BASIC CORPORATE GOVERNANCE PATTERN IN VARIABLE INTEREST ENTITIES

INTRODUCTION

The concept of Variable Interest Entities (“VIE”) originated from United States accounting principles. For recent decades, Chinese entrepreneurs borrowed the concept of VIE to develop their own businesses under the Chinese government’s special regulatory environment. Currently, the foreign direct investment market is not completely open to foreign investors. Many foreign investors are not permitted to invest in prohibited industries, and there are also restrictions on the percentage of foreign shares allowed in a domestic company. For the purpose of attracting foreign investors and circumventing restrictions on foreign direct investment, the VIE structure is widely used by Chinese companies to enter foreign capital markets; the same is also true of foreign companies attempting to obtain control over Chinese companies. The most recent and pertinent case arose in 2014 regarding Alibaba’s utilization of VIE to issue stock in the New York Stock Exchange and successfully connect its United States’ entity with Chinese-domestic business. Understanding how VIEs’ structure achieves the goal of controlling the desired domestic company and what are the differences in its corporate governance in comparison to traditional United States governance methods is important. This comment will parse through these questions and provide a brief analysis under both historic and current regulation trends.

4 Zeng & Bai, supra note 2.
I. VIE AND CORPORATE GOVERNANCE CONTRACTS

The structure of a VIE functions to circumvent the heavy restrictions set by the Chinese government on foreign ownership and enables the companies to be listed on the overseas stock market. Typically, there are four parties under a VIE structure: (1) a company listed on the overseas stock market (“ListCo”), which owns (2) a wholly foreign-owned company (“WFOE”); (3) a Chinese domestic company which operates the substantive business (“OpCo”), the VIE itself; and (4) Chinese owners of the OpCo/VIE. The OpCo is the company holding the prerequisite license to conduct business in the industry, barring or restricting foreign investors, and generating value from its operation of the business. On the other hand, the WFOE is basically a shell company holding a license allowing it to conduct consulting business with OpCo, as its only client. The owners of the OpCo are usually the founders who retain majority ownership in the substantive business.

With the parties being identified and duly organized, the essential part of the VIE structure comes into play: the contractual arrangement. Generally, in lieu of equity interests, the pivotal contractual arrangement constitutes the structural core between the WFOE and the OpCo. The primary purpose of this contract is to transfer the OpCo’s profits to the shell WFOE as the former’s primary beneficiary in the form of fees and royalties, while also providing de facto control over the OpCo. The WFOE and even the ListCo can be viewed as shareholders of the OpCo, demanding returns or “dividends” on their investment. The legal majority shareholders, as well as the founder and effective controller of the OpCo, are akin to directors and managers of a corporation because both control the operation of the invested business, and

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8 Guo, supra note 7, at 578.
9 Id. at 577.
11 Kan, supra note 6.
12 Id.
13 Ma, supra note 1, at 1063.
14 Ma, supra note 1, at 1068.
15 Roberts & Hall, supra note 10.
foreign investors’ interests are largely dependent on the owners’ management and operation.\textsuperscript{16} Under the effective corporate governance mechanism, Chinese owners are expected to owe fiduciary duties to the foreign investors. This is not always the case; the current uncertainty of VIEs’ legal status and the absence of clear legal resort once the contracts are breached essentially render the interest of ListCo and WFOE at the mercy of the Chinese owners.\textsuperscript{17} Regardless of the risks posed by regulatory uncertainty, it is still necessary to recognize what function these contracts play in VIE’s corporate governance.

\textbf{A. Call Option Agreements}

The Call Option Agreement grants the WFOE the right to purchase the OpCo’s shares from its owners through one or a series of transactions.\textsuperscript{18} The purchase price is predetermined and typically set as “the lowest permissible price under the People’s Republic of China (“PRC”) law.”\textsuperscript{19} The WFOE will have difficulty exercising this right if there are still prohibitions or strict restrictions on the foreign investment in the OpCo’s industry.\textsuperscript{20}

In lieu of recent events, such as the newly drafted Foreign Investment Law by China’s Ministry of Commerce\textsuperscript{21} and the relaxation on foreign investment in previously restricted industries,\textsuperscript{22} such call-option rights might be substantiated in the future. The newly drafted law has been interpreted to indicate that so long as the effective controllers of the VIE are Chinese nationals, the existing VIE in the restricted industries will survive.\textsuperscript{23} Able to acquire up to one hundred percent of the shares in an e-commerce business,\textsuperscript{24} the WFOE can effectively exercise its rights to purchase shares in the OpCo

