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Considerations for Investors in Chinese VIE Structures

Recent regulatory developments in the U.S. and in China and calls by investors for more transparency have increased scrutiny on Chinese companies that are listed on U.S. stock exchanges using the "variable interest entities" ("VIEs") structure. Despite progress between U.S. and Chinese regulators to vet the Chinese auditors of these companies (as discussed in more detail below), such scrutiny (with attendant potential for increased litigation) and higher disclosure costs in the U.S. have resulted in more Chinese VIE holding companies delisting from U.S. exchanges to relocate to stock exchanges in China or Hong Kong (or seek secondary listings in Hong Kong as a compromise) or engaging in take-private deals, including management-led buyouts. In addition, recent regulatory developments in China that increase the costs of U.S. listings compared to those in China or Hong Kong, including more stringent rules on providing data outside of China and the possible exclusion of listings in Hong Kong from mandatory data compliance review, may accelerate this "homecoming" trend.

These U.S. delistings and take-private transactions offer risk and opportunity for private fund managers. However, firms invested in VIE holding companies should carefully assess the regulatory risk of such structures to their portfolio. Managers considering participating in take-privates involving such companies should understand the potential for subsequent litigation—most commonly, appraisal actions in the Cayman Islands challenging the deal price and related discovery proceedings initiated in U.S. courts that may impose significant costs on buyers, as well as potential securities lawsuits in U.S. courts.

I. Introduction to VIEs

In part due to the outcry after Enron used off-balance sheet entities to hide liabilities in the early 2000s, U.S. accounting standards require the consolidation of an entity for reporting purposes when the parent company possesses the risks and rewards of ownership over an entity through a contractual structure alone, even without conventional stock ownership. VIEs rely on this method of consolidation for contractually controlled entities, and in recent years, have become a useful tool for investors who wish to gain exposure to companies but are not able to directly invest in the companies due to regulatory restrictions or other commercial reasons. In particular, the structure has permitted Chinese operating companies to access foreign capital that would otherwise not be available due to Chinese government restrictions against foreign ownership in certain industries.

A typical Chinese VIE structure involves the incorporation of a holding company outside of China (most often, in the Cayman Islands). This holding company then enters into a suite of control documents that will give it the ability to exercise control over, and receive economic interests from, a Chinese operating company. The VIE structure is based on contractual arrangements and the holding company does not own any equity interests in the Chinese operating company. Investors invest in the non-Chinese holding company and have no direct investment in the Chinese operating company.

As compared to companies incorporated in China, VIE holding companies can avail themselves of a number of advantages, such as going public outside of China (which would otherwise not be allowed for certain Chinese companies due to restrictions against non-Chinese ownership) and accessing the more flexible financing arrangements available outside of China. Over the past two decades, the VIE structure has been widely used by Chinese companies to go public in international markets, in particular in the U.S., which imposes a less burdensome disclosure-based approach to public listings as compared to stock exchanges and regulators in China (including Hong Kong), which engage in substantive reviews and impose more requirements for listings. Hundreds of VIE-structured Chinese companies have successfully listed in the U.S., including big names such as Alibaba, JD.com and Pinduoduo.

II. New Risks Facing Chinese VIE Holding Companies Listed in the U.S.

Although there has been some positive progress by the U.S. and China in recent months (including the recent signing of the Statement of Protocol by the U.S. Public Company Accounting Oversight Board (the "PCAOB"), the China Securities Regulatory Commission (the "CSRC") and the Ministry of Finance of China on the inspections and investigations of audit firms based in China and Hong Kong), recent regulatory developments in both countries may create new risks for investments in VIE holding companies.

A. U.S. Regulatory Developments

As the relationship between the U.S. and Chinese governments has cooled in recent years, VIE structures face greater scrutiny from the U.S. Securities and Exchange Commission (the "SEC") and under the new Holding Foreign Companies Accountable Act enacted in 2020 (the "HFCAA").

