WINSTON & STRAWN LLP

BLOG

Understanding China's Variable-Interest Entities

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Companies invested or considering investing in variable-interest entity (VIE) structures in China should take precautionary measures to protect against risks illustrated by recent events in China and the United States.

A VIE is a financial designation that requires businesses to consolidate financial statements for entities that are controlled through means other than equity ownership, as interpreted by the U.S. Financial Accounting Standards Board in FIN 46(R) (Consolidation of Variable Interest Entities). VIEs are commonly used in China to allow foreign investors to participate in industries that are explicitly or practically restricted from foreign investment. Recently, the risks of investment in China-based VIEs have been highlighted by enforcement actions and draft regulations in China as well as guidance from the U.S. Securities and Exchange Commission (SEC). This briefing will describe the typical VIE structure, background on the risks, and guidance for companies considering investment in China-based VIEs.

Typical China-Based VIE Structure

Technically, the VIE refers only to a Chinese entity owned by Chinese individuals or entities without foreign investment or foreign equity ownership (the operating company). The operating company is typically owned by its founders, may be the parent of multiple subsidiaries serving different functions in the business, and will obtain all necessary licenses and approvals to conduct business in China.

The VIE is controlled by a multinational enterprise structure (the control company) that will have both Chinese and foreign investment and shareholders. Typically, the control company is established by the founders of the operating company. In China, the control-company structure is classified legally as a round-trip investment, meaning that it is an outbound investment by Chinese entities or individuals followed by a return inbound investment. To legally conduct this type of investment, the founders will need to obtain approval from the State Administration of Foreign Exchange (SAFE) under Circular 37. Without the proper SAFE approvals, the control company will not be able to conduct an inbound investment into China.

Many control companies follow a standard structure. Each founder will obtain SAFE approval to establish and invest in a British Virgin Islands (BVI) entity. The BVI entities, one per founder, will become the original shareholders of a

Cayman Islands entity. The Cayman entity will be the special-purpose vehicle to obtain foreign investment. The main purpose of the BVI companies is to avoid the need for change-of-registration procedures in China each time new investors subscribe to the Cayman entity.

The Cayman entity will establish a Hong Kong holding company, and the Hong Kong holding company will establish a wholly foreign-owned enterprise (WFOE) inside China through which foreign investment from the Cayman company will flow. The purpose of this structure is to take advantage of tax treatment for disbursements from mainland China to Hong Kong, and from Hong Kong to the Cayman Islands. The WFOE will execute contracts with the operating company and the founders to obtain control and redistribute the operating company's profits back to the WFOE (i.e., the control contracts). The type of control contracts varies depending on the nature of the business and other factors.

Risks to the VIE

It would be surprising if the Chinese government eliminated the ability of companies to utilize China-based VIEs in every circumstance and industry, because many of China's most influential companies utilize VIEs. Nonetheless, there is a risk that China's central policy could change in ways that affect VIEs in certain industries or prohibit certain aspects of control contracts.

Industry-specific restrictions that directly and indirectly affect VIE arrangements have happened in the past, particularly for the steel and video-game industries. If China perceives a potential risk in an important industry, it will not hesitate to limit foreign participation. Likewise, local governments have the ability to limit the VIE structure in their jurisdictions through interpretation and local rules.

At the same time, the enforceability of control contracts has not been clearly tested in Chinese courts. There have been multiple occasions when the VIEs purportedly breached the provisions of control contracts to unilaterally make decisions or take actions that would be forbidden or require the approval of the control company. Rather than seeking enforcement in court, these issues have been handled through negotiation. In that situation, the negotiation position for the foreign investors would lack strength because there is unpredictability in enforcing the control contracts in Chinese courts. Thus, there is a risk of decrease in value in the investment because of a breach of the control contracts.

Likewise, it is not uncommon for the control contracts to have been drafted by counsel engaged by the founders. Often, the founders establish the entire structure—at least the control-company portion—prior to seeking or finalizing investment. Thus, the initial drafting of the control contracts may have been done by counsel for the founders, whose conduct the control contracts purport to control.

In addition, China recently enacted multiple laws that regulate cross-border transfer of certain data and personal information, specifically the Data Security Law and the Personal Information Protection Law. In the last two months, the Cybersecurity Administration of China (CAC) has initiated investigations and enforcement actions against Chinese companies for their data and personal-information practices. It is relatively clear that some of the CAC's actions relate to cross-border transfer by VIEs of data or personal information. At the same time, investors in the control company need to have visibility into the business of the VIE. Thus, data and information-sharing provisions in control contracts could be outdated and violate current law.

Guidance for Companies

Companies considering investing in control companies should take steps to try to limit their risks before closing the investment. Companies already invested in control companies should consider reviewing their investment to identify and limit risks. Depending on the specific situation, there may be a variety of actions that could be taken. However, in most circumstances, the following steps are advisable:

- conduct a review of current legislative, regulatory, and other policy trends in the specific industry, including possibly conducting anonymous consultations with national and local government authorities to understand government opinions and trends to determine potential risks to investment;

- conduct due diligence on the operating company, control company, and control contracts, including a review of the formation documents, approvals, and Chinese legal analysis of the control contracts;
- insert adequate protections and exit provisions in the investment or share-purchase contract; and
- establish a procedure for reviewing data that would limit the risks for the VIE while providing adequate understanding for the company, which most likely would involve a review within China by trusted advisors.

This briefing contains a general overview of Chinese laws and regulations and their application to proposed transactions. We welcome you to contact us directly if you would like further information or assistance. Winston works closely with attorneys at the firm’s strategic alliance partner, Yuanda China Law Offices, who are qualified to practice Chinese law and provide comprehensive legal services across the full range of Chinese legal matters, including representing clients in due diligence, handling transactions involving China-based VIEs, forming entities and VIEs, obtaining and reviewing government approvals, and coordinating with government agencies.

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