Client Alert

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China VIEs: Recent Developments and Observations

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As many of our readers are aware, the "variable interest entity" ("**VIE**") structure has proven popular over the past decade as a means to facilitate the offshore financing of PRC companies doing business in regulated sectors such as the Internet and value-added telecommunications. A VIE structure typically involves contractual arrangements pursuant to which an offshore entity (typically through one or more wholly foreign-owned enterprise ("**WFOE**") subsidiaries established in China) controls, and consolidates for financial accounting purposes the operating results of, one or more Chinese onshore operating entities (an "**OpCo**") whose equity is owned by People's Republic of China ("**PRC**") nationals.

A number of developments in the past 18 months have led to greater scrutiny of the VIE structure. This Alert reviews a recent decision of the Supreme People's Court in the Chinachem case and an arbitral award in a contract dispute involving a Chinese domestic online gaming company operated by NASDAQ-listed GigaMedia utilizing a VIE structure, and considers the potential impact of these two cases on the use of the VIE structure going forward.[1]

THE CHINACHEM CASE

China's Supreme People's Court rendered a ruling in October 2012 that ended a 12-year dispute between Chinachem Financial Services, a Hong Kong company ("**Chinachem**"), and China Small and Medium Enterprise Investment Co. Ltd., a mainland Chinese firm ("**China SME**"). The dispute involved ownership of shares representing a 6.5% stake in the China Minsheng Banking Corporation ("**Minsheng**") that Chinachem asserted ownership of via an entrustment (委托投资) arrangement. The Court ruled that two deeds of entrustment through which China SME acted as Chinachem's proxy to buy and hold the shares in Minsheng, together with two loan agreements through which Chinachem lent the investment funds to China SME, were entered into with the clear intent of circumventing China's restrictions on foreign investment in China's banking sector and accordingly were invalid and unenforceable under Article 52 of the PRC Contract Law, which provides that contracts are invalid where they "conceal illegal intentions within a lawful form" ("以合法的形式掩盖非法目的"). The Court affirmed the lower court's decision that the Minsheng shares at issue—by then reportedly worth approximately US$700 million compared with Chinachem's original investment of approximately US$11 million in 1995—belonged to China SME. Notably, however, Chinachem was not wholly denied a remedy. In addition to ordering that Chinachem's original US$10,940,000 investment be returned, the Court increased the compensation to be paid by China SME to include 40% of the value of the shares at issue, based on the market price of Minsheng shares in the period leading up to the decision, as well as 40% of the RMB595 million in dividends that had a accrued on the shares at issue. In so ruling the Court applied a fairness principle under both Chinese civil and contract laws to attribute

[1] The text of the GigaMedia arbitration award is not publicly available. This Alert draws on public reports on the GigaMedia arbitration.

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fault to both China SME and Chinachem for entering into an invalid agreement. In so doing, the Court increased substantially the remedy of approximately RMB46 million that had been awarded by the lower court in Beijing.

Various commentators have cited the Chinachem decision as significantly undermining the viability of the VIE structure. We would emphasize, however, that pending further action by PRC regulators, the legal risks and uncertainties associated with the VIE structure have not changed. Moreover, the issues presented in the Chinachem decision differ from those typically associated with VIE structures in a number of important respects.

As noted, at issue in the Chinachem decision was the question of the legal effectiveness under the PRC Contract Law of the entrustment arrangement forming the basis of Chinachem's claim of ownership in the Minsheng shares. Citing 1994 regulations issued by the People's Bank of China, the Court stressed in its decision that when Chinachem first made its investment in Minsheng in 1995, foreign investment in China's banking sector was prohibited and therefore that Chinachem's original investment in Minsheng through China SME violated the "then mandatory provisions of the financial administrative system." The Court also cited 2003 regulations of the China Banking Regulatory Commission that liberalized foreign investment restrictions in the sector but that still required PRC government approval for foreign investments in Chinese banks, noting that Chinachem did not obtain such approval after 2003 for its investment in Minsheng. The Court concluded that the parties must have been aware when they entered into the entrustment arrangement that they violated mandatory legal provisions and therefore that the deeds of entrustment must be legally invalid. The judgment's wording suggests the key fact underlying the Court's ruling was that the parties intentionally breached certain mandatory provisions of Chinese financial regulations in entering into the entrustment arrangement. It is worth noting that this kind of entrustment arrangement has been much less widely used by foreign investors investing in China than the VIE structure, which has enjoyed relatively broad use. As such, the direct legal and practical implications of the Chinachem decision may be limited.