SEC Actions: On July 30, 2021, SEC Chair Gary Gensler published a statement on investor protection requiring additional disclosures by offshore issuers associated with China-based operating companies.[1] Chair Gensler was concerned that "average investors" in VIE holding companies "may not realize that they hold stock in a shell company rather than a China-based operating company." Building on the disclosure guidance for China-based issuers published by the SEC's Division of Corporation Finance in November 2020,[2] Chair Gensler directed SEC staff to ensure that the below additional disclosure items be prominently and clearly disclosed by VIE holding companies seeking to register securities in the U.S.:

- That investors are buying shares of the offshore holding company (i.e., the shell company issuer), instead of the China-based operating company, and that the business of the issuer is different from that of the operating company;

- That the operating company's financial performance and the enforceability of the contractual arrangements as between the issuer and the operating company may be significantly affected by future actions of Chinese regulators;

- Detailed financial information, including quantitative metrics to allow investors to understand the financial relationship between the VIE and the offshore issuer;

- Whether the operating company and the issuer, when applicable, received or were denied permission from Chinese regulators to be listed in the U.S., and the risks that such approval could be denied or rescinded (and a duty to disclose if approval was rescinded); and

- That the HFCAA (discussed in more detail below) may result in the delisting of the issuer in the future if the PCAOB is unable to inspect its public accounting firm.

On September 20, 2021, in furtherance of Chair Gensler's statement, the SEC published a comprehensive Investor Bulletin on U.S Listed Companies Operating Chinese Businesses Through a VIE Structure.[3] The Investor Bulletin explains in detail what a VIE structure is and how it works, and emphasizes in particular the risks with investing in VIE holding companies, including that the Chinese government has never approved these structures, that a breach of the agreements between the holding company and the China-based operating company will likely be subject to Chinese law and jurisdiction, and that there may be conflicts of interest between investors in the U.S.-listed holding company and the legal owners of the China-based operating company. This

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1 *See* SEC, *Statement on Investor Protection Related to Recent Developments in China*.

2 *See* SEC, *Disclosure Considerations for China-Based Issuers*.

3 *See* SEC, *Investor Bulletin: U.S.-Listed Companies Operating Chinese Businesses Through a VIE Structure*

SEC guidance indicates that the SEC is wary of the VIE structure and believes it had the potential to confuse U.S. investors and leave them with limited recourse should the enforceability of the arrangements underlying the structure be tested.

Holding Foreign Companies Accountable Act: The PCAOB, which has historically not had access to auditors in China,[4] adopted a final rule implementing the HFCAA[5] in September 2021. The HFCAA requires the SEC to ban trading in the U.S.-listed securities of China-based companies if the PCAOB is unable to assess auditors within a prescribed time period.

In December 2021, the SEC adopted rules implementing the HFCAA, and in March 2022, the SEC began identifying issuers—including numerous VIE holding companies linked to operating companies based in China—that have used accounting firms that the PCAOB was unable sufficiently to inspect. Among other things, an issuer identified by the SEC must make additional disclosures (e.g., the percentage of the shares owned by Chinese governmental entities) in its next annual report, and, if the issuer is using a VIE structure, it must provide such additional disclosures for both itself and the China-based operating company. If an issuer is so identified by the SEC for three consecutive years,[6] the SEC will prohibit trading in its securities on U.S. stock exchanges and over-the-counter markets. Though the HFCAA is not particularly targeted at VIEs, given the large number of Chinese operating companies listed in the U.S. through the VIE structure, VIEs would be significantly affected by these rules going forward.

