

# 2008 Update to Investment and Operating in Restricted Industries in China

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## OVERVIEW

There are a number of business sectors in China such as telecommunications services, online commerce and auction in which direct foreign investment is restricted.<sup>1</sup> Limits are placed on the percentage amount of foreign ownership of companies in these sectors. Foreign ownership in these sectors may also increase the difficulty of obtaining government operating permits.<sup>2</sup> Nevertheless, some of these heavily regulated sectors present substantial market opportunities. A number of companies in these sectors have gone public in the U.S. despite the restrictions on foreign investment. This memorandum describes a corporate structure that a non-Chinese corporation may use for investment and participation in restricted industries in China. This structure has worked for companies seeking access to capital markets in the U.S., and should work for access to capital markets in Hong Kong or Singapore.

The foreign entity is referred to below as a “**Cayman Company**,” reflecting that many of these organizational structures have a Cayman Islands company at the top. The structure described is based on a review of U.S. Securities and Exchange Commission (“**SEC**”) filings of Cayman Islands companies that have gone public in the U.S. Under this corporate structure, the Cayman Company may invest and conduct business in China through a series of contractual arrangements with a Chinese domestic entity with domestic ownership composition. These contractual arrangements enable the Cayman Company to do business in the restricted sectors and operate in an ever-changing regulatory environment with minimal disruptions.

### Basic Structure

The simplest structure is when the Cayman Company provides the necessary funds to its key directors or officers who are residents in China to capitalize or acquire a Chinese entity, which will hold the required Chinese government-

issued licenses and approvals. The directors or officers are the equity holders of the Chinese entity. The affiliation between the Cayman Company and the Chinese entity occurs through contractual relationships. The Cayman Company does not have any direct ownership interest in the Chinese entity. Through various agreements with the directors or officers, shareholders and the Chinese entity, the Cayman Company exerts de facto control over the Chinese entity, without having an ownership interest. These agreements can include loan agreements, power of attorney agreements, exclusive service agreements, share pledge agreements and other operating agreements. Taken together, these agreements provide the Cayman Company with effective financial and operational control over the Chinese entity.

### MORE COMPLEX STRUCTURES

In many cases, conducting business in key municipalities in China requires compliance with local regulatory and licensing authorities in addition to national authorities. A Cayman Company that desires to operate in restricted industries in cities such as Beijing and Shanghai may have to establish contractual relationships with a different affiliated entity in each city. Moreover, the operations of a Cayman Company may involve more than one business sector. Depending on the level of foreign ownership allowed and the existence of definitive licensing rules that govern these foreign-invested entities in each sector, the Cayman Company may establish separate companies in order to maximize its ownership control. If there are no foreign ownership limitations on a specific sector, the Cayman Company may form a wholly-owned subsidiary to handle that part of the business. If foreign investment is limited in another business sector, for which the government provides detailed guidance on how a foreign-invested company may obtain approvals and licenses, the Cayman Company may enter into a joint venture with a Chinese entity for that part of the business, along with contractual arrangements with the Chinese entity. As for other parts of the business in

<sup>1</sup> See the Catalogues for the Guidance of Foreign Investment Industries (effective Dec 1, 2007), under this list and its updates, business sectors are divided into four types: allowed, encouraged, restricted and prohibited.

<sup>2</sup> See the Provisions on the Administration of Telecommunications Enterprises with Foreign Investment (effective Jan. 1, 2002).

restricted business sectors, clear-cut governmental rules with respect to the procedures for approval and licensing of a foreign-invested enterprise may be lacking. To minimize delays and other impacts of regulatory uncertainties, the Cayman Company may form a series of contractual arrangements with one or more affiliated Chinese entities.

### **CONTRACTUAL CONTROLS, LOAN AGREEMENTS AND EXCLUSIVE OPTION AGREEMENTS**

The Cayman Company may make loans to certain of its directors or officers for the exclusive purpose of funding or acquiring a Chinese entity as a vehicle for engaging in a business sector in which foreign investment is restricted. As consideration for the loan agreements, these directors or officers of the Cayman Company, who become the principal owners of the Chinese entity, enter into exclusive option to purchase agreements with the Cayman Company. In the event the Chinese government removes its limitations on foreign ownership, the Cayman Company may exercise the exclusive and irrevocable option to purchase all of these equity interests in the Chinese entity. The outstanding loans will be cancelled in connection with the purchase. Such arrangement is commonly used, though the enforceability of the option might be challenged because there has been no approval from the foreign investment authority (Ministry of Commerce or its local agencies). The foreign investment authority will not approve such arrangement in principle.

#### **Powers of Attorney**

The creation of irrevocable powers of attorney provides the Cayman Company with effective voting control over the Chinese entity. The scope of voting powers is similar to those granted to a trustee to be exercised on behalf of a beneficial owner. The principal owners of the affiliated Chinese entity (the directors or officers of the Cayman Company) irrevocably appoint a Cayman Company officer as attorney-in-fact to vote on their behalf on all matters they are entitled to vote on, such as those relating to the transfer of their respective equity interests and the appointment of the chief executive officer of the Chinese entity.

