrate the *de facto* and potential risks concerning the breach of contracts and control over VIEs. Part ? analyzes recent Shanghai CIETAC arbitration decisions and the Chinachem case adjudicated by the Chinese Supreme People's Court, both of which interpret the controversy surrounding VIE agreements. Part VI focuses on the responses by Hong Kong and U.S. securities regulators to the above-mentioned developments. Finally, Part VII explains the logic of the VIE's evolution and proposes a new regulatory framework and action plan for it.

I. Chinese Wine in the American Bottle

A. The Concept of the VIE in the U.S.

The term "Variable Interest Entity" has its origins in American accounting rules, namely the Financial Accounting Standards Board (FASB)'s Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46).[5] FIN 46 was promulgated in 2003 to expand on the interpretation of Accounting Research Bulletin (ARB) 51.[6] Under ARB 51, a parent company was to consolidate its subsidiary if it had a "controlling financial interest."[7] A controlling financial interest was present if the parent com-

structure enables domestic companies in China to list their companies overseas and obtain financing from overseas markets while circumventing the approval requirements created by the People's Republic of China in the M&A rules).

4. *See* Serena Y. Shi, Comment, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1268, 1291 (2014).

5. Project Updates, *Reconsideration of FIN 46(R) Consolidation of Variable Interest Entities*, (June 18, 2009), http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011143. FIN 46 was issued in January 2003. It was subsequently revised and replaced by FIN 46R in December 2003.

6. *Id.*

7. *Id.*

pany had a majority of the voting interest (the voting interest principle). The standard reads:

> The usual condition for a controlling financial interest is *ownership of a majority voting interest*, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary).[8]

FIN 46, however, amended how certain legal entities, formerly known as "Special Purpose Entities" (SPEs),[9] should be consolidated in financial statements. FIN 46 was promulgated in response to the outrage over off-balance sheet activities following the Enron scandal.[10] SPEs are business entities formed for the purpose of conducting a single prescribed activity, including risk sharing among investors and isolation of the company from its project risk and securitization.[11] Although SPEs were mostly used for legitimate business purposes, inadequate accounting guidance in this area allowed some companies to manipulate their financial statements to hide losses and fabricate earnings. Companies achieved this by structuring the SPEs such that they were separate and unconsolidated entities.[12]

Under FIN 46 (which was reissued as FIN 46R), however, the voting interests principle under ARB 51 is no longer the sole determinant of "controlling financial interests" where SPEs are concerned.[13] Now, there is a two-stage process. First, the entity must be considered a VIE;[14] if so, then it will be consolidated if the "parent" (or primary beneficiary) is exposed to the majority risk of the entity/VIE's returns and losses (the risk and rewards principle).

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8. *ARB 51: Consolidated Financial Statements*, Financial Accounting Standards Board (Aug. 1959), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820901468&blobheader=application%2Fpdf.

9. SPEs are also known as "Special Purpose Vehicles" (SPVs) or "Financial Vehicle Corporations" (FVCs) in some places. Arlette Wilson & Jefferson Jones, *New Accounting Guidelines for Variable Interest Entities: Will the New Rules Reduce the Risk?*, 5 J. Risk Fin. 54, 54 (2004); Reimund Mink, *Classification and Terminology of Financial Corporations in the Updated SNA*, 16 (2006), presented at the Fourth Meeting of the Advisory Expert Group on National Accounts, Frankfurt, Germany, Jan. 30 - Feb. 8, 2006, *available at* https://unstats.un.org/unsd/nationalaccount/aeg/papers/m4Liabilities.pdf.

10. Wilson & Jones, *supra* note 9, at 54.

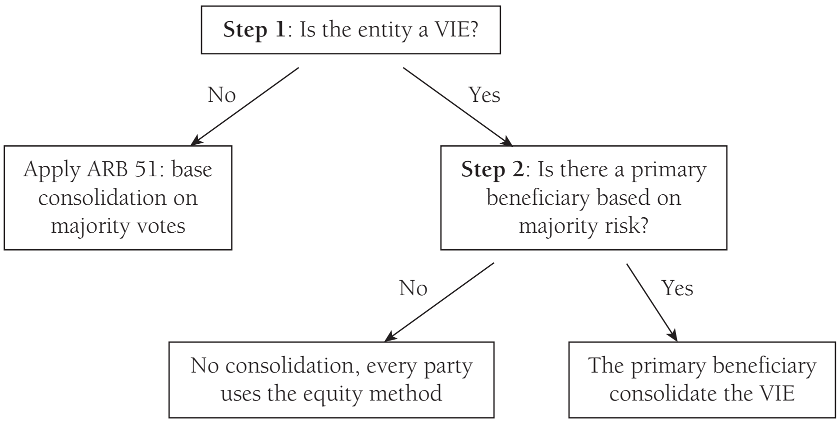
11. *Id.*

12. *Id.* at 54-55.

13. Project Updates, *supra* note 5.

14. Jenny Li Zhang, Economic Consequences of Recognizing Off-Balance Sheet Activities, 6 (Jan. 5, 2009) (unpublished Ph.D. dissertation, University of Washington), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266456.

Figure 1: The Test for VIE Structure[15]



- In the first stage, an entity is considered a VIE under FIN 46R if it possesses one or more of the following characteristics:[16]
- It is thinly capitalized. That is, it does not have sufficient equity investment at risk;
- The residual equity holders do not control the entity;
- Equity holders do not participate fully in an entity's residual economics (returns and losses); or
- The entity was established with non-substantive voting interests.

In the second stage, the question then becomes, who is the "primary beneficiary"? The primary beneficiary is the entity which, by the risk and rewards principle, is exposed to the majority of the expected losses. If no party takes the majority of the expected losses, then "the party which is entitled to the majority rewards of the VIE is the primary beneficiary."[17]

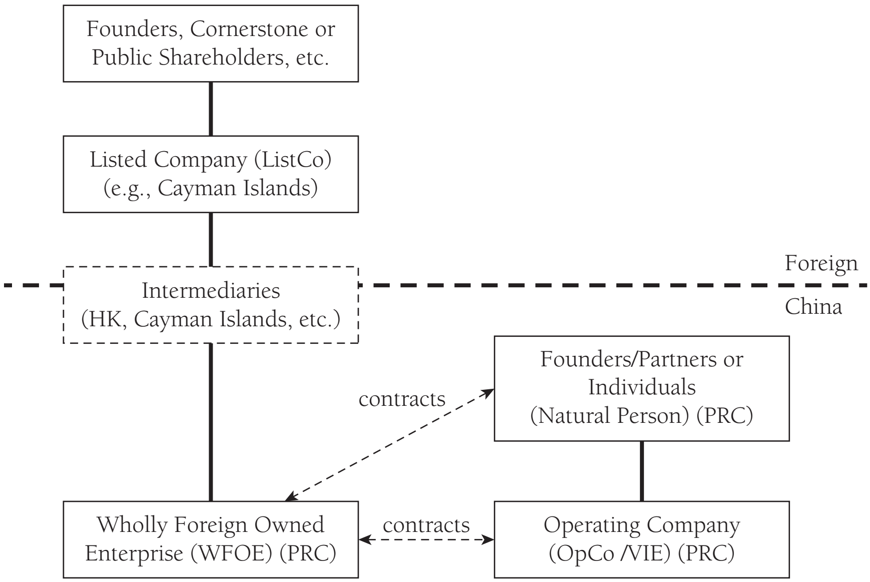
B. VIEs Rise in China[18]

VIEs in the People's Republic of China (China or the PRC), however, are essentially investment vehicles—the result of an amalgamation of various contractual arrangements and undertakings that try to establish control and quasi "ownership" over an entity without the use of direct equity ownership.[19] The model shown in Figure 2 was first used by the internet

15. *Id.*
16. Umit G. Gurun, Alina Lerman, & Joshua Ronen, *Anticipatory and Implementation Effects of Fin 46 on the Behavior of Different Market Participants*, 5-6 (June 15, 2009), *available at* http://faculty.som.yale.edu/alinalerman/documents/GurunLermanRonen.pdf; *Sic-12 and Fin 46R - The Substance of Control*, PRICEWATERHOUSECOOPERS,19 (2004), *available at* http://www.pwc.com/gx/en/ifrs-reporting/pdf/sic12_fin46r.pdf.
17. Zhang, *supra* note 14, at 7.
18. For a more detailed description about VIE structures in China, *see* David Schindelheim, *Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for Foreign Investors Part of China's Economic Development Plan*? 21 CARDOZO J. INT'L & COMP. L. 195 (2012).
19. *See id.* at 198.

company Sina.com in 2000 for its listing on NASDAQ.[20]

Figure 2: A Typical VIE Structure[21]



The historical and perhaps main reason for using VIEs in China is to avoid the restrictions on foreign direct ownership and investment in specific Chinese industries.[22] The Catalogue for the Guidance of Foreign Investment Industries (the Catalogue), a publication jointly issued by the National Development and Reform Commission (NDRC) and MOFCOM of the PRC, delineates three broad categorizations of industries–those which encouraged, restricted, and prohibited foreign investment.[23] If a sector is not mentioned in the Catalogue, foreign investment is generally "permit-

20. *See* Neil Gough, *In China, Concern About a Chill on Foreign Investments*, N.Y. Times (June 2, 2013), http://dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments/?_r=0.

21. Paul L. Gillis, *Accounting Matters Variable Interest Entities in China*, Forensic Asia, 1 (Sept. 18, 2012), *available at* http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf, with editorial modification.

22. *See Understanding the VIE Structure: Necessary Elements for Success and Legal Risks Involved*, Cadwalader, Wickersham & Taft LLP, 2 (Aug. 10, 2011), *available at* http://www.cadwalader.com/resources/clients-friends-memos/understanding-the-vie-structure-necessary-elements-for-success-and-the-legal-risks-involved [hereinafter *Understanding the VIE Structure*].

23. *See* Ministry of Commerce People's Republic of China, *外商投资产业指导目录 [Catalogue for the Guidance of Foreign Investment Industries]* (2011), *available at* http://images.mofcom.gov.cn/wzs/accessory/201112/1325217903366.pdf. The English translation, for reference only, is available at http://english.mofcom.gov.cn/article/policyrelease/aaa/201203/20120308027837.shtml. Note that the 2011 Catalogue was further amended on May 1, 2013. Information on these amendments, in Chinese, is available at http://www.nnccpit.org/index.php?m=content&c=index&a=show&catid=19&id=1281.

ted."[24] By instituting the VIE structure, foreign investors are able to gain an interest in restricted and prohibited industries, e.g. the internet and information technology sector.[25] This is possible because the Listed Company does not have any equity ownership in the Operating Company (VIE). For Chinese domestic firms, the use of VIEs enables them to "gain access to [foreign] capital markets through offshore listings."[26]

The Chinese government's enhanced regulation of equity acquisition by foreign investors has substantially added to the popularity of using the VIE structure. For a direct acquisition, the foreign investor acquires equity in a Foreign Invested Enterprise (FIE) or domestic enterprise through an existing foreign or Chinese equity holder pursuant to either (1) an equity acquisition agreement or (2) a subscription for some new equity with the target.[27] In many cases, such "foreign investors" are offshore holding companies in which both Chinese residents and cornerstone foreign private equity investors hold an interest.[28] Over time, the Chinese government became increasingly skeptical of such a practice, called "round trip investments," which is often carried out in respect to an overseas listing pre-IPO restructure.[29]

The Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (2006 M&A Rules), which became effective in September 2006, was promulgated jointly by MOFCOM, the State-owned Assets Supervision Administrative Commission (SASAC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE).[30] Under the 2006 M&A Rules, "[w]here a domestic company, enterprise or natural person intends to take over its domestic affiliated company in the name of an overseas company which it lawfully established or controls, it shall be subject

24. *See A Primer on Foreign Investment Structures & Special Development Zones in China*, CADWALADER, WICKERSHAM & TAFT LLP (June 27, 2011), *available at http://www.cadwalader.com/resources/clients-friends-memos/a-primer-on-foreign-investments-investment-structures-special-development-zones-in-china-3.*

25. *See* Schindelheim, *supra* note 18, at 196, 226 (discussing, specifically the internet sector).

26. *Understanding the VIE Structure*, *supra* note 22, at 1-2.

27. Peter Corne & Carl Hinze, *The Current State of M&A in China*, THE METROPOLITAN CORPORATE COUNSEL (Dec. 2007), *available at* http://www.metrocorpcounsel.com/pdf/2007/December/76.pdf.

28. *境外PE投资架构的税务考量*, ALL CHINA LAWYERS ASS'N (July 9, 2014), http://www.acla.org.cn/html/lvshiwushi/20140709/17264.html.