In recognition of the SEC rules, on August 26, 2022, the PCAOB signed a Statement of Protocol with the CSRC and the Ministry of Finance of China, which enables the PCAOB to inspect and investigate registered public accounting firms headquartered in mainland China and Hong Kong. Under the framework of the Statement of Protocol, the PCAOB will be able, in its sole discretion, to select the audit firms and clients it will examine and review all audit work papers without any redaction (the requested documents will be provided through the CSRC, and the inspection and investigation work will need to be conducted in Hong Kong). The PCAOB inspectors started their work in Hong Kong in September and will then determine whether it can complete the inspections and investigations by the end of 2022. Though the signing of the Statement of Protocol shows the commitment of China to resolve the audit work paper issues (and to eliminate the impact of HFCAA over Chinese companies listed in the U.S.), both the SEC and HFCAA regard this merely as a step in the process and the effect is yet to be seen.[7]

In the meantime, the SEC has warned Chinese companies against switching their lead audit firms to U.S.-based auditors to avoid the HFCAA. The SEC's chief accountant recently stated in a speech that, "Issuers and accounting firms looking to avoid the uncertainty about whether they will be in compliance with HFCAA . . . . should be forewarned that doing so may well result in investigations and enforcement actions by the PCAOB, the SEC, or both, and that the attendant liabilities may attach not only to the accounting firms and their associated persons, but also to issuers, their audit committees, and officers and directors."[8]

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4 Any company listed in the U.S. must be a reporting company with the SEC, and the audit of the financial statements of any such reporting company must be conducted by an audit firm registered with, and subject to the jurisdiction of, the PCAOB. Registration requires regular PCAOB inspections to assess auditor compliance with legal and professional standards. The PCAOB was restricted from inspecting the audit work and practices of PCAOB-registered audit firms in China (including Hong Kong-based audit firms, to the extent their audit clients have operations in mainland China) with respect to their audit work for U.S.-listed companies with operations in China (including Chinese companies with VIE structures) and in the past audit work papers of the audit firms maintained in China could not be provided to the PCAOB without the consent of Chinese regulators.

5 For more information on the HFCAA, please see our client alert on this subject.

6 Further legislation is being considered in the U.S. to shorten the number of non-inspection years before delisting from three to two, which could result in a company being delisted as soon as 2023.

7 *See* SEC, *Statement on Agreement Governing Inspections and Investigations of Audit Firms Based in China and Hong Kong* and PCAOB, *Statement of Protocol Marks First Step Toward Complete Access for PCAOB to Select, Inspect and Investigate in China*.

8 *See* SEC, *Statement Audit Quality and Investor Protection under the Holding Foreign Companies Accountable Act*.

B. Chinese Regulatory Developments

Chinese regulators have never officially addressed the legitimacy of VIE structures; nor has the enforceability of VIE-control contracts been tested in Chinese courts. While Chinese law remains largely silent on the long-term viability of VIEs, recent regulatory developments in China may hamper the listing of VIE holding companies in the U.S.

CSRC Draft Rules: On December 24, 2021, the CSRC published for public comment Draft Rules that require a Chinese company, including a VIE, to file with the CSRC within three business days after applying for listing on a non-Chinese exchange.[9] While the Draft Rules require prompt notice to the CSRC, it is yet to be seen whether the CSRC will engage in any substantive review of overseas listing applications as a matter of practice.

Negative List: On December 27, 2021, China's National Development and Reform Commission and the Ministry of Commerce promulgated *Special Administrative Measures (Negative List) for the Access of Foreign Investment (2021 Version)*, which provides that overseas listings by Chinese companies that engage in business in which foreign investment is prohibited must be approved by Chinese regulators. No rules have thus far been promulgated on how VIE holding companies may satisfy the requirements of Chinese regulators to be listed in the U.S. or other international markets if the China-based operating company is engaged in any business that is set forth in the Negative List.

New Data Privacy Rules: In response to the U.S. Clarifying Lawful Overseas Use of Data Act (CLOUD Act), China promulgated the *Chinese Data Security Law* in June 2021, which requires review and approval by Chinese authorities before data stored in China can be provided to foreign judicial and law enforcement authorities. In August 2021, the Chinese government issued the *Chinese Personal Information Protection Law*, which imposes restrictions on transferring personal data overseas. And in February 2022, China amended the *Measures for Cybersecurity Review* published in 2020 to impose a mandatory review requirement prior to the overseas listing (potentially excluding listings in Hong Kong) by any network platform operator who possesses personal information of more than one million users. These increasingly restrictive rules on data and privacy may permit the Chinese government to further tighten its control over overseas listings by Chinese companies, including VIE-structured companies, by limiting the flow of data to foreign regulators and requiring pre-review prior to certain overseas listings.