Rather than relying on entrustment structures or other mechanisms to support effective ownership of the equity of the domestic OpCo which typically holds key licenses and assets and generates most of the revenues within the group, the VIE structure employs contractual arrangements that under applicable accounting principles enable the OpCo's operating results to be consolidated for financial accounting and reporting purposes with those of the offshore-held corporate group. In a typical VIE, the intra-company operating agreements are entered into on arm's-length terms based on actual services and support being provided by one group member to another.

In light of these differences, any definitive predictions about the implications of the Supreme People's Court's Chinachem decision for VIE structures are at best premature. The decision does *not* involve a challenge to the legality of the VIE structure and so offers limited if any guidance as to how the Supreme People's Court might approach enforcement of VIE arrangements if presented with the issue in the future.

THE GIGAMEDIA CASE

Unlike the Chinachem case, the arbitral award rendered in 2011 by the Shanghai Sub-commission of the China International Economic and Trade Arbitration Commission ("**Shanghai CIETAC**") did involve a VIE structure. According to public reports late last year that first focused attention on the award, the Shanghai CIETAC panel adopted similar reasoning to the Supreme People's Court in its Chinachem decision. Again, however, the decision should be read in context.

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GigaMedia Limited, a Singaporean company listed on the NASDAQ ("**GigaMedia**"), had, via a wholly-owned subsidiary, acquired a controlling interest in T2CN Holding Limited, a British Virgin Islands company ("**T2CN**") with online gaming operations held via a VIE structure. In July 2010, a dispute arose between GigaMedia and one of the founders of the T2CN gaming business over control of the related OpCo, after GigaMedia's board voted to replace the founder as CEO of its PRC operations. The founder wished to regain control of the OpCo by asserting that the VIE agreements were legally invalid.

The arbitral tribunal found that the GigaMedia VIE structure was designed "to enable the WFOE, which did not have online operation qualifications, to participate in the operation of online games in the PRC and to obtain financial returns therefrom." The tribunal took the view that this arrangement violated provisions of Chinese regulations prohibiting foreign investors from exercising control over online gaming businesses in China and therefore ruled that the VIE agreements were invalid—like the court in the Chinachem decision, relying on Article 52 of the PRC Contract Law, which renders invalid contracts that "conceal illegal intentions within a lawful form."

Shanghai CIETAC's GigaMedia award illustrates a risk that investors using VIE structures have been aware of for some time, namely, the uncertainty of enforceability under PRC law of the inter-company operating agreements. At the same time, it is important to view the award in its proper context.

It bears noting that, at around the time the dispute arose, foreign involvement in China's gaming industry had been singled out by the PRC General Administration of Press and Publication ("**GAPP**") for scrutiny. In its Circular 13 issued in September 2010, GAPP sought to directly prohibit use of contractual arrangements to indirectly control or participate in online gaming businesses. The GAPP circular implied a scope of jurisdiction with regard to VIE arrangements that to date has not been affirmed by any other PRC government body. As such, the outcome might well have been different if GigaMedia were operating in a different sector. Even in relation to usage of VIEs in the game sector, the award may not be that instructive. The alarm Circular 13 initially caused in the online gaming industry has since abated and Circular 13 has not been actively enforced.

It should also be born in mind that an arbitral award like the one in the GigaMedia case is not a judicial decision but the result of a private dispute resolution proceeding. Arbitral awards, which are generally confidential, may not be a useful guide as to how a court or another arbitral tribunal might approach similar issues.

LOOKING FORWARD

While raising potential concerns about the future status of the VIE structure in China's regulatory landscape, the Supreme People's Court's Chinachem decision and Shanghai CIETAC's GigaMedia award, by their terms, neither mandate nor contemplate a prohibition of future use of VIEs.

The Chinachem decision addressed an entrustment arrangement that was put in place in 1995 and in our experience has been seldom used by other foreign investors since. In contrast, the VIE structure has been used extensively for over a decade, both for foreign investors to invest into restricted sectors such as value-added telecommunications and education and for Chinese private investors to access capital to grow their business in these same sectors. A recent example is the June 2013 NYSE listing of retail website LightInTheBox, whose PRC operations are structured as a VIE.

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What these recent developments do highlight is the importance of careful planning and structuring by foreign investors, when considering a VIE structure, taking account of the specific circumstances. While no measure can eliminate risk entirely and future regulatory developments may in fact necessitate a broader reassessment of the VIE structure, appropriate planning points to consider include:

- OpCo shareholding should be shared among trustworthy individuals who ideally will not be heavily involved in the operation of the business.
- It may be feasible to enhance control by appointing trusted individuals to senior management of the OpCo.
- Commercial agreements should be carefully drafted in order to enhance control and document the funds flows and services elements of the commercial relationships between corporate group members.

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