29. *See* Howard Chao & Kaichen Xu, *China's Regulation of "Round Trip Investments"*, TOPICS IN CHINESE LAW, O'MELVENY & MYERS LLP (Jan. 2008), *available at* http://www.omm.com/files/Publication/4cdb8217-4aa1-4ad7-9091-0130a5ea4528/Presentation/PublicationAttachment/b76d9dbd-f240-43c2-b29b-01dcb3fd9928/TICLRoundTripInvestments.pdf.

30. *See* Kirkland & Ellis LLP, *New Rules For Chinese Company M&A Transactions Involving Foreign Investors*, PRIVATE EQUITY NEWSLETTER, 3, n.1 (Sept. 1, 2006), *available at* http://www.kirkland.com/siteFiles/Publications/2862933E994B6CCBC83903986270D0C5.pdf.

to the examination and approval of the MOFCOM."[31] As a practical matter, MOFCOM and CSRC rarely approve such affiliated acquisitions and they have also failed to release any workable guidelines on how to apply for examination and approval of these acquisitions. Since VIEs do not involve any equity acquisition, there is no need to obtain regulatory approval; this allows VIEs to bypass the need to obtain approvals for cross-border acquisitions under the 2006 M&A Rules for cross-border acquisitions, which are "notoriously difficult to obtain."[32]

In 2009, China Qinfa (HKEx. 00866) went public in Hong Kong with the VIE structure, a move that surprised many and potentially angered regulatory authorities.[33] Unlike those emerging asset-light companies, Qinfa is a traditional asset-heavy company that engages in the coal operation business.[34] Through a VIE structure, Qinfa circumvented the 2006 M&A Rules, foreign currency exchange regulations, and industry-admission policy. Even if the VIE might serve as a comfortable "excuse" for regulatory authorities to acquiesce in the offshore financing and listing of emerging asset-light companies, severe concerns arise about whether the VIE could be acceptable in any other sector, especially a sector that encompasses traditional asset-heavy companies like Qinfa.[35]

Through in-depth consideration, one could also find intrinsic irony when Chinese executives, with help from investment bankers and lawyers, wrack their brains to make use of the VIE to list their business overseas. The essence of VIE treatment in the U.S. is substance over form; by searching for the primary beneficiary, it overcame the stark and oversimplified shareholder criteria and was introduced to rein in rampant financial reporting fraud and debt evasion.[36] VIE treatment in the U.S. seems more stringent and effective than many straightforward legal restrictions. In contrast, VIE usage in China held high the tenet of free will and contractual freedom, focusing on deed arrangements over equity investment with a real

31. *Interim Provision on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, Ministry of Commerce People's Republic of China, art. 11 (Aug. 10, 2006), http://english.mofcom.gov.cn/article/policyrelease/Businessregulations/201303/20130300045825.shtml.

32. Hai-Ching Yang, *An Update on China's Variable Interest Entities: Navigating Regulations and Mitigating Risks for 2013*, K&L Gates, 2 (Mar. 8, 2013), *available at* http://www.klgates.com/files/Publication/17f27e53-67f8-4438-9444-2c4aa401f933/Presentation/PublicationAttachment/8b5055c4-f814-41e8-b3ec-95398f6e7708/Asia_Alert_382013.pdf.

33. Cristiano Rizzi, *A Review and Outlook of VIE (Variable Interest Entity) and Other Related Issues: an Introduction*, China Blawg (June 17, 2013), http://blawg.lehmanlaw.com/wordpress/?p=1905.

34. *See generally Company Profile*, Qinfa Group , http://www.qinfagroup.com/en/About%20us.html (last visited Nov. 26, 2014).

35. *See* Steve Xiang, Anthony Wang & Wenfeng Li, *Chinese Government Urged to Regulate Popular Foreign Investment Structure*, Asia Alert, Weil, Gotshal & Manges LLP, 2-4 (Oct. 2011), *available at* http://www.weil.com/~/media/files/pdfs/October_2011_Asia_Alert_Corrected.pdf.

36. *See FASB Interpretation No. 46 (revised December 2003) FIN46(R)-3*, Financial Accounting Standards Board, (2008), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true.

hope to circumvent government restrictions and regulations; in other words, form over substance.[37] The grotesque combination of these two approaches is too manipulative in nature and, as a result, doomed to face challenges.

II. Chinese Style VIE: Parties and Components

Given the abovementioned background, it is best to define the parties in a Chinese-styled VIE structure and explain how such a structure is achieved.

A. The Parties

The entities typically involved in VIEs are the listed entity (ListCo) and its intermediaries,[38] which own the Wholly Foreign Owned Enterprise (WFOE), along with the Chinese operating entity (OpCo or VIE) and its legal owner, which is a Chinese national (Chinese Partners/Founders).

(a) The ListCo and its Intermediaries. The ListCo is usually incorporated in offshore jurisdictions, like the Cayman Islands or the British Virgin Islands, but incorporation in onshore jurisdictions, like the United States, is not uncommon. The ListCo serves merely as a holding company, and therefore typically does not have any operations. The intermediaries (if any) are typically incorporated in Hong Kong as well as offshore jurisdictions. These are usually incorporated to avoid a withholding tax on dividends, but Chinese rules make this implausible.

(b) The WFOE. The WFOE is incorporated in the PRC by either the ListCo or its wholly-owned intermediaries prior to listing. WFOEs are heavily regulated, and are required to only pursue businesses that are within the ambit of its business license.[39] For the purposes of the VIE, the WFOE will often obtain a license that will allow it to conduct a consulting business with the OpCo as its only customer.[40]

It should be noted, however, that in industries where ownership is not restricted or prohibited, the multinational may conduct all its operations

37. *See China VIE Structure for Foreign Investment Under Attack from Multiple Directions: Will it Emerge (Relatively) Unscathed or Is its Very Survival Threatened?*, HOGAN LOVELLS LLP, 1-3 (Jan. 2012), *available at* http://www.hoganlovells.com/files/Publication/7acf9f60-c4d8-4363-aa1c-9b76af0cdd0d/Presentation/PublicationAttachment/92f53946-f08c-4125-9dc7-a43946eb8b2b/Hogan_Lovells_Client_Note_-_China_VIE_Structure_for_Foreign_Investment_Under_Attac.pdf.

38. Though it is not technically correct to term the intermediaries as "ListCo," the ListCo often wholly owns these intermediaries. Thus, for the purposes of this paper (and for simplicity), unless stated otherwise, they will be treated as being one and the same.

39. *See* The Canadian Trade Commissioner Service, *Establishing a Wholly Foreign-Owned Enterprise in China*. THE CANADIAN TRADE COMMISSIONER SERVICE, (2014), http://www.tradecommissioner.gc.ca/eng/document.jsp?did=132208.

40. *See* David Roberts & Thomas Hall, *VIE Structures in China: What You Need to Know*, TOPICS IN CHINESE LAW, 2-3 (Oct. 2011), *available at* http://iis-db.stanford.edu/evnts/6963/TICL_-_VIE_Structures_in_China.pdf.

through a WFOE, without the need for a VIE structure.[41]

(c) The OpCo and Chinese Partner. The OpCo is owned by the Chinese Partner. The Chinese Partner is typically a founder or co-founder, the chairman of the ListCo, or a trusted employee or partner who is a Chinese citizen.[42] By having Chinese-only ownership, the OpCo is able to operate in industries that prohibit or restrict foreign ownership.[43] In effect, the OpCo is the license holder and, more importantly, the source of benefits and losses under a VIE structure.

B. Achieving the Structure

As shown in Figure 2, various contracts are signed between the OpCo and WFOE to mimic the effect of equity ownership. These include:

(a) Loan agreement. The loan agreement deals with capitalizing the OpCo and obtaining security for the loan that is used for that capitalization. The loan that is usually given by the WFOE to the Chinese Partner is "an RMB denominated, interest free loan running for a number of years with the potential for extension."[44] In return the Chinese Partner pledges his/her equity in the OpCo as security for breach of the loan agreement.[45] One problem here deserves particular attention: although the loan from the WFOE would bypass potential problems with the State Administration of Foreign Exchange,[46] the WFOE's constituent documents must give it the legal capacity to make the loan to begin with; otherwise, the actions of the WFOE would be ultra vires and void.

(b) Equity pledge agreement. The equity pledge, as mentioned above, acts as security for the loan extended by the WFOE to the Chinese Partner; however, under Chinese law, security interests must be registered with relevant Chinese authorities before it can be perfected.[47] Failure to do so may result in unenforceability.

(c) Call option agreement. The call option gives the WFOE the legal right to purchase the OpCo's shares from the Chinese Partner at a predetermined price; this is either based on the quantum of the loan extended by the WFOE to the Chinese Partners or on the "lowest permissible price

41. *See generally* Gillis, *supra* note 21.
42. *Id.* at 5.
43. *Id.*
44. *Id.*
45. *See id.* at 6.
46. *Cf.* the ListCo, which as an offshore public company, would have attracted regulatory scrutiny from SAFE, and also impinged upon rules restricting foreign acquisitions if it were used instead of the WFOE. *See also* Rocky T. Lee, *China: SAFE Regulations Affecting Inbound And Outbound Payments In Cross-Border M&A Transactions Within The People's Republic Of China*, MONDAQ (Sept. 26, 2011), http://www.mondaq.com/x/146588/Mergers+Acquisitions/SAFE+Regulations+Affecting+Inbound+And+Outbound+Payments+In+CrossBorder+MA+Transactions+Within+The+Peoples+Republic+Of+China.
47. *See Ensuring Creditor Protection in Asia Pacific Construction Projects*, DLA PIPER (2013), *available at* http://www.dlapiper.com/~/media/Files/Insights/Publications/2013/02/Ensuring%20creditor%20protection%20in%20construction%20pro__/Files/propertysecuritieslawasiapacific/FileAttachment/propertysecuritieslawasiapacific.pdf.

under PRC law."[48] However, the option is more for comfort than actual protection since it underscores the very reason why the WFOE cannot own the OpCo, i.e. because the OpCo lies in an industry that prohibits or restricts foreign investment. Thus, it is best for the ListCo to transfer the shares to another Chinese national (and come up with a new set of arrangements vis-à-vis the latter).

(d) Power of attorney. The Chinese Partners also typically give the WFOE power of attorney. This assigns to the WFOE all of the usual shareholder rights, including voting, attending shareholder meetings, and acting as necessary to execute the call option agreement.

(e) Technical service agreement and asset licensing agreement. The technical service agreement(s) give(s) the WFOE the right to the OpCo's residual profits in return for its (the WFOE's) exclusive provision of technical services to the VIE. These 'services' differ between industries and companies but "often include website maintenance, programming, sales support, fulfillment services, curriculum development, etc."[49] The WFOE also exerts indirect controls on the VIE through "negative and affirmative covenants in the technical consulting services agreement covering matters such as segregated dual-signature bank accounts, minimum QOS [(Quality of Services)] standards, systems design and operational management requirements, on-site training and supervision, management outsourcing arrangements, etc."[50]

Some variations can exist between VIE structures. For example, many WFOEs do not extract all of the OpCo's profits through service agreements. Moreover, in some cases, an additional asset licensing agreement is used, whereby the WFOE licenses certain assets, typically intellectual property, to the OpCo in return for royalty fees.

All in all, 'ownership' and control is achieved from contracts.[51] However, the viability of the listing depends on the fundamental requirement that the OpCo's financials are consolidated with that of the ListCo; this requirement allows the ListCo to generate interest in its listing.[52] The use of consolidation to attract funds, however, is not a new notion; the United States Steel Corporation used this tactic for the very same purpose in 1902. United States Steel likely recognized the value of this tactic because "[c]onsolidated balance sheets might have provided a more impressive picture of the security which would be offered [to] prospective bond holders at a time when the corporation's management was becoming aware of a

48. Gillis, *supra* note 21, at 6.

49. *Id.*

50. Robert Lewis, *China Watch: A Foreign Lawyer's View from the Inside*, THE LAWYER (Oct. 19, 2011), http://www.thelawyer.com/china-watch-a-foreign-lawyers-view-from-the-inside/1009862.article.

51. *See* Stacey P. Slaughter, *China's Forbidden Investment: Emerging Legal Risks for Investors Who Deal with Chinese Variable Interest Entity (VIE) Structures*, ROBINS, KAPLAN, MILLER & CIRESI L.L.P. (Mar. 1, 2012), http://www.rkmc.com/resources/articles/china-s-forbidden-investment.

