One Online Shop, Two Websites: A Post-Closing Analysis of the Wal-Mart/Yihaodian Transaction in the Shadow of MOFCOM's Conditional Approval

Wal-Mart has moved forward to complete its acquisition of a majority interest in the business of Yihaodian, after MOFCOM issued a conditional approval of the transaction that explicitly prohibited Wal-Mart from taking control of Yihaodian's value-added telecom business directly or through a VIE arrangement. A tough balancing act of attempting to realize intended synergies while heeding MOFCOM's ruling has produced a "One Online Store, Two Websites" model. Does this model succeed in capturing the transaction's synergistic value? If so, how does this model sufficiently separate the value-added telecom business from the direct sales business controlled by Wal-Mart? Is this model instructive on how foreign investors may steer clear of the VIE structure, if required to do so, and yet still retain their intended business?

This article originally appeared in *China Legal Review* on November 28, 2012.

Earlier, on August 13, 2012, the PRC Ministry of Commerce ("MOFCOM") issued a "conditional approval" in connection with its antitrust review, approving the then proposed acquisition by Wal-Mart of a majority equity interest in the entity controlling Yihaodian, one of the largest and fastest-growing online retailers in China. The "conditional approval" required Wal-Mart not to take control of Yihaodian's value-added telecom business (VATB), which had been an important part of Yihaodian's overall business, and further specifically prohibited Wal-Mart's use of a so called "VIE" (variable interest enterprise) structure to avoid restrictions on foreign ownership of VATB. MOFCOM's ruling called into question whether the transaction could deliver the synergy expected by the parties and challenged the viability of the VIE structure going forward.

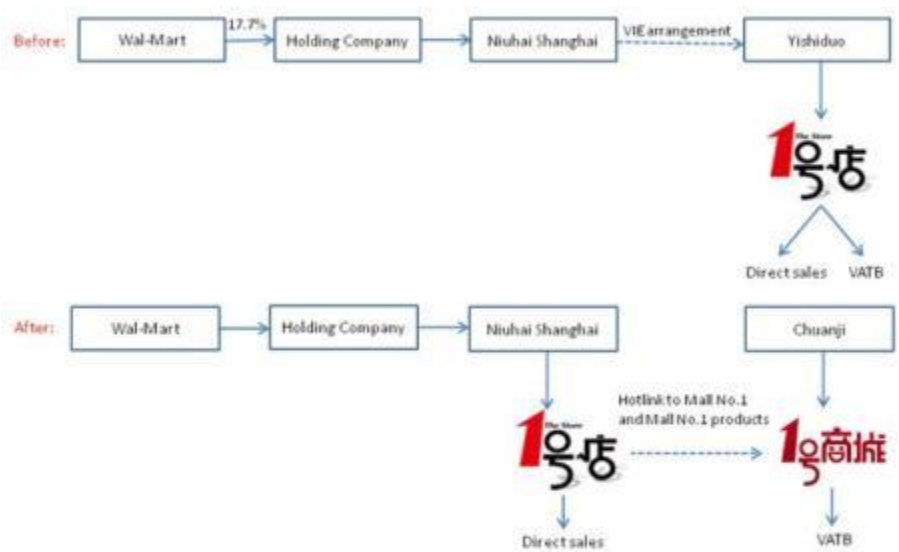
On October 26th, 2012, Wal-Mart announced that it had closed the Yihaodian acquisition. Wal-Mart has now assumed majority control of the Yihaodian business. However, as we commented in our article **《MOFCOM's Conditional Approval of Wal-Mart's Acquisition -- What does it Mean for Wal-Mart and Yihaodian and for the Future of the**

About the Authors

Yingxi Fu-Tomlinson is the office managing partner of Kaye Scholer's Shanghai office and a member of the corporate department. She has advised multinational corporations, private equity funds, and Chinese companies on a wide range of strategic and financial inbound and outbound investment, acquisition, restructuring and joint venture projects in various industries. Yingxi has represented many high technology companies and financial institutions in mergers and acquisitions, public offerings and private placements and other general corporate and commercial matters. She can be reached at ***yingxi.fu@kayescholer.com.***

Steven Wright is a partner in Kaye Scholer's Shanghai office. He focuses his practice on mergers and acquisitions and foreign direct investment and has advised US and European multinational corporations on a range of issues relating their China-based operations, including acquisitions, Sino-foreign joint ventures, establishment of wholly foreign-owned enterprises and representative offices, regulatory compliance, corporate governance and employment matters. In addition, he regularly supervises legal work for the Asia Pacific region in connection with major international transactions. He can be reached at ***steven.wright@kayescholer.com***

