What the Future Holds for China's VIE

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Two recent and noteworthy events in the US and China cause one to ponder what the future holds for the variable interest entity (VIE), an ingenious creation which, for the past decade, has been widely used to attract eager foreign capital, because it seems to have overcome certain People's Republic of China (PRC) regulatory hurdles facing foreign investors while cleverly using US and international accounting standards that would inject financial life in to offshore companies even though such offshore companies do not own an equity stake in the Chinese operations.

The first event took place in July 2012, when the US Securities and Exchange Commission (SEC) commenced an investigation of New Oriental Education and Technology Group on whether there is a sufficient basis for the consolidation of New Oriental's VIE into New Oriental's financial statements. A month later, the PRC Ministry of Commerce (MOC), when rendering its antitrust clearance with respect to Walmart's acquisition of a controlling stake in an offshore holding company that controls Yishiduo, which operates one of the largest and fastest growing online supermarkets in China, imposed a condition that Walmart should not "conduct through VIE structure" the value-added telecom business (VATB) operated by Yishiduo.

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This article will address what companies and investors need to understand about the VIE.

Popularity of the VIE

Chinese law restricts or even prohibits foreign investment in certain industries, such as education, publishing, media and VATB. The PRC government authorities enforce this policy by means of the foreign investment approval process, which is principally administered by the MOC and its local counterparts, as well as by means of a permits and licences process controlled by relevant PRC authorities in charge of specific industries. However, it did not take long before China-based companies seeking foreign capital, enthusiastic foreign investors and their advisers developed a seemingly acceptable work-around of this foreign ownership limitation. That work-around is the VIE.

Typically, under a VIE structure, the offshore holding company has a wholly-owned subsidiary in China (known as a WFOE) which, instead of directly operating a restricted business or owning equity interests in a company that operates such business, enters into contractual arrangements with a Chinese operating company with no foreign ownership (this is the VIE) that are intended to make the WFOE the primary beneficiary of the VIE. These contractual arrangements would take the legal ownership of such restricted business away from foreign investors, and hence are thought of as a means to get around the foreign ownership restriction. Meanwhile, US and international accounting standards generally permit the offshore holding company to consolidate the financial results of the VIE if two basic tests are satisfied; under US GAAP, the WFOE or other consolidating entity must have the power (by contract or otherwise) to direct the activities of the VIE that most significantly affect its economic performance and the obligation to absorb losses of the VIE that could be significant to it or the right to receive economic benefits from the VIE that are significant to it. Accordingly, the VIE structure allows foreign investors to consolidate the financial and operating results of the restricted business without direct equity ownership in the operating company.

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Since late 2006, the VIE structure has also been used to address a different regulatory issue in China. Because Circular 10, which came into effect in September 2006, has made it nearly impossible for Chinese companies looking to go public outside China to set up the structure required for an offshore listing with direct ownership of the Chinese operating company, some companies have opted to use the VIE structure to circumvent the Circular 10 restrictions.

The VIE structure was initially introduced in China by internet companies in the early 2000s. In the past decade, many Chinese companies have used, and the market seems to have accepted, the structure, also referred to as the Sina model after Sina.com used it to go public in the US in 2000. Nearly all offshore-listed internet and e-commerce companies, including Sohu, Baidu, Ctrip, Renren, Youku and Dangdang, operate under VIE structures. These companies have been generally accepted as model candidates for VIE structures, primarily because of their asset-light features and the relative ease of placing as much business value as possible in the WFOE, which help to justify the passage of economic benefits from the VIE to the WFOE and ultimately to the offshore publicly-listed companies.

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Business as usual?

Though the VIE structure is popular with both China-based companies seeking foreign capital to fund their businesses for which foreign investment is restricted and foreign investors eager for a piece of the pie in high growth sectors in China, there has been no clear indication from the Chinese government as to whether the structure actually complies with Chinese law. Though obviously used as an avenue to circumvent foreign investment restrictions or the Circular 10 hurdles, the Chinese government has not yet taken systemic enforcement measures against the companies using these structures. Before the MOC's conditional antitrust clearance of the Walmart acquisition, the strongest indication that the Chinese government might take a position with respect to VIEs came during a monthly news briefing in September 2011, at which an MOC spokesman stated that the MOC and other relevant agencies were collectively researching whether, and to what extent, the VIE structure should be regulated in China.

Nonetheless, the path of VIE in the last decade has not always been smooth.

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In March 2011, Buddha Steel, a China-based company that went public in the US by means of a backdoor listing (a reverse merger with a US shell company), withdrew its registration statement for a $38 million underwritten public offering in the US. The company stated in a press release that they were advised by Hebei provincial authorities that their VIE agreements "contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy."