52. *See* Gillis, *supra* note 21, at 1, 3 (discussing how Chinese company are consolidated into the financial statements of the offshore parent companies).

need to go to the market for additional working capital."[53]

That said, the key rationales for consolidation in the beginning of the twentieth century were the "need to avoid misrepresentations of liquidity, or to ensure that readers were aware of the resources to which funds had been directed, or to reflect the position of an 'economic entity.'"[54] This was due, in part, to the concept of the holding company being popularized in order to allow companies to bypass the problems associated with amalgamations in the U.S.[55]

Unlike ownership in consolidated companies over 100 years ago, ownership in VIEs is not equity-based.[56] Rather, it is based on contractual ownership that mimics equity ownership.[57] For VIEs, then, the ListCo is effectively suggesting to shareholders and securities regulators that although contractual 'ownership' is different in form from equity ownership, the two are in substance the same.[58] However, there has been increasing evidence that the VIEs' legal substance is different from the economic substance, or at best, has a tenuous semblance. Three threats emerged from government regulatory interference, illustrating this tenuous connection between VIEs' legal and economic substance: willful breach of contracts, disputes over control, and unfavorable judiciary and arbitration decisions.[59]

III. Government Regulatory Interference

A. Other Agencies and Local Governments

The first clouds of regulatory interference in VIE management actually came from peripheral agencies. For example, in July 2006, the Ministry of Information Industries, which was then integrated into the Ministry of Industry and Information Technology (MIIT), released a notice document entitled "Strengthening the Administration of Foreign Investment Value-added Telecommunications Services" (Notice).[60] Value-added telecommunications services, which are highly regulated in China, include online data processing and Internet access services that regularly employed the

53. R. G. Walker, Consolidated Statements: A History and Analysis 153 (1978).

54. *Id.* at 220.

55. *Id.* at 261.

56. Yang, *supra* note 32, at 1.

57. Duane Lawrence, *China Companies Evading Rule With U.S. Listings Stump Regulators*, Bloomberg (Oct. 9, 2011, 5:00 PM), http://www.bloomberg.com/news/2011-10-09/china-companies-evading-rule-with-u-s-listings-stump-regulators.html.

58. While it is acknowledged that the ListCo does disclose that there are regulatory risks etc., this is essentially the underlying premise by which they are listing. *See, eg.*, Carbonite, Inc., Form 10-K Annual Report, Carbonite, Inc., (Mar. 7, 2012), *available at http*://investor.carbonite.com/secfiling.cfm?filingID=1193125-12-101462.

59. *See infra* Part IV and V of this paper.

60. *Notice of the Ministry of Information Industry on Strengthening the Administration of Foreign Investment in Value-added Telecommunications Services*, Ministry of Commerce (July 13, 2006), http://english.mofcom.gov.cn/aarticle/policyrelease/announcement/200712/20071205275842.html.

VIE structure.[61] Without mentioning the VIE structure explicitly, the Notice called for "an immediate stop of unauthorized foreign investors providing VAT service in China and prohibits domestic telecom companies from leasing, transferring or selling telecom business operation licenses in any form to foreign investors."[62]

A more explicit government agency rule which targeted the VIE structure appeared in September 2009. The General Administration of Press and Publication (GAPP), the National Copyright Administration (NCA), and the National Office of Combating Pornography and Illegal Publications jointly issued a document entitled, "The Notice Regarding the Consistent Implementation of the 'Stipulations on Three Provisions' of the State Council and the Relevant Interpretations of the State Commission Office for Public Sector Reform and the Further Strengthening of the Administration of Pre-examination and Approval of Internet Games and the Examination and Approval of Imported Internet Games" (2009 GAPP Notice).[63] The 2009 GAPP Notice "expressly prohibits foreign investors from using contractual or other control arrangements to gain control over domestic Internet game operators."[64] However, the agencies issuing the 2009 GAPP Notice did not include MOFCOM, MIIT, or the Ministry of Culture, and the absence of these powerful administrations cast doubt on the Notice's influence.[65] For example, Taomee Holdings Limited, a company that operated through a VIE structure, listed on the New York Stock Exchange (NYSE) in June 2011.[66]

Chinese local governments also joined the chorus of skepticism. In September 2010, Buddha Steel filed a registration statement for an initial public offering in the United States. The registration statement disclosed the company's VIE arrangement, which allowed Buddha Steel to exert control over and reap all of the economic benefits from a steel company

61. *Sector Primers– Internet*, Orrick, Herrington & Sutcliffe LLP, 2 (Feb. 2012), *available at* http://www.orrick.com/Events-and-Publications/Documents/4521.pdf.

62. David Huang, *China Imposes Stricter Regulations on Foreign Invested Internet and Telecom Businesses*, Dorsey & Whitney LLP (Aug. 2006), http://www.dorsey.com/china_report_aug_2006/.

63. *See, e.g.*, *Email from Guantao Law Firm to China Mobile Games and Entertainment Group Limited*, Guantao Law Firm (Hong Kong) (Aug. 27, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1528752/000104746912008541/a2210847zex-99_7.htm.

64. Paul McKenzie, *GAPP Issues Notice Further Restricting Foreign Participation in China's Internet Gaming Industry*, Morrison & Foerster LLP, 1 (Oct. 16, 2009), *available at* http://www.mofo.com/~/media/Files/Resources/Publications/2009/10/GAPP%20Issues%20Notice%20Further%20Restricting%20Foreign%20P__/Files/091016GAPPRegulations/FileAttachment/091016GAPPRegulations.pdf.

65. David Roberts, *O'Melveny & Myers Publishes Paper on VIE Structures in China: What You Need to Know*, O'Melveny & Myers LLP (Nov. 1, 2011), http://www.omm.com/fcwsite/abc.aspx?url=newsroom%2fpenPDF.aspx%3fpub%3d1167.

66. Taomee Holdings Limited, Prospectus Filed Pursuant to Rule 424(b)(4), (June 10, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1507051/000119312511162606/d424b4.htm.

located in Hebei province.[67] In March 2011, local government authorities in Hebei province notified the OpCo that the VIE agreements "'contravene current Chinese management policies related to foreign-invested enterprises and are against public policy.'"[68] To avoid legal action, Buddha Steel therefore had to quickly request that its SEC filing be withdrawn. Although some lawyers interpreted this behavior as "a 'one off' event motivated by facts peculiar to this situation[,]"[69] the apparent regional veto on VIE arrangements did cast new doubt, adding another layer of complexity to the VIE situation.

B. MOFCOM and CSRC

Probably the most worrisome indications of increasing regulatory control over VIEs came from MOFCOM, which addressed the VIE structure in general rather than targeting specific industry sectors. In March 2011, the General Office of the PRC State Council issued the Notice on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.[70] Subsequently, MOFCOM promulgated an implementing rule: "Regulation on Implementing of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (Provisions), on August 25, 2011, which went into effect on September 1, 2011.[71] Article 9 of the Provisions specifically emphasized that "security review [will be] based on the essential content and actual impact of the transaction . . . .[and that a] [f]oreign [investor] shall not avoid M&A security review through any means, including . . . contractual control."[72]

It should be noted that not all M&A transactions will trigger a security review. The security review process only applies if the target domestic

67. Buddha Steel, Inc., Form S-1 Registration Statement, 1 (Sept. 17, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1367777/000114420410049933/v196530_s1.htm.

68. Thomas M. Shoesmith, *Client Alert: PRC Challenge to Variable Interest Entity Structures?*, Pillsbury Winthrop Shaw Pittman LLP, 2 (Mar. 31, 2011), *available at* http://www.pillsburylaw.com/siteFiles/Publications/ChinaAlertPRCChallengetoVIEStructures_03_31_11pdf.pdf.

69. *Id.*

70. GuoWuYuan BanGong Ting GuanYu JianLi WaiGuo TouZi Zhe BingGuo JingNei QiYe AnQuan ShenCha ZhiDu de TongZhi (国务院办公厅关于建立外国投资者并购 境内企业安全审查制度的通知) [Circular of the General Office of the State Council on the Establishment of Security Review System Regarding Merger and Acquisition of Domestic Enterprises by Foreign Investors] (promulgated by the General Office of the State Council, Feb. 3, 2011, effective Feb. 3, 2011) 6 Guo Ban Fa, *available at* http://www.fdi.gov.cn/1800000121_39_57_0_7.html.

71. *China Formalises National Security Review System for M&A Transactions by Foreign Investors*, MWE China Law Offices (Sept. 16, 2011), http://www.mwechinalaw.com/news/2011/chinalawalert0911c.htm [hereinafter *China Formalises National Security Review System*].

72. *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*, Ministry of Commerce, art. 9 (Sept. 8, 2011), http://english.mofcom.gov.cn/aarticle/policyrelease/domesticpolicy/201112/20111207869355.html.

entity is involved in a business that concerns either national defense security issues or national economic security issues.[73] The former includes military industry enterprises and supporting enterprises; enterprises adjacent to major and sensitive military facilities; and other entities relevant to the national security of China.[74] The latter refers to entities that are involved in major agricultural products, major natural resources and energy industries, important infrastructure projects, transportation services, key technologies, and major equipment that is related to national security.[75] MOFCOM has five business days to decide whether the Merger or Acquisition requires national review, but if it decides against a national security review, a designated list of bodies may request that the transaction still undergo a national security review.[76]

MOFCOM also scrutinizes antitrust aspects of the VIE structure. A researcher found in late 2012 that MOFCOM "issued a decision on the conditional anti-monopoly approval of Walmart's acquisition of Yihaodian [(Store No.1)], a major China online retailer, which expressly preclude[d] Walmart from engaging in value-added telecommunications business services currently provided by Yihaodian via the VIE structure."[77] The researcher notes, "[t]his [was] the first time that the [MOFCOM] explicitly prohibited the use of a VIE structure . . . [and] was concerned over WalMart getting access to the restricted [value-added telecommunication business] without obtaining the requisite regulatory approval."[78] A greater general concern was that MOFCOM essentially equated foreign control and bearing of economic outcome through the use of the VIE structure with foreign ownership itself. Even if the VIE structure was narrowly interpreted, those dependent upon those structures would feel precarious if they ever were in front of MOFCOM for an antitrust review.[79] In other words, if their company is VIE dependent, foreign investors have to re-evaluate their exit strategy because the sale of their company to strategic buyers would trigger MOFCOM's antitrust review.

The CSRC was the other key regulator that espoused an increasingly adverse attitude concerning usage of the VIE structure. In September 2011, various media outlets published articles regarding an unofficial internal report written by the CSRC staff that attracted a lot of attention from VIE investors. The report supposedly suggested that the VIE poses a major threat to China's national security, and thus, urged MOFCOM to

73. *See China Formalises National Security Review System*, *supra* note 71.

74. *See id.*

75. *Id.*

76. Dawn Bernd-Schulz, *Latest Developments in M&A Laws and Regulations in China*, BLANK ROME LLP, 14 (Nov. 2011), *available at* http://www.blankrome.com/sitefiles/ChineseMALaws.pdf.

77. Daniel Dusek et al., *China M&A: Looking Ahead to 2013*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, 116 (Jan. 2013), *available at* https://www.skadden.com/sites/default/files/publications/Skadden_2013_Insights_Global_M-A.pdf.

78. *Id.*

79. Yingxi Fu-Tomlinson & Niping Wu, *What the Future Holds for China's VIE*, INT'L FIN. L. REV. (Sept. 25, 2012), http://www.iflr.com/Article/3093966/What-the-future-holds-for-Chinas-VIE.html.

take the lead in enforcing regulations.[80] The report also recommended that all existing companies using the VIE structure be subject to approval by MOFCOM and the CSRC when they list overseas.[81] This proposal would restrict and regulate new listings rather than existing ones. The report observed that while the general regulatory requirements were in place for years, enforcement has been inconsistent and many such requirements in fact have been widely avoided *through the use* of VIE structures. Hence, it has been suggested that these approvals occur in collaboration with the United States Security Exchange Commission (SEC), so that the applicants would be reviewed before the actual listing occurs.[82] The report also recommended that Chinese Internet companies be encouraged to list domestically, and that the use of VIE structures be discouraged.[83]

It remains unclear if this CSRC Report has been officially accepted by the State Council. But, it appears that the Chinese government is increasingly concerned by the usage of VIE structures to circumvent foreign direct investment restrictions in certain sectors and to avoid obtaining permission to list offshore. Recently, the CSRC issued a rule regarding the application process for overseas listing by PRC enterprises which sheds light on the fate of the VIE (Circular 45).[84] Circular 45 allowed joint stock limited companies to apply with the CSRC to list overseas provided that the company meets listing requirements.[85] However, such an application will be denied "if one of its shareholders [are] invested in the issuer through a VIE structure."[86] Hence, if the joint stock limited company is part of a VIE structure, it will be denied by the CSRC. The CSRC is trying to make it easier for domestic enterprises to list overseas, while discouraging companies from using the VIE structure.