#### **Exclusive Service Agreements, Trademark or Software License Agreements, and Share Pledge Agreements**

The Cayman Company may serve as the exclusive service provider for its affiliated Chinese entity. For example, the Cayman Company may deploy and maintain the

Chinese entity's technology and network platforms. The

Cayman Company may also grant the Chinese entity licenses to use its registered trademarks and software, in addition to providing administrative and marketing support. In return, the Chinese entity will pay service, licensing, and royalty fees. As a guarantee against the event that the affiliated Chinese entity defaults on its payments, the principal owners of the Chinese entity (the directors or officers of the Cayman Company) may pledge their equity interests in the entity. Under a share pledge agreement, a breach of the service or licensing agreements will entitle the Cayman Company to sell the owners' shares and retain the proceeds from such sale, or to require the owners to transfer his or her interest without consideration to an individual designated by the Cayman Company. The combination of exclusive service agreements and the share pledge agreement gives the Cayman Company a high degree of control over the operations of the affiliated Chinese entity.

#### **Other Operating Agreements**

In addition to acting as an exclusive service provider for the Chinese entity, the Cayman Company may enter into an agreement to guarantee their performance of contracts with third parties. As consideration for these performance guarantees, the affiliated Chinese entity may pledge all its assets for the Cayman Company's benefit, agree to accept the Cayman Company's guidance on day-to-day operations, financial management, approval for the appointment and dismissal of key employees, and agree not to enter into any transaction without the Cayman Company's prior written consent.

In theory, such a share pledge may be construed as a type of foreign debt guarantee provided by the directors or officers, and the validity of foreign debt guarantee is subject to the registration with competent foreign exchange authority (State Administration of Foreign Exchange or its local agencies) in accordance with Chinese law. In practice, however, the foreign exchange authority will not grant the registration for a foreign debt guarantee provided for a non-loan transaction.

### **U.S. ACCOUNTING TREATMENT**

For U.S. accounting purposes, the affiliated Chinese entity may be classified as a variable interest entity ("VIE"). See Financial Accounting Standards Board ("FASB")

Interpretation No. 46, *Consolidation of Variable Interest Entities*. Under the FASB rule, since the equity owners of such an affiliated Chinese entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties, a VIE's financial statements are consolidated in the financial statements of its "primary beneficiary," the Cayman Company.

## 2008 UPDATE

The business structure described above has been widely used in the restricted telecommunication service sector in the past several years. Without an express prohibition in Chinese law, the Chinese government was silent on the enforceability of this structure until the issuance of the *Circular on Intensifying the Administration of Foreign Investment in Value-add Telecommunications Services* ("**Circular**") by Ministry of Information Industry ("**MII**") on July 13, 2006.

The Circular expressly prohibits foreign investors from covertly getting around the limitation by licensing its domain name or trademark to a domestic company and requires that the domain name and trademark of a value-added telecommunication service provider must be owned by the provider or its shareholders. Despite being clear and certain on several specific matters, *e.g.* domain name, trademark and server, *etc.*, this Circular leaves it to governmental discretion to decide how broadly this Circular should be applied. If interpreted strictly, this Circular could apply to any structure or arrangement that appears to evade Chinese law, including the business structure described above. However, if interpreted loosely, the business structure can still work after making some adjustments with respect to the ownership of the domain name and trademark according to the Circular. So far we are not aware of any actual action having been taken by the government to challenge this structure and it continues to be used by many foreign investors. But the MII may declare this structure illegal at any time according to this Circular.<sup>3</sup>

## CONCLUSION

The web of agreements and ownership interests enables a Cayman Company to operate in restricted business sectors in China through one or more affiliated Chinese entities. This structure provides global investors with more opportunities for investing in these sectors and with the exit possibility of a U.S. IPO. The Cayman Company's directors or officers, who become owners of the Chinese entity with the use of loans from the company, effectively relinquish their operational control through the agreements. This structure has characteristics of a trust in that the directors or officers are holding the shares in the affiliated Chinese entity for the benefit of the Cayman Company. While the contractual structures described have been "tested" in U.S. IPOs, uncertainties about the Chinese political and legal systems are usually cited in SEC filings as a risk of conducting business in China. Much of the risk stems from the ever-changing regulatory regime, as well as the broad discretion that government authorities' exercise in determining whether such contractual arrangements are enforceable. Even if foreign investment rules have been liberalized, monitoring these rules is essential to avoiding disruptions to the Cayman Company's operations. Note that such arrangements have not been tested before any PRC court if there is any dispute over relevant agreements. Essentially, there is no risk free solution for a foreign investor to enter restricted or prohibited sectors in China, so contractual arrangements may be challenged, but it is the only alternative available.

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<sup>3</sup> Another change occurred in the real estate sector, on May 23, 2007, the Ministry of Commerce and the State Administration of Foreign Exchange jointly released the *Circular of Further Strengthening and Regulating the Approval and Supervision of Foreign Direct Investment in Real Estate Industry*. According to this circular, foreign investors are banned from bypassing the approval of foreign investment in real estate by changing the actual controlling parties of domestic real estate enterprises. So the above contractual arrangement may not be used for real estate investments any more.