After this case occurred, there was debate among lawyers, scholars and other observers as to whether it marked the beginning of the end for VIEs or was a more limited attack, possibly targeted at the particular industry, reverse merger companies, or other unique circumstances. In the months following the Buddha Steel case, several internet companies with VIE structures successfully completed their US initial public offerings , including 21Vianet Group, an internet data centre operator, and Renren, commonly referred to as China's Facebook.

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There are a number of possible reasons why Buddha Steel did not simply end the market acceptance of VIE structure. Buddha Steel, a producer of cold-rolled precision steel products, is not engaged in an asset-light business such as the internet. Further, the steel industry, a key pillar of the economy, is heavily regulated in China. The Chinese government may be sensitive to the extent of foreign involvement in such steel companies. Finally, the fact that this challenge arose at the local rather than national level might alleviate the fear that there would be a nation-wide crackdown on the VIE structure. Nonetheless, the Buddha Steel transaction shows the underlining vulnerability of the VIE structure when facing regulatory scrutiny in China.

Even among asset-light internet businesses, however, VIEs are not completely immune. Consider the example of China's most acclaimed internet entrepreneur, Jack Ma, and Alibaba, the hugely successful Internet company that he founded and in which he serves as CEO. In May 2011, Yahoo!, a major shareholder of Alibaba, disclosed that without the knowledge or approval of Alibaba's board or shareholders, Alibaba had transferred its ownership interest in Alipay, a leading online payment platform in China, to a Chinese company controlled by Ma, and deconsolidated Alipay from Alibaba's financial statements (presumably, the deconsolidation was a result of termination of the VIE arrangements between Alibaba and Alipay's parent).

According to Ma, the transfer of Alipay to a Chinese company owned by him and removal of foreign control of Alipay by severance of the VIE arrangements was the right decision as it would facilitate or even be necessary for Alipay's application for a licence required for its third-party payment business. Nonetheless, these transactions caused an uproar and questions were raised as to whether proper corporate approvals were followed; fair consideration was given and as to what really motivated Ma to authorise and effect these transactions on behalf of both Alibaba and Alipay.

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Four months after the dispute arose, Yahoo!, Alibaba and Alipay resolved the issue in a deal that at that moment appears to have appeased all parties. Under this deal, Alibaba would receive a royalty and services fee from Alipay amounting to 49.9% of Alipay's income and, further upon the occurrence of a liquidity event of Alipay (an initial public offering, for example), Alibaba would receive a payment of between $2 billion and $6 billion payment. These seem to be significant amounts reflecting the value of Alipay that Alibaba would receive even as it would not retain control over Alipay.

Whether the Alipay case is an indication of Chinese regulators' close scrutiny and potential rejection of VIE structure when used in sensitive industries such as online payment (which is part of the heavily regulated banking sector), or a reflection of the vulnerability of the contractual nature of the structure, or a bit of both, is a hotly debated issue. Nonetheless, it highlights potential regulatory and practical risks inherent in the VIE structure.

After New Oriental and Walmart

Although the episodes such as Buddah Steel and Alibaba/Alipay produced a sense of trepidation at times, the use of the VIE structure continues to be a common place in the market. This is probably because until the SEC's pending investigation of New Oriental, the financial consolidation feature of the VIE structure was not seriously questioned by the SEC. In addition, until the MOC's peculiar conditional antitrust clearance of the Walmart acquisition, the control by, and the resultant flow of economic benefit to, foreign investors in connection with the operations of restricted industries through the VIE structure was not formally challenged by the national level PRC government authority in any specific transaction or through issuance of any rules and regulations.

The latest high-profile development pertains to New Oriental, a China-based educational service provider listed on New York Stock Exchange. On July 13 2012, New Oriental was informed that the SEC had issued a formal order of investigation which New Oriental believes concerns whether there is a sufficient basis for the consolidation of New Oriental's VIE into New Oriental's financial statements.

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While no information regarding specific reasons behind the SEC investigation is publicly available, MuddyWaters Research, a US investment firm specialising in researching Chinese companies and shorting shares of some of these companies, reported that New Oriental's VIE structure is weak and deviates widely from best practices. In particular, MuddyWaters' report identified the following problems in New Oriental's VIE arrangements:

First, limiting the standalone value of the VIE is critical to VIE structures. In the case of Baidu, its VIE agreements reflect an attempt to place as much as possible the business substance and economic value in Baidu's wholly-owned subsidiaries in China, with a view to decreasing the standalone value and operational independence of its VIEs. Baidu runs an asset-light business, and its wholly-owned subsidiaries provide the key operating services and own the key intellectual property rights. Further, Baidu's VIEs pledge their accounts receivables and assets to Baidu's wholly-owned subsidiaries. In comparison, about two-thirds of New Oriental's total assets are in its VIE, and almost all of its fixed assets belong to the VIE. Also, there is no accounts receivables and assets pledge as in the case of Baidu.