IV. Breach of Contracts and Dispute over Control

Another vulnerability of the VIE structure lies in the conflict of interests between parties. The VIE structure might collapse if and when the legal owner of the OpCo moves to take the company back and breaches the VIE agreements. Normally, however, that is unlikely to happen because the legal owner of the OpCo is also the majority shareholder and typically the CEO of the ListCo. However, if such a legal owner and/or shareholder was forced out of the ListCo, or if another substantial business change occurs externally, the VIE tie would probably be broken.[87] Then, the contractual arrangements may prove to be less reliable than having direct ownership of the OpCo.[88]

80. Bernd-Schulz, *supra* note 76, at 24.
81. *Id.*
82. *Id.*
83. *Id.*
84. Yang, *supra* note 32, at 3.
85. *Id.* at 3-4.
86. *Id.* at 4.
87. *See infra* Part IV and V of this paper.
88. *See id.*

A. Giga Media

The first case concerning conflicts of interest and breach of contracts involved Giga Media Limited (Giga Media), which was incorporated in Singapore as a company limited by shares on September 13, 1999.[89] Headquartered in Taibei, Giga Media mainly provided online games and cloud computing services.[90] Giga Media operated their Asian online game and service business in the PRC through three VIEs until June 30, 2010, when the PRC issued restrictions on foreign equity ownership of companies providing Internet content services as well certain other licensing restrictions.[91] These VIEs held the PRC licenses required for the operation and service business, and were all owned by PRC nationals.[92]

Ji Wang was the former head of the company's Asian online game and service business in the PRC, and the former CEO of T2CN, the WOFE that has a contractual relationship with the OpCos. In early 2010, Giga Media decided to remove Wang from his post as operating head to a less important position, which Wang did not accept; the conflict escalated later when the company fired Wang. The company seals, financial seals (chops) and business registration certificates, documents, records, data and tangible property—including license agreements, trademarks and domain name documentation—held in the offices of T2CN were missing. Lacking access to these documents due to the dispute with Wang, Giga Media could not obtain the financial information necessary to report the financial results of T2CN. Somewhat fortunately in this case, however, the VIE structure in the PRC only accounted for about 20% of Giga Media's income. Thus, the ListCo survived by deconsolidating T2CN's results, which took effect on July 1, 2010.[93]

B. Ambow Education

Another, though more chaotic case, involved Ambow Education Holding Ltd. (Ambow Education), a leading provider of educational and career enhancement services in China. The CEO, Dr. Jin Huang, established Ambow Education in 2000.[94] It went public on the New York Stock Exchange on August 5, 2010.[95] Ambow Education was registered in the

89. GigaMedia Ltd., Annual Report (Form 20-F), 49 (June 30, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1105101/000095012311063164/c19286e20vf.htm#C19286105.

90. *GigaMedia Overview*, GigaMedia Ltd., http://www.gigamedia.com.tw/Overview.html (last visited Nov. 30, 2014).

91. GigaMedia Ltd., Annual Report (Form 20-F), *supra* note 89, at 49.

92. *Id.*

93. *Id.* at 50.

94. Ambow Educ. Holding Ltd., Registration Statement (Form F-1), 143 (July 14, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1494558/000119312510158771/df1.htm [hereinafter Ambow Educ. Holding Ltd., Registration Statement (Form F-1)].

95. Ambow Educ. Holding Ltd., *Exhibit 99.1 to Report of Foreign Issuer (Form 6-K)*, United State Sec. and Exch. Comm'n, 8 (Sept. 20, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1494558/000110465913071328/a13-20766_1ex99d1.htm [hereinafter Ambow Educ. Holding Ltd., *Exhibit 99.1*].

Cayman Islands in 2005 due to PRC regulatory restrictions on foreign investment in the education sector—particularly for companies with services for students in grades one to twelve—and on Internet content businesses. Ambow conducted their business in China primarily through contractual arrangements between Ambow Online, one of their wholly-owned subsidiaries in China, and several domestic PRC companies (OpCos) that were owned either by Ambow employees or by entities controlled by Ambow employees. The OpCos' shareholders pledged their respective equity interests and entrusted all of their rights to exercise voting power over these OpCos to Ambow Online.[96]

On July 2, 2012, a former employee alleged certain financial improprieties and wrongful conduct by senior executives in connection with the company's 2008 acquisition of a training school in the PRC.[97] The company's audit committee initiated investigations, but no result was published afterwards.[98] Worrying about the internal control of the company, the third largest shareholder, GL Asia Mauritius II Cayman Limited (GLA), filed a petition on April 23, 2012 in the Grand Court of the Cayman Islands (Grand Court), the company's jurisdiction of organization, to request an order to "wind up" the company on a just and equitable basis.[99] On March 15, 2013, the second largest shareholder of Ambow Education, Baring Asia Private Equity Fund V, L.P. (Baring), sent out a "Going Private" Proposal.[100] Soon thereafter, all three members of the audit committee resigned from the board, claiming they could not continue the investigation as the CEO, Dr. Jin Huang, refused to resign. The company's auditor and the legal counsel for the audit committee also resigned,[101] and the New York Stock Exchange halted the company's ADS trading on March 22, 2013.[102] As a result of these unexpected events, Baring withdrew its "going private" proposal.[103]

96. Ambow Educ. Holding Ltd., *Registration Statement (Form F-1)*, *supra* note 94, at 148.

97. Ambow Educ. Holding Ltd., Report of Foreign Issuer (Form 6-K), (July 2012), http://www.sec.gov/Archives/edgar/data/1494558/000110465912047538/a12-15903_16k.htm.

98. *See* Ambow Educ. Holding Ltd., *Exhibit 99.1*, *supra* note 95, at 28.

99. Press Release, Ambow Educ. Holding Ltd., Ambow Education Holding Ltd. Responds to Shareholder Petition (May 6, 2013) (on file with SEC), *available at* http://www.sec.gov/Archives/edgar/data/1494558/000110465913037349/a13-11619_1ex99d1.htm.

100. Press Release, Ambow Educ. Holding Ltd., Ambow Education Holding Ltd. Announces Receipt of "Going Private" Proposal; Resignation of Directors and Appointment of a New Director (Mar. 18, 2013), *available at* http://investors.ir.ambow.com/us/AMBO/announce/60/EN/ambo0318_gACUj1yF2IC3.pdf.

101. Press Release, Ambow Educ. Holding Ltd., Ambow Education Holding Ltd. Announces Resignation of Independent Auditor and Counsel to Audit Committee (Mar. 22, 2013), *available at* http://investors.ir.ambow.com/us/AMBO/announce/62/EN/Ambow_Press_Release_re_Resignation_of_PWC_FHeDaJQLHfD3.pdf.

102. Ambow Educ. Holding Ltd., *Exhibit 99.1*, *supra* note 95, at 8.

103. Press Release, Ambow Educ. Holding Ltd., Ambow Education Holding Ltd. Announces Withdrawal of Non-Binding Going Private Proposal (Mar. 26, 2013), *available at* http://investors.ir.ambow.com/us/AMBO/announce/63/EN/ambow0326_FMca3BpuQeuI.pdf.

On June 7, 2013, the Grand Court ordered Ambow Education into Provisional Liquidation.[104] Three days later, the court revised the order and dismissed Ambow Education's board of directors and empowered the provisional liquidators to take control of the company's books and records and conduct the company's business, thus ending the wrangling between CEO Huang and external shareholders.[105]

The collapse of Ambow Education stems from the instability of the VIE structure. From 2008 to May 31, 2010, it merged 24 schools, all of which were controlled by VIE agreements.[106] The consideration was paid half by cash and half by shares in Ambow Education.[107] Nonetheless, after going public, the stock price was much lower than the expectation of the merged schools, and the company refused the schools' requests to turn their stocks into tradable ADS.[108] Conflicts of interest thus arose between the founders of these merged schools and CEO Huang. In fact, the employee that alleged certain financial improprieties and wrongful conduct was actually the founder of one of the merged schools, further complicating the conflicts; meanwhile, the founder of another merged school filed lawsuits first to freeze the ownership transfer of the school, and then to invalidate the VIE agreements.[109]

C. Alibaba Group

The most renowned episode so far was probably the dispute between Alibaba and Yahoo, which exposed the risks associated with VIEs to the world. Alibaba Group is an e-commerce global leader and the largest e-commerce company in China.[110] It was founded in 1999 by Chairman Jack Ma and 18 other partners.[111] Yahoo! Inc. (a U.S. company) and Softbank (a Japanese company) invested in Alibaba Group and became its principal shareholders.[112] Before 2009, the corporate group was structured

104. Press Release, Ambow Educ. Holding Ltd., Ambow Education Holding Ltd. Announces Appointment of Joint Provisional Liquidators by The Grand Court Of The Cayman Islands (June 10, 2013), *available at* http://investors.ir.ambow.com/us/AMBO/announce/70/EN/Ambow_Press_release_re_Appointment_of_Joint_Provisional_Liquidators_aqNtcNIPC6rk.pdf.

105. Matthew Miller, *Court Orders China's Ambow into Provisional Liquidation*, REUTERS (June 11, 2013), http://www.reuters.com/article/2013/06/11/ambo-liquidation-idUSL3N0EN1ID20130611.

106. Ambow Educ. Holding Ltd., Registration Statement (Form F-1), *supra* note 94, at F-12 (stating that Ambow Education entered into 24 acquisitions in 2008 and 2009).

107. Xiaolong Cao, *Ambow Education Saving Itself*, NEW FINANCIAL VIEW (June 30, 2013), http://finance.sina.com.cn/chanjing/gsnews/20130630/112915965368.shtml.

108. *Id.*

109. *Id.*

110. *See Leslie* Picker, *Alibaba Files for US Public Offering of E-Commerce Giant*, BLOOMBERG (May 7, 2014, 10:08 AM), http://www.bloomberg.com/news/2014-05-06/alibaba-files-for-us-public-offering-of-e-commerce-giant.html.

111. Marc Lajoie et al., *What Is Alibaba?*, WALL ST. J., http://projects.wsj.com/alibaba/ (last visited Oct. 18, 2014).

112. Yahoo! Inc. held about 40% of shares (together with its wholly-owned subsidiary Yahoo! Hong Kong) and Softbank held about 30% of shares. *Prospectus of Alibaba.com Ltd. Global Offering*, ALIBABA.COM LTD., 144 (Oct. 23, 2007), *available at* http://globaldoc

through equity control.[113] To expedite obtaining an essential regulatory license, Alibaba Group transferred the ownership of Alibaba Group's online payment business, Alipay, to the Chinese domestic company Zhejiang Alibaba E-Commerce Co., the majority owner of which was Jack Ma.[114] The consideration for Alipay was at a price much lower than market value.[115] Nevertheless, after this change in ownership, Alibaba Group still controlled Alipay, via contractual method or the VIE structure. However, in early 2011, Ma terminated the VIE arrangement.[116] As a result, Alibaba Group and Yahoo no longer retained control over Alipay, and the profits of Alipay could no longer be reflected on Yahoo's balance sheet. Alipay was regarded as one of the most valuable investments Yahoo held and, consequently, Yahoo's stock price dropped 9.8% the day after Yahoo disclosed this information.[117]

Yahoo and Ma provided different accounts as to when Yahoo learned about the termination of the VIE arrangement. Yahoo insisted that the transaction occurred without the knowledge or approval of Alibaba Group's board of directors or shareholders.[118] On the other hand, Ma claimed that the board had discussed a solution for Alipay for more than three years and the VIE arrangement was acquiesced.[119] Nonetheless, it is clear that Ma not only unilaterally halted the VIE agreement, but also that, by the time of termination, Yahoo and Softbank had yet to receive compensation.

Ma claimed that his purpose for restructuring Alipay, by unilaterally terminating the VIE arrangement, was to ensure that Alipay obtained a

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uments.morningstar.com/documentlibrary/document/45dda2cbefcb49dc.msdoc/original.

113. *Press Conference on Alipay*, ZDNET (June 15, 2011), *available at* http://tech.163.com/11/0615/01/76I66VUD000915BF.html [hereinafter ZDNET].

114. *See* Yahoo! Inc., Quarterly Report (Form 10-Q), 8 (May 10, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1011006/000119312511134295/d10q.htm.