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\textsuperscript{16} See, e.g., Shi, supra note 7, at 1292.
\textsuperscript{17} See id. at 1291–94 (discussing the notion that misalignment of interests can prompt Chinese owners to walk away with important interests in the VIE but foreign investors are limited in pursuing recovery); see also Guo, supra note 7, at 584.
\textsuperscript{18} See Guo, supra note 8; Roberts & Hall, supra note 10.
\textsuperscript{19} Id.
\textsuperscript{20} Guo, supra note 14.
\textsuperscript{21} Major Tian, What’s Next for the Variable Interest Entity Structure?, CKGSB KNOWLEDGE (Feb. 5, 2015), http://knowledge.ckgsb.edu.cn/2015/02/05/finance-and-investment/whats-next-for-the-variable-interest-entity-structure/.
\textsuperscript{23} Tian, supra note 21.
\textsuperscript{24} Ip, Bailey & Gong, supra note 22.
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without worry of it being invalidated later. This expectation means that once the foreign investors are capable and willing to exercise purchase rights under the Call Option Agreements, foreign investors can effectively gain control over the company and even prevent Chinese owners from manipulating business operations or triggering a management change resembling a takeover.

B. Loan Agreements, Services Agreements & Equity Pledge Agreements

Loan agreements, services agreements, and equity pledge agreements go hand-in-hand. The loan agreements between Chinese owners and the WFOE act as the main investment; the former shall repay the latter out of the OpCo profits. The consulting services agreement or functionally equivalent contracts, such as know-how or trademark licensing contracts, disguise WFOE profits as fees and royalties. On the other hand, equity interests of the OpCo are viewed as security for the loan and other compliance components of the VIE arrangements.

In theory, managers of a corporation only owe fiduciary duties to shareholders as the residual claimants of the corporate value and creditors of the corporation. In the case of a WFOE, shareholders can require stringent covenants in the loan agreement such as limits on repayment methods and acceleration clauses to enforce the VIE structure as a whole. By using debt, agency costs are reduced through various monitoring and bonding mechanisms. The effectiveness of these contractual provisions is predicated by the ability to enforce such agreements. The underlying contract might be rendered unenforceable by PRC courts if it is viewed as “concealing illegal intentions with a lawful form.” Under the current regulatory trend, while possessing interests in a certain industry by foreign investors may not continue to be viewed as “illegal intentions,” contractual provisions are still limited in

25 See Guo, supra note 8; Ma, supra note 1, at 1067–68.
26 Id.
27 Ma, supra note 1, at 1067.
28 Ma, supra note 1, at 1067.
29 Leo E. Strine, Jr, One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 BUS. LAW. 1, 8 (2010).
30 Roberts & Hall, supra note 10, at 3.
32 Ma, supra note 1, at 1070.
their ability to create change at the board and management levels. The most high-profile case echoing these concerns is the dispute between Alibaba and Yahoo, regarding the split of Alipay from its offshore holding company. Yahoo, a major investor of Alibaba’s ListCo, could do nothing but reach a settlement in that instance.

C. Voting Rights Agreements or Power of Attorney Proxy

It is difficult to monitor important corporate decisions of the OpCo by either the WFOE or the ListCo. While it is possible that parties would manage to agree on assigning to the WFOE all of the usual shareholder rights, including voting, attending shareholder meetings, and acting as necessary to execute the call option agreement, there are still governmental hurdles. As discussed, without the Chinese government’s confirmation on the legality of foreign shares, there will always be a chance that corporate decisions will be nullified. A proxy arrangement involving such a situation was recently held unenforceable by the Supreme People’s Court.

CONCLUSION

If the Chinese legal environment remains stagnant in restricting foreign investment in selected industries, the VIE can only achieve a minor improvement to corporate governance. ListCos can continue to try to maximize financial arrangements without participating in any form of the decision-making process of VIE. As the PRC government starts to reduce restrictions, it may appear unnecessary to set up a new VIE since foreign investors could directly purchase equity interests in Chinese companies. Such liberalization

35 Guo, supra note 8, at 579.
36 See Ma, supra note 1 at 1069–70 (discussing that a Hong Kong ListCo’s request of enforcing a proxy arrangement was refused by the Supreme People’s Court on the ground that the arrangement intended to bypass China’s investment restrictions and was consequently invalid because it was “concealing illegal intentions with a lawful form”).
would affect the existing VIE by transforming contractual rights of WFOEs to shareholders, thereby granting them ordinary corporate governance capability.

Zhiyuan Liu*