Control is another critical feature. In the case of Baidu, the VIE agreements give Baidu the right to designate for appointment board members and senior executives of its VIEs, the consent right with respect to material business decisions of its VIEs, and the proxy and irrevocable power of attorney to vote on behalf of the owners of its VIEs at shareholder meetings. In contrast, New Oriental has few or no such rights with respect to its VIE, leaving New Oriental with insufficient control over the operation and business of its VIE.

Thirdly, shareholders of a VIE routinely pledge their equity interests in the VIE to the offshore company or its wholly-owned subsidiaries, and such pledge should be registered with Chinese authorities to ensure its validity and priority. MuddyWaters Research alleged that it took New Oriental and its VIE more than five years to register the pledge of the equity interests in the VIE to New Oriental.

Finally, some of the contracts that pass the income of New Oriental's VIE to New Oriental have already expired and have not been properly renewed.

Although the investigation is still pending, no finding has been made by the SEC, and no further disclosure has been made by the company, the value of New Oriental's share has dropped precipitously. It is certainly too early to say whether the SEC's investigation is an isolated action concerning only the financial consolidation of New Oriental's VIE with New Oriental or whether it instead signals the beginning of the SEC's attempt to scrutinise broadly the use of the VIE structure by China-based companies. Nonetheless, one should not overlook the following factors and their potential implications:

(i) This is the first time the SEC has formally questioned whether a VIE structure adopted by a China-based company listed in the US provides "sufficient basis for consolidation";

(ii) The SEC's investigation was launched amid many reports and attacks on the financial reporting integrity of China-based companies listed in the US and the jitters caused not long ago by the Alibaba/Alipay episode; and

(iii) The New Oriental structure appears to present a relatively weak case for consolidation under the US GAAP standards for consolidation of "variable interest entities" and leaves a fair amount of room for the SEC to challenge.

Indeed, the investigation immediately made the headlines on both sides of the Pacific and caused concern over whether, beyond the uncertainty of the legality of the structure under Chinese law in China, on the US side the SEC may also view the use of the VIE structure for this type of investment unfavourably.

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If the SEC's view of the financial consolidation feature of the VIE structure cannot be ascertained merely from its commencement of investigation of New Oriental, the unfavourable view of the MOC on the VIE structure seems to be expressed subtly yet quite clearly through its Anti-monopoly Bureau's conditional antitrust clearance of Walmart's acquisition of a controlling interest in an offshore holding company that essentially controls the online retail business of Yihaodian (or Store No.1).

Store No.1 is operated and controlled through a web of entities including a VIE. Walmart, a minority shareholder of Niuhai Holding, an offshore entity, seeks to acquire a majority stake in Niuhai Holding. Niuhai Holding in turn is the sole shareholder of Niuhai Information Technology (Shanghai) Co. Neither Niuhai Holding nor Niuhai Shanghai owns the Yihaodian.com domain name or the associated Internet Content Provider licence, both of which are required to operate the online retail business of Store No.1. Instead, a PRC domestically-owned company, Shanghai Yishiduo E-commerce Co, presumably the VIE of Niuhai Holding, is the registrant of the Yihaodian.com domain name and the associated Internet Content Provider licence, and hence, should be the legal owner of Store No.1.

In terms of customer interfacing, Store No.1 seems like one hypermarket with a wide range of merchandise on the offer. Behind this user-friendly interface, Store No.1 engages two lines of business. First, Store No.1 sells its own merchandise directly to customers, most likely enabled by inventory working capital financing by Niuhai Shanghai and perhaps other affiliates, given Niuhai Shanghai's sizable capital and Yishiduo's insignificant level of capital. Second, Store No. 1 functions as an e-commerce platform providing B2C services to third-party vendors, called contractual tenants, who would, upon payment of a fee, display and sell their merchandise to customers of Store No.1. This second line of business is commonly considered as VATB, a restricted foreign investment area where the VIE structure is often used to sidestep such restriction. Whether and how Niuhai Parent and Niuhai Shanghai control Store No.1 and its legal owner Yishiduo is not public information; however, based on the MOC's announcement of its conditional antitrust clearance of Walmart's acquisition it is safe to assume that Niuhai Holding and Niuhai Shanghai control Store No.1 and its legal owner, Yishiduo, and also receive economic nbenefit and take economic risk arising from the operations of Store No. 1.