115. *See* Loretta Chao & Amir Efrati, *Yahoo's China Feud Turns Ugly, Stock Falls*, WALL ST. J. (May 14, 2011), http://online.wsj.com/articles/SB10001424052748703730804576321030705428022. Jack Ma explained that the price was an arrangement under VIE structure. ZDNET, *supra* note 113.

116. See iChinaStock, *Alibaba Group No Longer Controls Alipay Via VIE Structure*, BUSINESS INSIDER (May 31, 2011, 1:22 PM), http://www.businessinsider.com/alibaba-group-no-longer-controls-alipay-via-vie-structure-2011-6.

117. Jennifer Saba, *Yahoo, Alibaba Partnership on the Rocks*, REUTERS (May 11, 2011, 5:49 PM), http://www.huffingtonpost.com/2011/05/11/yahoo-alibaba-china_n_860805.htm.

118. Steven Russolillo, *Corporate News: Yahoo Not Told of Alibaba Move*, WALL ST. J. (May 13, 2011), http://online.wsj.com/news/articles/SB10001424052748704681904576319000833038480; Joseph Menn, *Yahoo Says Alibaba Board Not Informed of Sale*, FINANCIAL TIMES (May 13, 2011, 1:23 AM), http://www.ft.com/intl/cms/s/2/159a1c10-7cf2-11e0-a7c7-00144feabdc0.html#axzz2sE3GFPQX.

119. Mark Lee, *Alibaba's Ma Says Yahoo, Softbank Were 'Wrong' About Alipay*, BLOOMBERG (June 14, 2011), http://www.bloomberg.com/news/2011-06-14/alibaba-s-ma-says-yahoo-softbank-were-wrong-about-alipay.html; Joy Shaw et al., *China VIE Structure May Hold Hidden Risks*, FINANCIAL TIMES (Nov. 11, 2011, 12:27 AM), http://www.ft.com/intl/cms/s/2/0a1e4d78-0bf6-11e1-9310-00144feabdc0.html#axzz3Fb4eGVSP.

Third Party Payment Business License,[120] which it received on May 26, 2011.[121] Nevertheless, an apparent conflict of interest between Ma and the principal shareholders of Alibaba Group remained evident. In 2005, Yahoo sold its China operations to Alibaba Group in return for a 40% stake in Alibaba.[122] Since then, Yahoo's web search empire has crumbled while Alibaba Group is fast becoming a global force in wholesale e-commerce.[123] Ma has tried several times, albeit to no avail, to negotiate a deal that would allow Alibaba Group to buy back Yahoo's stake in Alibaba.[124]

The VIE control over Alipay was weak, as demonstrated by the result. Under the VIE structure that was implemented, Yahoo had no means to preemptively restrict Ma, putting Yahoo and Softbank into a dilemma.[125] Ultimately, Alibaba Group, Yahoo, and Softbank reached an agreement regarding Alipay on July 29, 2011.[126] The agreement was consistent with the two agreed-upon principles established at the outset of the negotiations: (1) to structure the inter-company relationship between Alipay and Taobao in such a way so as to preserve the value within Alibaba Group, and (2) to provide that Alibaba Group is appropriately compensated for the value of Alipay, including at least $2 billion and up to $6 billion in proceeds from an IPO of Alipay or other liquidity event.[127]

D. New Oriental Education

After the Alipay incident, almost any change in VIE arrangements led to a strong, sometimes excessive, reaction in the market. Consider New Oriental Education, which is the largest provider of private educational services in China. The company's first school was established in Beijing in

120. According to the Administrative Measures for the Payment Services Provided by Non-financial Institutions and its drafts, foreign-invested payment institutions will be separately regulated. Consequently, Alipay was unlikely to obtain the license at the first opportunity without restructuring. In addition, VIE structures face regulatory risks due to the ambiguous attitude of regulatory authorities. *See* ZDNET, *supra* note 113.

121. *See* Huang Yuntao & Kelvin Soh, *Alipay Gets Licence to Set up e-Payment System*, REUTERS (May 26, 2011, 6:40 AM), http://ca.reuters.com/article/technologyNews/idCATRE74P26120110526.

122. David Barboza, *Yahoo Is Paying $1 Billion For 40% Stake in Alibaba*, N.Y. TIMES (Aug. 11, 2005), http://www.nytimes.com/2005/08/11/technology/11yahoo.html?pagewanted=all.

123. Jeff Sommer, *Yahoo's Asian Lifeline*, N.Y. TIMES (Jan. 19, 2014), http://www.nytimes.com/2014/01/19/technology/yahoos-asian-lifeline.html; Kathrin Hille & Joseph Menn, *Battle looms as Alibaba strains at Yahoo leash*, FINANCIAL TIMES (Sept. 22, 2010, 6:09 PM), http://www.ft.com/intl/cms/s/0/106d6b50-c665-11df-9cda-00144feab49a.html#axzz2sE3GFPQX.

124. Joseph Menn & Kathrin Hille, *Dispute Saps Yahoo's Hold over Alibaba*, FINANCIAL TIMES, (May 13, 2011, 11:45 PM), http://www.ft.com/intl/cms/s/2/0107b9ca-7d4b-11e0-bc41-00144feabdc0.html#axzz2sE3GFPQX.

125. *See* Evelyn M. Rusli, *Yahoo and Alibaba Resolve Dispute Over Alipay*, N.Y. TIMES (July 29, 2011), http://dealbook.nytimes.com/2011/07/29/yahoo-and-alibaba-resolve-alipay-dispute/.

126. *Id.*

127. *Id.*

1993 by Michael Minhong Yu, the Chairman and CEO of the company.[128] To facilitate foreign investment, they established an offshore holding company, New Oriental Education & Technology Group Inc. (New Oriental Education or EDU).[129] On September 7, 2006, EDU was listed on the New York Stock Exchange.[130] As Chinese law and regulations regarding the education business have some special restrictions on foreign invested companies, EDU applied the VIE structure. At the time of listing, the ownership of New Oriental China (OpCo) was shared by eleven EDU employees or shareholders.[131] In the following years, with the exception of one shareholder, an entity controlled by Yu, all of the former, ultimate shareholders of New Oriental China left the company.[132] From December 2011 until January 2012, New Oriental China changed its shareholding structure, requesting that the ten former shareholders transfer all of their equity interests in New Oriental China, without consideration, to Beijing Century Friendship Education Investment Co., Ltd. (Century Friendship), an entity controlled by Yu.[133]

Such restructuring attracted the attention of both the SEC and Muddy Waters, a short seller. Concerned about the restructuring, the former issued a formal order of investigation,[134] while the latter published a research report on EDU, in which it attacked EDU's VIE structure by questioning whether New Oriental China could be regarded as a VIE of EDU and whether New Oriental China could consolidate its member schools into EDU's operation.[135] Three months later, the SEC's investigation results quieted the doubts raised by Muddy Waters. The SEC staff had no objection to the Company's inclusion of its OpCo, New Oriental China, into its consolidated financial statements, and also had no objection to the Company's consolidation of New Oriental China's schools into New Orien-

128. *Overview*, NEW ORIENTAL EDUCATION & TECHNOLOGY GROUP, http://english.neworiental.org/Default.aspx?tabid=3463 (last visited Oct. 9, 2014).

129. *See generally* New Oriental Educ. & Tech. Group Inc., Registration Statement (Form F-1), (Aug. 22, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1372920/000119312506177813/df1.htm.

130. Press Release, New York Stock Exchange, NYSE Welcomes New Oriental Education & Technology Group, Inc. (Sept. 7, 2006), *available at* http://www1.nyse.com/press/1157538336576.html.

131. Press Release, New Oriental Educ. & Tech. Group Inc., New Oriental Further Strengthens Corporate Structure (July 11, 2012), *available at* http://www.prnewswire.com/news-releases/new-oriental-further-strengthens-corporate-structure-162052955.html.

132. *Id.*

133. *See id.*

134. Press Release, New Oriental Educ. & Tech. Group Inc., New Oriental Announces Unaudited Financial Results for the Fiscal Quarter and Fiscal Year Ended May 31, 2012 (July 17, 2012), *available at* http://investor.neworiental.org/phoenix.zhtml?c=197416&p=irol-newsArticle_Print&ID=1715179&highlight=; Dinny McMahon & Kathy Chu, *China Clamps Down on Corporate Sleuthing*, WALL ST. J., July 20, 2012, at C10.

135. *Report on New Oriental Education & Technology Group: Initiating Coverage on EDU-Strong Sell*, MUDDY WATERS RESEARCH, 26-29 (July 18, 2012), *available at* http://www.muddywatersresearch.com/wp-content/uploads/2012/07/MW_EDU_07182012.pdf.

tal China or into New Oriental China's WFOE.[136]

Even after the abovementioned restructuring, however, the company still faces risks. As indicated by Muddy Waters, EDU lacks the contracts that would enable it to substantially influence the daily operations and material decisions of New Oriental China.[137] In fact, by its very own admission, EDU conceded that contractual arrangements may not be as effective as direct ownership, stating that "if New Oriental China, any of its schools and subsidiaries or its shareholder fails to perform its respective obligations under the contractual arrangements," EDU could only rely on relief after the fact.[138] That perhaps was also the reason why the SEC indicated that it would continue to review EDU's disclosure documents after releasing the investigation result.[139]

V. Uncertainty and Invalidity Surrounding the Contracts

The aforementioned parties threatened to challenge or even unilaterally terminate the VIE agreements because the legal validity of these contracts is highly questionable or seriously tenuous under Chinese laws. Article 52 of Contract Law of the PRC reads:

A contract shall be null and void under any of the following circumstances:

> (1) a contract is concluded through the use of fraud or coercion by one party to damage the interests of the State;
> (2) malicious collusion is conducted to damage the interests of the State, a collective or a third party;
> (3) an illegitimate purpose is concealed under the guise of legitimate acts;
> (4) damaging the public interests;
> (5) violating the compulsory provisions of laws and administrative regulations.[140]

Since the VIEs have been employed to circumvent Chinese regulations on foreign ownership or the associated approval process, items (3) and (5) of

136. Press Release, New Oriental Educ. & Tech. Group Inc., New Oriental Announces Unaudited Results for the First Fiscal Quarter Ended August 31, 2012 Group (Oct. 29, 2012), *available at* http://investor.neworiental.org/phoenix.zhtml?c=197416&p=irol-newsArticle_Print&ID=1750883&highlight=.

137. *See Report on New Oriental Education & Technology Group: Initiating Coverage on EDU-Strong Sell*, *supra* note 135, at 27.

138. New Oriental Educ. & Tech. Group Inc., Form 20-F: Annual Report for Fiscal Year 2012, 15 (Aug. 18, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1372920/000119312513382302/d566858d20f.htm.

139. Press Release, New Oriental Educ. & Tech. Group Inc., New Oriental Announces Filing of Annual Report on Form 20-F for Fiscal Year 2012 (Oct. 29, 2012), *available at* http://investor.neworiental.org/phoenix.zhtml?c=197416&p=irol-newsArticle_print&ID=1744978&highlight=.

140. The Contract Law became effective on Oct. 1, 1999. 2 CHINESE LAW SERIES: CONTRACT LAW OF THE PEOPLE'S REPUBLIC OF CHINA, art. 52 (promulgated by Order No. 15 of the President of the People's Republic of China, Mar. 15, 1999) (Wei Luo trans. 1999), *available at* http://www.npc.gov.cn/englishnpc/Law/2007-12/11/content_1383564.htm [hereinafter 2 CHINESE LAW SERIES].

Article 52 are of most concern.[141] There is no clear legislative or judicial guide defining what constitutes "an illegitimate purpose" as stated in item (3), which, therefore, subjects the term to varying interpretations. On the other hand, "laws" in item (5) refers to those promulgated by the National People's Congress or its Standing Committee, and "administrative regulations" refers to those regulations issued by the State Council.[142] The Supreme People's Court ruled that all courts shall only rely on laws and administrative regulations to declare a contract invalid, while the rules formulated by ministries and commissions underneath do not apply.[143] Moreover, even for laws and administrative regulations, their "compulsory provisions" should be divided into those that are administrative in nature as opposed to those that are of validity in nature; only the violation of the latter would trigger the invalidation of a contract.[144]

Some recent arbitration and judiciary decisions have significantly deepened the worries concerning VIE contracts and their performance.

A. Arbitration Cases of Shanghai CIETAC

In 2010 and 2011, two related arbitrations arising from a VIE dispute were reviewed by the Shanghai Sub-commission of the China International Economic and Trade Arbitration Commission (Shanghai CIETAC); the arbitrations, though conducted by different arbitrators, both rendered awards invalidating the VIE agreement and the entire arrangement on similar grounds.[145] These cases are the first in which Shanghai CIETAC has rendered a direct award based on the invalidity of VIEs.