VIE Structure?〉 published in the September issue of *China Legal Review,* the transaction could not have been closed without significant modifications to the initially contemplated transaction structure in order to comply with MOFCOM's ruling. The modifications had to address two conflicting goals, i.e., (i) capturing as much as possible the transaction's intended synergistic value by keeping the direct sales business and VATB together and realizing the valuation of the transaction based on the original structure, while at the same time (ii) responding to MOFCOM's requirement of segregating VATB from the business to be controlled by Wal-Mart. This balancing act has ultimately produced the "One Online Store, Two Websites" model.



As shown in the diagram above, prior to the effectiveness of the transaction and related restructuring undertaken by relevant parties, Yihaodian was owned and operated by a domestic company named Shanghai Yishiduo E-commerce Co., Ltd. ("Yishiduo"). Yishiduo, in turn, was effectively owned and controlled, through a VIE arrangement (which is basically a series of contractual arrangements designed to provide benefits equivalent to equity ownership), by Niuhai Information Technology (Shanghai) Co., Ltd. ("Niuhai Shanghai"), while Niuhai Shanghai was indirectly wholly owned by an offshore holding company (the "Holding Company"). Previously, Wal-Mart's connection with Yihaodian was its 17.7% interest in the Holding Company, which it desired to increase to 51.3% through the transaction.

> ***"The 'conditional approval' … specifically prohibited Wal-Mart's use of a so called 'VIE' (variable interest enterprise) structure to avoid restrictions on foreign ownership of VATB."***

Prior to MOFCOM ruling's on the transaction, and the restructuring that followed as a result of such ruling, Yihaodian engaged in two separate businesses, direct sales and VATB. Direct sales allowed

Yihaodian to sell its merchandise directly to customers, while the VATB provided an online-platform for third party "tenants" to sell their products to customers. Despite engaging in two distinct types of business, Yihaodian provided a seamless interface and one-stop shopping experience for customers.

In our previous article, we speculated that the reason for Wal-Mart and its subsidiaries to utilize a VIE structure to control Yihaodian was to circumvent restrictions on foreign ownership of VATB. MOFCOM's decision meant that Wal-Mart and its subsidiaries could no longer own Yihaodian's VATB, even through a VIE structure. Therefore, we said it would be necessary for Yihaodian to separate its direct sales and VATB business if the transaction were to proceed, with the VATB business being assumed by a domestically owned third party. We noted that this loss of the VATB could reduce the synergy and cross-marketing opportunities that Wal-Mart had envisioned when it decided to undertake the transaction, and that it would also impact the valuation of the transaction.

Wal-Mart seems to have indeed caused Yihaodian to spin off its VATB business. Yihaodian's VATB has now been moved from "yihaodian.com" to "1mall.com" and the domain name "1mall.com" is now owned by a domestic entity, Shanghai Chuanji E-commerce Co., Ltd. ("Chuanji"). Chuanji seems to be the owner and operator of the VATB, and the VATB has a new name, which reads "yihaoshangcheng" in Chinese and may be translated as "Mall Number 1". All of the above seems to have created a legal segregation of the VATB from Yihaodian to Chuanji.

"This loss of the VATB could reduce the synergy and cross-marketing opportunities that Wal-Mart had envisioned when it decided to undertake the transaction, and that it would also impact the valuation of the transaction."

This legal segregation seems to have been completed artfully and aggressively in order to retain intended synergies by keeping the direct sales and VATB together in the eyes of consumers and also providing Wal-Mart a measure of control over, and allowing Wal-Mart to continue to receive benefits from its relationship with, the spun-off VATB. The new name of the VATB, "yihaoshangcheng" in Chinese or "Mall Number 1" when translated into English, seems designed to emphasize continuity with "Yihaodian", which means "Store Number 1" in Chinese. The look and feel of Yihaodian and Mall Number are very similar. Indeed, they are one click away from each other and a search of merchandise in one website will often bring you products available on the other website. More importantly, the trademark "Mall No.1" (as shown in the diagram above) is in fact owned by Niuhai Shanghai and licensed to Chuanji, though we should note that there is no publicly available information as to whether Chuanji makes any trademark license fee payment to Niuhai Shanghai and, if so, whether such fee in any way relates to Chuanji's earnings. If Niuhai Shanghai and Wal-Mart, by virtue of its majority ownership of Niuhai, are indeed able to capture some of the economic benefit of Mall No. 1's business through a licensing arrangement and other fees, then it would appear that Wal-Mart has taken a relatively aggressive approach by creating a relationship with Chuanji that is something less than a VIE control/defacto ownership relationship, but considerably more than that of unrelated third parties.