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In reviewing the antitrust clearance application for the Walmart acquisition, the MOC found the transaction would likely eliminate or restrict competition in the Chinese VATB market, and therefore, has explicitly prohibited Walmart from engaging in VATB "currently operated by Yishiduo" through the VIE structure. For Walmart, this means, in essence, that either it foregoes the transaction in the hope that the VIE arrangement may remain intact, or if it still wishes to close the transaction, it would have to segregate the VATB part of the operation from the direct sale part of the operation and consequently, to relinquish its control over and ability to receive profit from the operations of the VATB.

Setting aside the direct impact of the MOC decision on Walmart and other transaction parties, and conceivably many new fundamental business issues they will now have to resolve if they would like to proceed with the transactions, the bigger question concerns the future of the VIE. This is the first time that a PRC national level authority has specifically and explicitly mentioned the VIE structure. So, what are the implications and possible areas of concern?

It should be noted that the MOC's decision on the Walmart transaction does not expressly characterise the VIE structure as an illegal structure designed to specifically circumvent the PRC legal restriction on foreign ownership of certain business. This is certainly understandable because the MOC was dealing with an antitrust review application and, therefore, its opinions must have nexus to such review and the transaction subject to the review. What is of concern is that the MOC's decision appears to essentially equate foreign control and bearing of economic outcome through the VIE structure with foreign ownership itself. Does this view by the MOC expressed in the context of an antitrust review also reflect the broader general view of the Chinese government authorities on the VIE structure that goes beyond a simple antitrust review? Does it signal that actions affecting the VIE structure more directly, such as promulgation by relevant regulatory authorities of rules and regulations or issuance by the highest court of China of judicial interpretation challenging legality of VIE structure directly, will be forthcoming? These are the questions raised by investors, businesses already using the VIE structure, and financial and legal advisers. Given that the VIE structure has helped, and will continue to help, China-based companies raise financing in overseas capital markets, especially in connection with less sensitive and yet higher-risk businesses, and that significant local wealth and foreign investment are already tied to offshore listed Chinese companies that are dependent on the VIE structure, it is probably unlikely that the Chinese government would promulgate rules or take other enforcement action that would outright ban or require dismantling of the VIE structure in the near future.

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The MOC's decision on the Walmart transaction, however, does make the future of the VIE structure murky. Those dependent on the VIE structure will now probably be worried if they ever have to get in front of the MOC for an antitrust review. Thus, for example, financial investors engaging in projects that rely on the VIE structure may need to avoid exiting through sale to strategic buyers if the transactions would trigger the MOC's antitrust review. Also, in recent years many China-based companies that were listed in the US or Hong Kong have gone private or have attempted to go private, including notable ones such as Alibaba.com and Focus Media. This going private trend is expected to continue. Indeed, many of those companies being taken private adopt the VIE structure. If one such going private transaction becomes subject to the MOC's antitrust review, one would surely question the fate of the going private transaction. Even if the going private transaction itself might not trigger the PRC antitrust filing, financial sponsors and founders may wish to think ahead about those exit options that would not trigger the MOC's antitrust review.

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In the Walmart decision, the MOC appears to essentially equate the VIE structure with foreign ownership itself. This view, even though given in the context of antitrust clearance, could be basis for support to Chinese courts to void VIE contracts and to refuse coordinating on the enforcement of foreign court judgments even if investors prevail in overseas lawsuits. It may indeed make the VIE structure more vulnerable to performance risk, especially when the interests of foreign investors and Chinese controllers diverge. A related question is whether, given the view expressed by the MOC that equates the VIE structure with foreign ownership itself, PRC law firms might be more hesitant to issue clean opinions on the legality and enforceability of the VIE structure, and if they do, what impact this will have on auditors' reports, foreign investors' risk appetite and private Chinese companies whose only viable option to raise capital is international capital markets.

Final thoughts

Since the SEC seems to be scrutinising the financial consolidation of the VIE structure adopted by New Oriental and potentially other companies under a similar VIE structure, and since the Chinese government has sent out the clearest signal to date questioning the legality of the VIE, the future of the VIE structure is uncertain.

Those who are looking to invest in China should be aware of this risk and avoid using the VIE structure, if at all possible.

Those who have already adopted the VIE structure may wish to explore the possibility of unwinding it and reverting to a traditional parent and subsidiary structure, or bringing equity ownership completely onshore for domestic ownership.