Given the confidential nature of arbitration, limited information about the facts and findings of these disputes exists and was only recently disclosed by the lawyers who represented these cases. A description of the background of the case is quoted below:

> T Company is a wholly Chinese-owned company engaged in the online game operation business and has the internet content provider license and other permits that cannot be secured by foreign-invested enterprises. The foreign investor established a WFOE in China through a British Virgin Islands company. The WFOE executed a series of profit conveyance agree-

141. *See* Donald Clarke, *Who Owns the Chinese Internet?*, Chinese L. Prof Blog (July 7, 2011), http://lawprofessors.typepad.com/china_law_prof_blog/2011/07/who-owns-the-chinese-internet.html.

142. Interpretations of the Supreme People's Court of Certain Issues Concerning the Application of the Contract Law of the People's Republic of China (Part One), art. 4 (promulgated by the Adjudication Committee of the Supreme People's Court, Dec. 29, 1999, effective Dec. 29, 1999), *available at* http://www.asianlii.org/cn/legis/cen/laws/itspcocictaotclotproco1363/.

143. *See id.*

144. However, if violation of rules formulated by ministries or commissions results in damaging public interests, or it is unclear whether certain compulsory provisions of laws and administrative regulations is of validity in nature, but the violation of it results in damaging public interests, the courts may refer to item (4) of Article 52 to hold the contract invalid.

145. Kenneth Kong & Shelly Sui, *Shanghai CIETAC's Finding on VIE Case Raises Plenty of Questions*, China Bus. L. J., 90–91 (2013).

ments with T Company and a series of control agreements with the founding shareholder of T Company. In the course of their cooperation, a conflict arose between the founder and investor over control of T Company. The founder wished to regain control of T Company by denying the validity of the VIE agreement, whereas the investor wished to have the VIE agreement performed so as to achieve actual control of T Company.[146]

Therefore, the focus of the case was whether the VIE agreement and arrangements were valid. Shanghai CIETAC tribunal eventually found:

that the core objective and result of the arrangement (which consisted of securing control over the decision-making and returns of T Company through the WFOE by executing the profit conveyance agreements and control agreements with T Company and the founder) was 'to enable the WFOE, which did not have online game operation qualifications, to participate in the operation of online games in the PRC and to obtain the attendant returns.[147]

In the end, the tribunal made the following award:

Accordingly, the tribunal, based on PRC Contract Law, rendered an award invalidating the VIE agreement on the grounds that the lawful form of the VIE agreement (including both the control agreement and profit conveyance agreement parts) covered up illegal objectives and, by extension, violated mandatory provisions of administrative regulations of the state.[148]

There are a few caveats that need to be addressed. First, with respect to online game business, the abovementioned 2009 GAPP Notice is clearly pertinent. Yet, perhaps worrying is that the prohibition from the 2009 GAPP Notice was not from any law and administrative regulation and the Shanghai CIETAC tribunal did not cite the 2009 GAPP Notice directly; instead it used other, more general regulations, particularly item (3) of Article 52 of PRC Contract Law.[149] Second, not all of the agreements under the VIE structure were petitioned to be scrutinized in the arbitrations, begging the following question: Should all of the agreements be taken together as a whole for the purpose of review in order to render an award, or could they be arbitrated in a piecemeal fashion? Are these attendant agreements not also meaningful to the scope and enforcement of the arbitration? Third, like in other countries, arbitration awards in China are regarded as the decision of an individual case and, legally speaking, would not constitute a viable reference in future proceedings.[150]

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146. *Id.*

147. *Id.*

148. *Id.*

149. *Memorandum from Han Kun Law Offices on Legal Analysis on Recent Rulings Related to VIE Structure*, HAN KUN LAW OFFICES, art. 3.2 (July 8, 2013), *available at* www.hankunlaw.com/backuser/picinfo/20137811354.pdf [hereinafter HAN KUN LAW OFFICES].

150. *See* Catherine A. Rogers, *Context and Institutional Structure in Attorney Regulation: Constructing an Enforcement Regime for International Arbitration*, 39 STAN. J. INT'L L. 1, 37 n.198 (2003); Mark S. Hamilton, *Sailing in a Sea of Obscurity: The Growing Importance of China's Maritime Arbitration Commission*, 3 ASIAN-PAC. L. & POL'Y J. 477, 516 (2002).

B. Chinachem Case by Supreme People's Court

In 1995, Chinachem Financial Services (Chinachem) and China Small and Medium Enterprises Investment Co. Ltd. (SME) entered into a series of agreements, which included certain entrustment agreements and loan agreements.[151] Pursuant to the entrustment agreements, Chinachem, through SME, subscribed to the capital of Minsheng Bank, and SME agreed to hold this equity interest in Minsheng Bank on behalf of Chinachem, managing and exercising all rights and interests associated with the shares according to the instructions of Chinachem.[152] Meanwhile, Chinachem and SME also entered into loan agreements in which Chinachem agreed to lend SME loans for subscribing capital in Minsheng Bank, with the interest of the loan being equal to the dividends obtained from Minsheng Bank.[153] The amount of loans was equivalent to the amount which was entrusted to SME for subscribing capital of Minsheng Bank. Not surprisingly, those agreements were designed to circumvent PRC laws and regulations on foreign investment in the financial industry.[154]

Nonetheless, the cooperation soon went awry. In 2001, SME brought a lawsuit against Chinachem regarding the ownership of the shares in Minsheng Bank and the related dividends. After lengthy lawsuits, the Supreme People's Court issued the final judgment in December 2012, which held that the agreements between Chinachem and SME were invalid on the grounds that these agreements established a trust relationship that circumvented PRC laws and regulations: namely, the third item of Article 52 of PRC Contract Law in which "an illegitimate purpose is concealed under the guise of legitimate acts."[155]

There are some commonalities between the Chinachem case and the VIE structure, such as the involvement of overseas entities that seek to dodge Chinese foreign investment regulations as well as the set of agreements which render the same effect in terms of control over the equity interest by an entity other than the registered shareholders. However, four significant differences exist between the two schemes.

First, the biggest problem in the Chinachem case is the circumventive entrustment agreements through which SME was supposed to hold equity interest on behalf of Chinachem. In contrast, no part of VIE agreements would provide that the equity interest in the OpCo is held by the registered shareholders on behalf of the WFOE.[156] Second, Chinachem signed the entrustment and loan agreements itself as an offshore company, while the WFOE, a PRC incorporated and duly authorized enterprise, is the counterpart to all VIE agreements. Third, both sets of agreements in the Chinachem case were entered into without the involvement of Minsheng Bank and its other shareholders. In a typical VIE structure, the OpCo and

151. *See* Han Kun Law Offices, *supra* note 149, at 2.
152. *See id.*
153. *See id.*
154. *See id.*
155. *See id.*; *see also* 2 Chinese Law Series, *supra* note 140, art. 52.
156. *See* Han Kun Law Offices, *supra* note 149, at 6-7.

all of its registered shareholders are the counterparties signing the agreements; this reduces the likelihood that the agreements would be held invalid on the grounds that the WFOE and particular shareholders of the OpCo were colluding to damage the interests of the OpCo or its other shareholders.[157] Fourth, Chinachem expected to receive the interests of the arguably problematic "loans."[158] The WFOE under a VIE is usually paid for services within the approved business scope provided to the OpCo.

Aside from these meaningful factual and legal differences, the Chinachem case decision by the Supreme People's Court is not a binding precedent and, strictly speaking, has no reference value to subsequent cases of a similar nature. That being said, it remains a very legitimate concern whether the attitude taken by the Chinese highest court in the Chinachem case could possibly also reflect its broader and more general view on the VIE structure. When considering this case in conjunction with the two arbitration cases of Shanghai CIETAC, it is fair to say that a realistic sense of doubt exists with respect to the validity of the contracts underlying the VIE structure.

VI. The Reactions from Hong Kong and the U.S.

Cast in the shadows of doubt, the VIE in Mainland China has certainly caused great concern in overseas stock markets that host the ListCo of the arrangement. In particular, regulators and stock exchanges have responded with a variety of actions, so as to offset the negative impact of such developments, and protect the interests of investors to the greatest extent possible.

A. The HKEx

Hong Kong Exchanges and Clearing Limited (HKEx) issued its first listing decision opinion, viz. HKEx-LD43-3, in 2005 to address the issue.[159] It essentially adopted a disclosure-based approach to make decisions about companies using the VIE structure. Usually the appropriate disclosure of risks, the insurance of proper operation, and the legality of the contractual arrangements would enable a listing approval by HKEx.[160]

After the Alipay incident, the HKEx revised the rule in November 2011.[161] In this amendment, it stated that the listing decision involving VIEs would be made on a case-by-case basis, and the Listing Division would normally refer the applicant to the Listing Committee if non-

157. *See id.*
158. *See id.* at 7.
159. *See HKEx-LD43-3 (First Quarter of 2005)*, Hong Kong Exchanges and Clearing Ltd., (2005), *available at* http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/LD43-3.doc.
160. *See id.*¶ ¶11, 13(c).
161. *See HKEx-LD43-3 (First Quarter of 2005, updated in November 2011, August 2012, November 2012, December 2012, November 2013 and April 2014)*, Hong Kong Exchanges and Clearing Ltd. (2014), *available at* http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/LD43-3.pdf.

restricted businesses were concerned.[162] The latter indicated that the company would face a stricter review. In addition, the HKEx also required the company to provide reasons for the use of VIE-structured contracts in its business operation and to unwind these structured contracts as soon as the law would allow the business to operate without them. To solve the problems raised by the weak control of the VIE, as revealed in the Alipay dispute, the HKEx required VIE agreements to: (1) grant the company's directors the power to exercise all rights of the OpCo's shareholders; (2) contain the provision of arbitration and corresponding judicial support; and (3) ensure that structured contracts encompass provisions for dealing with the OpCo's assets.[163]

Amendments released in 2012 by the HKEx further elaborated upon its disclosure requirements concerning VIEs. Now, a company must disclose (1) risks associated with conflicts of interests with VIE shareholders, less effective control compared with direct ownership, (2) economic risks to which the company is exposed as the beneficial of the VIE, and (3) possible raise of tax and regulatory risks. Moreover, the following corresponding arrangements also required disclosure: (1) arrangements to protect the company in the event of death, bankruptcy or divorce of the VIE's registered shareholders; (2) arrangements to solve the conflicts of interests with VIE's registered shareholders; (3) legal bases through which directors believe the company effectively controls the VIE.[164]

In November 2013, the HKEx updated the rule again. The 2013 amendment limited the use of VIE structures mainly in two ways: (1) by defining the position that the Exchange will accept the use of VIEs in addressing the foreign ownership restriction only when restricted businesses are involved; (2) by making further requirements to lower the risks of VIEs, including (a) Statements from OpCo's shareholders to return any consideration they received to the company when the company acquires the OpCo to unwind the VIE structure; b) positive confirmation from PRC legal advisers on the legality of the VIE structure, which must be supported by appropriate regulatory assurance, where possible; (c) separate disclosure of the incomes from VIEs.[165]

The 2013 amendment was a reaction to the abovementioned arbitration cases of Shanghai CIETAC. While the amendment substantially increased the difficulty for companies with the VIE structure to go public in Hong Kong given the need to acquire appropriate regulatory assurance, it is still possible. For instance, Forgame Holdings Limited listed on the HKEx with a VIE structure in September 2013. In its prospectus, Forgame claimed that they obtained oral confirmation from the regulatory authority

162. *Id.* ¶¶ 16-17; *see also Legal Commentary: HKEx Updated Listing Decision on Contractual Arrangements*, Han Kun Law Offices, 1 (Dec. 19, 2011), *available at* http://www.hankunlaw.com/backuser/picinfo/20111222114152.pdf.

163. *See* Hong Kong Exchanges and Clearing Ltd., *supra* note 159, ¶ 18.

164. *See HKEx-LD43-3 (First Quarter of 2005, updated in November 2011, August 2012, November 2012 and December 2012)*, *supra* note 161, ¶ 19.

165. *See id.* ¶¶ 18-19.

that it had no objection to the contractual arrangements and that the contractual arrangements did not violate any PRC laws or regulations concerning online game operations.[166] To sum up, the VIE structure would not render companies unsuitable for listing on the HKEx, but the Exchange's attitude has become increasingly cautious since 2011, and with frequent amendments, additional disclosure and other requirements for assurance have been attached to VIEs.