After the spin-off of the VATB, Yihaodian's direct sales business has remained with "yihaodian.com". Perhaps because a VIE structure is no longer necessary for Niuhai Shanghai to operate Yihaodian's direct sales business, Niuhai Shanghai now owns and operates yihaodian.com and the Yihaodian business directly, without Yishiduo serving as a contractual intermediary.

The table below summarizes the changes to the operational structure of Yihaodian discussed above:

Changes to the Operational Structure of Yihaodian		
	Before	**After**
"Yihaodian.com" Domain Name	Owned by Yishiduo	Owned by Niuhai Shanghai
"Yihaodian" Trademark	Owned by Niuhai Shanghai	Owned by Niuhai Shanghai
Direct Sales Business	Operated under Yihaodian.com; owned by Yishiduo	Operated under Yihaodian.com; owned by Niuhai Shanghai
VATB	Operated under Yihaodian.com; owned by Yishiduo	Operated under "1mall.com" as "Mall No.1"; owned by Chuanji

So far, there is no publically available information regarding possible adjustment of the purchase price of the Wal-Mart/Yihaodian acquisition due to the spin-off of the VATB that was required by MOFCOM's ruling. Although the MOFCOM ruling in this case was not favorable to Wal-Mart generally, and effectively shut Wal-Mart out of operating in the VATB market through a VIE structure, Wal-Mart was able to create a solution that may minimize the negative impact of the MOFCOM ruling and realize as much as possible the transaction's synergistic value and the original transaction valuation. The solution produces the look, feel and function of "one online shop" for consumers, albeit under "two websites" owned by two seemingly unrelated entities. Whether or not the "one shop, two websites" model has sufficiently separated the VABT from the business controlled by Wal-Mart as required by MOFCOM is an interesting question, especially in light of Nuihai's ownership and license to Chuanji of the trademark "Mall No.1".

"Wal-Mart was able to create a solution that may minimize the negative impact of the MOFCOM ruling and realize as much as possible the transaction's synergistic value and the original transaction valuation."

As of the date of this article, there is already evidence that Wal-Mart has been active in integrating Yihaodian with Wal-Mart. On November 5, 2012, it was announced that Mainstays, one of the most popular of Wal-Mart's furnishings and household products brands, would be sold online in China exclusively through Yihaodian. Yihaodian's marketing of Mainstays may be regarded as significant step in Wal-Mart's entry into China's e-commerce market. It is also reported that two senior officers who formerly served in Wal-Mart's e-commerce team have joined the management team of Yihaodian.

"One Online Shop, Two Websites" Is Not the Solution for Everyone

As we discussed in our previous article, PRC authorities wish to limit foreign investment in China's VATB market and could seek to tighten the loophole created by VIE. This may reflect their concerns over network security and may be motivated by the government's desire to maintain strict controls on the Internet in China generally. Additionally, PRC authorities, including MOFCOM, no doubt understand that e-commerce is likely to be an important area for China's future economic growth. A recent nationwide buying spree for China's "Singles' Day" on November 11th (or 11/11), a day famous for significant discounts initiated by major e-commerce companies in China, demonstrated the vitality of the industry. It was reported that T-Mall, a bellwether of China's e-commerce market, achieved record sales of RMB 19.1 billion that day. These factors may help explain why e-commerce has been the subject of increased attention from PRC regulators.

> ***"PRC authorities wish to limit foreign investment in China's VATB market and could seek to tighten the loophole created by VIE."***

While the Wal-Mart transaction provides an interesting "one online shop, two websites" model, this model would not help every foreign investor to avoid the use of VIE structuring, if required to do so, and yet still effectively maintain a business in an area where foreign ownership is restricted. The "one online shop, two websites" model works for Wal-Mart because Yihaodian has a direct sales business that is valuable to Wal-Mart even after the VATB is spun-off. Therefore, this model is primarily instructive where VATB or another business in which foreign investment is restricted does not constitute the entire or the most valuable business subject to the VIE structure. The VIE structure still remains vulnerable to challenge by MOFCOM or other PRC authorities or interested parties through antitrust review, PRC national security review, or other venues.