B. The SEC

The SEC also is aware of the risks involving Chinese VIEs. Similar to Hong Kong authorities, the SEC does not view the VIE structure negatively, but does keep a close eye on information disclosure obligations relevant to VIEs.

In the 2012 American Institute of Certified Public Accountants (AICPA) National Conference on Current SEC and PCAOB Developments, the SEC and its staff indicated that it continues to focus on the consolidation of overseas VIE arrangements.[167] The SEC pointed out that a company should provide information in its Management Discussion and Analysis (MD&A) that would allow investors to assess the effects on the registrant's deconsolidation of the VIE and describe the economics flowing to the registrant as a result of its involvement in the VIE. Expected disclosures include critical judgments made in relation to the company's involvement in the VIEs (such as the validity and enforceability of contracts with the parties involved and whether there are any restrictions on the company's contractual rights) as well as details related to VIEs, such as the VIE's nature, purpose, size, and activities.[168] These expectations overlapped significantly with the disclosure requirements in ASC 810-10-50-2AA, which required the company to provide in their audited financial statements information about their VIE.

After the Shanghai CIETAC arbitration cases and ChinaChem case, which revealed the unfriendliness of Chinese adjudicators towards the VIE structure, the SEC strengthened the information disclosure requirements. An example of this practice occurred with Baidu Inc., a large Chinese internet service provider.[169] Though acclaimed as the best practice of VIE,[170] Baidu was pressed to not only discuss the impact of these recent cases on its business and its formal or informal talks with the Chinese

166. *See* Forgame Holdings Ltd., *Web Proof Information Pack*, FORGAME HOLDINGS LTD., 138 (Sept. 2013), *available at* http://www.hkexnews.hk/listedco/listconews/SEHK/2013/1003/LTN20131003746.pdf.

167. *O SEC! O SEC! Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments*, DELOITTE & TOUCHE LLP, 12 (Dec. 11, 2012), *available at* http://www.deloitte.com/view/en_US/us/Services/audit-enterprise-risk-services/Financial-Statement-Internal-Control-Audit/Accounting-Standards-Communications/1747a3b6cbb8b310VgnVCM3000003456f70aRCRD.htm.

168. *Id.*

169. *The Baidu Story*, BAIDU INC., http://ir.baidu.com/phoenix.zhtml?c=188488&p=irol-homeprofile, (last visited Nov. 30, 2014).

170. *See* MUDDY WATERS RESEARCH, *supra* note 135.

government about the structure, but also to specify who owns its various VIEs.[171] After negotiations, Baidu agreed to change its disclosure and add that it could lose control over the assets in its VIEs, including the right to use the well-known name baidu.com. According to Baidu, the result would be a material adverse impact on its earnings and reputation.[172]

At the same time, the SEC never loosened investigations into VIE companies that may be responsible for wrongdoings. Soon after New Oriental Education changed the shareholding structure of its VIE, the SEC issued a formal order of investigation concerning whether a sufficient basis existed for the consolidation of the VIE into the Company's consolidated financial statements.[173] Yet, while the investigation result indicated no objection to the consolidation, it did state that it would continue to review New Oriental Education's disclosure documents.[174] The company was also asked to address the risks in its VIE agreements.[175]

On September 26, 2013, the former executives of another Chinese VIE company, ChinaCast—which went public on NASDAQ through a reverse merger with a publicly traded company—were charged by the SEC for fraud and insider trading.[176] The former executives failed to retain their positions and were replaced by representatives of foreign investors; however, the successors didn't win the war: the company seals, business licenses and financial chops of the operation entities were all taken away by the former executives, which rendered the daily operations impossible.[177] Moreover, substantially all of the company's books and records were removed or destroyed.[178]

After ChinaCast retrieved the chops, the company found itself empty. The former executives secretly embezzled most of the company's assets by

171. Letter from Kathleen Collins, Accounting Branch Chief, SEC, to Jennifer Li, Chief Fin. Officer, Baidu, Inc. (June 18, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1329099/000000000013033273/filename1.pdf.

172. *See* Letter from Jennifer Xinzhe Li, Chief Fin. Officer, Baidu, Inc., to Kathleen Collins, Accounting Branch Chief, SEC (Aug. 29, 2013), *available at* http://ir.baidu.com/phoenix.zhtml?c=188488&p=irol-SECText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbmcueG1sP2lwYWdlPTkxNzcyNzUmRFNFUT0wJlNFUT0wJlNRREVTQz1TRUNUSU9OX0VOVElSRSZzdWJzaWQ9NTc=.

173. *See* New Oriental Further Strengthens Corporate Structure, *supra* note 131.

174. *See* New Oriental Announces Unaudited Results for the First Fiscal Quarter Ended August 31, 2012, *supra* note 136.

175. *See* Letter from Larry Spirgel, Assistant Dir., SEC, to Louis T. Hsieh, President and Chief Fin. Officer, New Oriental Educ. & Tech. Grp. Inc. (Nov. 20, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1372920/000000000012063314/filename1.pdf

176. *Litigation Release No. 22819*, United States Sec. and Exch. Comm'n2 (Sept. 26, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22819.htm.

177. ChinaCast Educ.n Corp., *Current Report (Form 8-K)*, 1-3 (Apr. 19, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1261888/000114420412022714/v309794_8k.htm [hereinafter ChinaCast Educ. Corp., (Apr. 19, 2012)].

178. ChinaCast Educ. Corp., *Current Report (Form 8-K)*, 6 (Dec. 21, 2012), *available at* http://www.getfilings.com/sec-filings/121221/CHINACAST-EDUCATION-CORP_8-K/ [hereinafter Chinacast Educ. Corp., (Dec. 21, 2012)].

withdrawing cash from bank accounts[179] and transferring holding interests of operating entities to unrelated third parties.[180] Additionally, the CEO of ChinaCast, Mr. Chan,[181] secretly pledged ChinaCast's existing term cash deposits as collateral to secure debts incurred by various third parties which were unrelated with ChinaCast's business.[182] Both the SEC and NASDAQ took action. NASDAQ suspended trading in ChinaCast on April 2, 2012 and then delisted the stock on June 25, 2012.[183] The SEC, on the other hand, conducted a year-long investigation into the matter, ultimately charging the previous management.[184]

The SEC's attitude towards the VIE paralleled its aggressive posture toward Chinese-based companies in the area of extraterritorial enforcement. On December 3, 2012, the SEC charged affiliates of the "Big Four" accounting firms[185] based in China for refusing to provide audit work papers and other related documents in compliance with SEC investigations into potential wrongdoing of nine China-based companies whose securities were publicly traded in the United States.[186] Regardless, the respondents argued that they "were ready, willing and able to produce documents [to the SEC], but were unable to do so" because Chinese national security laws prevented them from sharing such information.[187] On January 22, 2014, however, an administrative law judge ruled that the Chinese units of the global "Big Four" accounting firms were suspended from auditing U.S.-listed companies for six months.[188] This sentence incited significant concern among Chinese-based companies.

179. Chan and other former executives withdrew over Rmb760 million (approximately US$120 million) in cash from the bank accounts of two subsidiaries of the company without the prior knowledge of the Board. See ChinaCast Educ. Corp., Current Report (Form 8-K), 6 (May 14, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1261888/000114420412028609/v313134_8k.htm.

180. *See* ChinaCast Educ. Corp., (Apr. 19, 2012), *supra* note 177, at 1.

181. The company only effectively held a 49.2% indirect equity interest in an important holding subsidiary, which controlled two of three substantial operations, while Previously Issued Financial Statements claimed that the company had approximately 100% shares. According to records from Hong Kong Companies Registry, the margin was held by Chan. See ChinaCast Educ. Corp., (Dec. 21, 2012), *supra* note 178, at 1.

182. *Id,* at 2.

183. Complaint at 2–3, SEC v. Chan Tze Ngon & Jiang Xiangyuan, 2013 WL 5376056 (S.D.N.Y. Sept. 26, 2013) (No. 13-CIV-6828).

184. *Id.*

185. PricewaterhouseCoopers, Deloitte Touche Tohmatsu Ltd., Ernst & Young, and KPMG.

186. Press Release, Sec. and Exch. Comm'n, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents (Dec. 3, 2012) (on file with SEC), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486452#.UvsuhnmTSTW.

187. BDO China Dahua CPO Co., SEC Admin. Proc. File Nos. 3-14872, 3-15116, Initial Decision Release No. 553, 103 (Jan. 22, 2014).

188. *See id.* at 2.

VII. Realigning Interests to Disperse the Undesirable Smog

A. The Evolving Tripartite Game

If one were to reflect upon the ups and downs of the past fifteen years, it would become apparent that treatment of the VIE structure is a product of the times. In particular, three groups of players have been gaming with each other: Chinese entrepreneurs, foreign investors, and the Chinese government. In the first stage, ambitious Chinese business founders allied harmoniously with foreign Venture Capital or Private Equity (VC/PE) in inventing this "workaround" to cope with the Chinese government and achieve an indirect non-equity based investment in restricted or prohibited industries.[189] On the other hand, the VIE served as "a technical method that provides regulatory authorities an "excuse" to naturally accept internet enterprises' offshore financing and listing—on which regulatory authorities do not have any material disagreement no matter if the VIE exists or not—without amending laws or regulations."[190] Further, "since the VIE was an arguable issue, this unfinished controversy seemingly gave regulatory authorities more potential leverage in regulating these companies."[191]

After a new wave of VIE-styled overseas listings aimed to circumvent the 2006 M&A Rules' approval process, most notably Qinfa and its followers, it became difficult for Chinese regulatory authorities to tolerate VIEs, deeming the structure a manipulative tool that helped companies transfer their assets and profits offshore, even deliberately mocking PRC regulations. At the same time, the growth of China's capital market has been remarkable. Among other things, the Chinese-owned VC/PE industry developed rapidly, and private sectors now have better access to raise capital, including the domestic public offering and early-stage venture capital.[192] Likewise, the Shenzhen Stock Exchange set up ChiNext in 2009, where qualified small and growing enterprises' shares could be publicly traded.[193] Further, the listing rules on ChiNext are more flexible than traditional IPO rules.[194] More importantly, the Chinese government began to encourage and support leading companies in emerging industries to list on the Mainland stock markets.

Therefore, in the second stage, both regulatory authorities and courts have been sending out unfavorable messages regarding VIEs; yet, taking into account the number and size of companies currently listed overseas, it would be impractical for the government to suddenly declare a wholesale ban on the VIE structure. The extent of the dilemma and ambiguity that surrounds usage of the VIE, however, was enough to influence other players' behavior, imperiling the interests of foreign investors: business partners might have different ideas and interests, and ownership as a shareholder is different from "ownership" by contract.

189. *See* Schindelheim, *supra* note 18, at 208-09.
190. Rizzi, *supra* note 33.
191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.*

The contractual nature of VIE agreements presents a host of problems. Because VIE agreements are contractual in nature, it is always possible for Chinese founders to redeem the loans, thus obviating the equity pledge agreement. Although they would regain all rights attributable to a shareholder, the economic right to the OpCo's profits will still lie with the ListCo. A more drastic situation is where the founders and OpCo breach the contracts and pay damages, especially if it is more profitable or efficient to breach than to perform the contract.[195] Ultimately, there the success of the VIE structure is predicated on the parties' continued commitment to uphold the contract.

Even worse, the unbridled founders could simply pull the rug from under the ListCo and foreign investors by challenging the validity of the agreements with the WFOE. The Chinese government's distaste for the VIE would further encourage the founders' opportunistic behavior. This course of action does not even take into account the time-consuming and costly process for judicial intervention. Smog is a portmanteau of the words smoke and fog to refer to smoky fog. Consider the following analogy, in which the dubious attitude of regulators and judges is compared to a hazy fog and the brazen recantation of founders is akin to acrid smoke. Under such inimical atmospheric conditions, which can be said to characterize Stage 2 of the historical treatment of VIEs, foreign investors choke on each breath to the point of tears.

But the Chinese government may very well feel uncomfortable with intervention. Some commentators surmise that the continued uncertainty surrounding the VIE structure is likely "a deliberate policy of the Chinese government to selectively facilitate foreign investment in particular industries while limiting foreign equity ownership."[196] In my opinion, such benefits, even if they exist, come at too high a cost. If the regulatory inconsistency and vagueness were to continue together with their impacts on judiciary outcomes, they would severely impair the confidence of foreign investors and undermine the reputation and welfare of China in the long run. It is now time to start a new stage, Stage 3, refocused on the protection of investors, both foreign and domestic, as well as on market integrity.

B. Opening the Right Way

Taking the failures of the Giga Media and Anbow cases into consideration, a better structured set of contractual arrangements would serve the goals of Hong Kong and American regulators. The foremost priority is to ensure that the Chinese legal owner of the OpCo would maintain a sufficient stake in the success of the ListCo, which usually means giving the

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195. *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284 (7th Cir. 1985); Charles Goetz & Robert Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: A Theory of Efficient Breach,* 77 COLUM. L. REV. 554 (1977); *See, e.g.*, Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency,* 24 RUTGERS L. REV. 273, 284 (1970).

196. Schindelheim, *supra* note 18, at 197.

legal owner a significant amount of shares and a directorship and/or executive position in the offshore holding company.[197] Binding the participating parties by establishing mutual interest and fiduciary duty would reduce the incentives for Chinese founders to walk away or even steal and sabotage the arrangement.

If the disagreement seems unavoidable, then it would also be helpful to ensure that there are WFOE-friendly provisions for resolving disputes (i.e., choice of forum and choice of law provisions that are favorable to the WFOE). Nevertheless, even though the ListCo or foreign investors could obtain desirable results overseas, as long as enforcement of that decision has to occur in China, doubt will continue to exist over the validity of the VIE structure, given that "an illegitimate purpose is concealed under the guise of legitimate acts." Similarly, although foreign regulators may keep advising on how to improve the contract contents or even bluff to stop the accounting consolidation treatment for Chinese VIEs, the Chinese government should take the initiative to reexamine and overhaul its relevant policies.

First, the NDRC and MOFCOM should further reduce the restricted and prohibited foreign investment categories in the Catalogue, drawing on experiments from the Shanghai Free Trade Zone (Shanghai FTZ).[198] The Shanghai FTZ, which debuted in 2013, has opened many restricted industries to foreign investment; for example, value-added telecommunications services.[199] More importantly, the Shanghai FTZ has taken the innovative "negative list" approach, through which foreign investors are allowed to conduct any business (except certain reserved sectors) that is not set out in the "negative list." Both the Catalogue and negative list should not only undergo more frequent periodical review, but should also be substantially downsized. In May 2014, the NDRC promulgated new administrative measures on approval and filings of foreign investment projects and simplified the governmental review and approval process, which is a movement in the right direction.[200]

Second, the State Council and the legislature ought to revisit the rationale and criteria for foreign investment restrictions. Such restrictions were originally borne out of consideration for economic security or to foster certain national industries, with the goal of proactively preventing foreign capital control. But now, VIEs and equity-styled "round trip investment"

197. See Robert Lewis, *Foreign Investors in China Using the VIE Structure*, THE LAWYER (Nov. 11, 2011), http://www.thelawyer.com/foreign-investors-in-china-using-the-variable-interest-entity-structure/1010207.article.

198. For general information on the Shanghai FTZ, see http://en.shftz.gov.cn/About-FTZ/Introduction/.

199. MIIT and Shanghai Municipal People's Government, *Guanyu Zhongguo (Shanghai) Ziyou Maoyi Shiyan Qu Jinyibu Duiwai Kaifang Zengzhi Dianxin Yewu de Yijian* (关于中国（上海）自由贸易试验区进一步对外开放增值电信业务的意见) (Jan. 6, 2014), *available at* http://www.miit.gov.cn/n11293472/n11293832/n12843926/n13917072/15821232.html.

200. *See People's Republic of China Order No.* 12, NAT'L DEV. AND REFORM COMM'N (May 17, 2014), http://www.sdpc.gov.cn/zcfb/zcfbl/201405/t20140520_612252.html.

are more like a gimmick in pursuit of favorable tax treatments or freer asset transfer, carried out by special purpose vehicles (SPV) which are established in tax havens usually owned and controlled by Chinese citizens or recently naturalized foreigners, collectively referred to as "fake foreign investors." Meanwhile, once the SPV is listed, the indirect foreign investors are just financial investors (such as VC/PE) or public investors and, in most cases, none of them have the will or capacity to control the business operations in China. Admittedly, while there is a need to intervene from the perspectives of tax, foreign exchange, or capital flow regulation, the current restrictions seem overly superficial, counterproductive, and starkly restrict the nationality of "ownership" while entirely disregarding the nationality of "control."

Third, MOFCOM and CSRC should make available a clear and workable procedure for the review and approval that was mandated by the 2006 M&A Rules as soon as possible. In May 2007, August 2008, and May 2011, SAFE largely fulfilled its own part by issuing Circular No. 106, Circular No. 142, and Circular No. 19 respectively, which all dealt with foreign exchange administration.[201] In July 2014, SAFE released Circular No. 37 which further clarified and eased the foreign exchange regulatory procedures regarding SPVs and round trip investments.[202] But, as mentioned above, the lack of clear guidelines for implementation in the areas of foreign investment and securities regulation virtually installed a "class wall" against equity-styled round trip investments and contributed substantially to the second surge of VIEs. Using the analogy of the front door vis-a-vis the side door, once the direct equity investment becomes feasible and the approval becomes process reasonable, the attractiveness of VIEs would fade away.

Fourth, the current VIEs should be grandfathered on principle, and MOFCOM should take the lead in streamlining the regulation of new VIEs. Any retrospective ban would possibly create unpredictable market disruption as well as lawsuits; therefore, I am prone to the recommendation in the CSRC Report concerning "policies which distinguish the old from the new," which implies that China-based companies with existing overseas listings using VIE structures would, for the time being, be

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201. Hui Cao and Susan Monroe, *New SAFE Circular 19: Encouraging Round-Trip Investments and Consolidating Regulation of In-bound and Out-bound Investments*, Steptoe & Johnson LLP (June 2011), http://www.steptoe.com/publications-newsletter-227.html.

202. *See* *国家外汇管理局关于境内居民通过特殊目的公司境外投融资及返程投资外汇管理有关问题的通知*, State Admin. for Foreign Exch. (July 14, 2014), http://www.safe.gov.cn/wps/portal/!ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PwwB3Q6B8pFm8s7ujh4m5jwFQ3t3AwNPEyd_PwznQ0MDTmIDucJB9OFVYhhmjy3uHWQDlTYOdvUK9jYy8zSHy-OwHyRvgAI4G-n4e-bmp-gW5EQaZnrqOABlPSIw!/dl3/d3/L2dJQSEvUUt3QS9ZQnZ3LzZfSENEQ01LRzEwODRJQzBJSUpRRUpKSDEySTI!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/zcfg/zbxmwhgl/zjtzwhgl/node_zcfg_zbxm_kjtz_store/ce30120044b919a3a5ecf71fa25ece03.

grandfathered.[203] Also, MOFCOM has adopted a new position against the VIE structure, one which is contextualized in national security and anti-trust reviews, which has led to a new wave of speculation. In the future, a transparent and uniform review process targeting the VIE structure and focusing on the abovementioned control test should be worked out and initiated by MOFCOM, and supported by other agencies such as MIIT, CSRC, SAIC and SAT.

As a whole, China is moving from a regulatory state toward a more rule-based and market oriented country. The market should play a decisive role in the allocation of resources, while the non-public sector should be encouraged to expand, which will in turn stimulate vitality and creativity in the whole economy.[204] Against such a backdrop, the Chinese government must speed up transforming itself into a service-oriented government. Forcing the existing ListCos to dismantle the VIE structure is not in line with this trend, nor is it effective to shut one's eyes to such an open secret or awkwardly attempt to address it through beating about the bush. A clear stance and a systemic solution from MOFCOM and others under the coordination of the State Council will drive off the undesirable haze and relieve the court and investors of their concerns. Moreover, collaboration with foreign regulators should be enhanced to discipline the related parties and deter the opportunistic misconduct in violation of fiduciary duty.

Conclusion

The past fifteen years have witnessed a lot of successful VIEs which encouraged Chinese businesses to develop and list overseas, sidestepping foreign investment restrictions and obscuring regulatory hurdles. Increasingly, however, this practice has been losing its magical powers. Within China, from various industry regulators to local governments, an air of skepticism has gathered around the VIE arrangement. In the wake of different incidents, such as national security and antitrust reviews, MOFCOM kept sending out disquieting signals of warning; the internal CSRC Report made unfavorable recommendations too. Meanwhile, the underlying vulnerability of the VIE contractual arrangement manifested through cases such as Giga Media, ChinaCast, and Anbow Education, and allegations of breach of contract and disputes over control seriously distressed Alibaba and New Oriental Education. Recently, Shanghai CIETAC arbitrations and the Chinachem case further exposed the Achilles' heel of the VIE, namely, controversy concerning its validity and enforcement.

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203. *China VIE Structure for Foreign Investment under Attack from Multiple Directions: Will It Emerge (Relatively) Unscathed or Is Its Very Survival Threatened?*, Hogan Lovells (Jan. 2012), *available at* http://www.hoganlovells.com/files/Publication/7acf9f60-c4d8-4363-aa1c-9b76af0cdd0d/Presentation/PublicationAttachment/92f53946-f08c-4125-9dc7-a43946eb8b2b/Hogan_Lovells_Client_Note_-_China_VIE_Structure_for_Foreign_Investment_Under_Attac.pdf.

204. *CPC Acknowledges Market's "Decisive" Role,* Xinhuanet (Nov. 12, 2013), http://news.xinhuanet.com/english/china/2013-11/12/c_132882359.htm.

The three sets of trouble that VIEs are facing also have impacts on each other. With more government regulatory interference, the chance that adjudicators will invalidate the contracts of a VIE structure increases. Bearing this outcome in mind, the founder and registered owner of an OpCo tends to be more unscrupulous, even using it as leverage to push the outside investors of the ListCo into the corner. When fights over control get more messy and rampant, the Chinese government is more likely to take an even tougher line against such practice. The combination of these three factors creates a self-enforced, vicious spiral, and would possibly drive the VIE towards a perilous and catastrophic end.

Outside of China, the exacerbating hassle and the volatility of stock prices hurt, upset and scared away foreign investors from China-based, VIE structured, listed companies. In September 2014, Alibaba Group (NYSE: BABA, excluding Alipay) completed its IPO in the U.S.[205] and set the new world record for fundraising;[206] but, commentators continued to worry about its corporate governance vulnerabilities, including the VIE issue.[207] Meanwhile though not disdaining the VIE structure per se, both the SEC and HKEx became more vigilant, mandating further disclosure and limitations. As the distrust accrued, a premium would be replaced by a discount in terms of evaluation. Securities intermediaries and lawyers found it more difficult and risky to appease and ensure their clients. The cost for Chinese businesses to raise capital globally would inevitably increase. When former allies turn their backs against each other, "variable interest entities" might disappointingly degrade into "varied interest entities".

It is not in the best interest of China to allow this murky status quo. Although deliberative and selective regulation might offer some temporary benefits, in the long term it irreparably impairs the Chinese reputation and the integrity of the rule of law. To deter the egregiousness of opportunistic behaviors, the Chinese government should cooperate more closely with foreign regulators and provide stronger protection for foreign investors.[208] The existing VIEs could be grandfathered if there is no other violation. More importantly, a collective and coordinated regulatory framework should be set up for the VIE practice, a framework that is less restrictive, more transparent, and more user friendly. The State Council may require MOFCOM to take the lead and start to study the feasibility of reform as soon as possible, to refine and transform the Catalogue into one that is styled as a negative list, to recalibrate the foreign investment criteria based on a more precise "control" test, and to streamline and clearly define the review and approval process.

205. 阿里巴巴250亿美元IPO创全球纪录, FT CHINESE.COM (Sept. 22, 2014), http://www.ftchinese.com/story/001058311.

206. 马云能否兑现路演承诺？, FT Chinese.com (Sept. 22, 2014), ttp://www.ftchinese.com/story/001058308.

207. 阿里巴巴250亿美元IPO创全球纪录, *supra* note 205.

208. The CSRC has signed 58 Memorandum of Understandings (MOUs) with securities and/or futures regulators from 54 countries or regions worldwide. *See* CSRC Signed MOU with Jersey Financial Services Commission (April 18, 2014), http://www.csrc.gov.cn/pub/csrc_en/affairs/Cooperation/201406/t20140612_255983.html.

In both the U.S. and China, the VIE is a joint product of market and regulation, and should be treated as a normal option which a business can choose, rather than a mere trick of seeking the unjustifiable benefits of regulation arbitrage. In choosing equity or contract, entrepreneurs and investors are entitled to negotiate and decide on their own structure, contingent upon clear and accurate disclosure of the structure and its associated risks. For the sake of the parties involved in the VIE, it is advisable and beneficial to rid the smog that clouds its usage, and revert to its pure origins.