III. Potential Litigation Impact on Private Funds of Increased Take-Privates of Chinese VIE Holding Companies

As the foregoing regulatory developments increase the costs and risks of cross-border listings, a growing number of U.S.-listed, China-based companies are considering taking themselves private from the U.S. stock exchanges—sometimes with the potential to re-list on exchanges in China or Hong Kong. These transactions may expose investment funds involved in the deals to litigation risk, including appraisal proceedings brought by shareholders dissenting from the merger and U.S. securities lawsuits brought on behalf of the issuer's shareholders.

A. Cayman Appraisal Proceedings

For the large number of Chinese VIE holding companies incorporated in the Cayman Islands, a take-private transaction may lead to appraisal proceedings in the Grand Court of the Cayman Islands. Section 238 of the Cayman Islands Companies Act provides shareholders with a statutory right to dissent from the merger of a company and to be paid a judicially determined "fair value" for their shares instead of the merger price.[10] Any dissenting shareholders must first issue a notice of objection and dissent to the company, and if they cannot reach an agreement on the fair value of the dissenters' shares, the company then initiates an appraisal proceeding by filing a petition in the Grand Court. While the appraisal proceeding involves fact discovery, it is largely focused on expert valuation of the "fair" value. The entire process can take two-to-three years to complete.

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9 *Provisions of the State Council on the Administration of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments)* and *Administrative Measures for the Filing of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments).*

10 The take-private transaction is generally structured under the Cayman statutory merger regime, through which the previously listed company is merged with a corporate vehicle wholly owned by the buyer group's holding company.

Section 238 was introduced in the Cayman Islands only in 2009, and in recent years, the number of Section 238 cases has grown substantially, due largely to increasing numbers of take-private deals involving China-based operating companies listed in the U.S. through VIE structures. Dissenting shareholders often include investment funds that specialize in litigation event-driven opportunities. Because Cayman law allows dissenting shareholders to seek an interim payment from the company to mitigate the prejudice from delay in receiving value for their shares, many merger arbitrage funds view these appraisal opportunities as having limited downside and have flooded the space.

Besides the ability to seek interim payment, dissenting shareholders are also likely to find other aspects of a Cayman appraisal proceeding attractive. Compared with Delaware courts which typically have afforded greater weight to the deal price in appraisal proceedings,[11] Cayman courts have been more willing to adopt a blend of alternative valuation approaches, including DCF analyses, that may result in a wider range of potential valuations. Indeed, Cayman courts in five of the only six Section 238 cases that have gone to trial to date have found that the fair value of the company was higher than the merger price, with premiums ranging from 1.29% to 80% (although usually far lower than this upper limit). Most recently, a Cayman court determined that the fair value of a company was the merger price.[12]

Dissenting shareholders in Section 238 proceedings can also take advantage of a U.S. statute, 28 U.S.C. § 1782,[13] to seek discovery in U.S. courts in aid of the Cayman proceeding, including from non-parties to the proceeding, such as financial advisors, consultants, and the acquirers. These non-parties may need to engage in lengthy negotiations and even motion practice in U.S. courts to resolve disputes regarding the proper scope of discovery.[14] Notably, courts have concluded that subpoenas issued pursuant to Section 1782 are subject to the same protections for non-parties provided by the Federal Rules of Civil Procedure, including that a requesting party must "take reasonable steps to avoid imposing undue burden or expense," and that a court must protect non-parties from "significant expense resulting from compliance" with subpoenas, including by shifting attorneys' fees and costs to the requesting party.[15]

B. U.S. Securities Proceedings

Public shareholders in an issuer that delists from a U.S. stock exchange as a result of a take-private deal may also assert claims under the U.S. securities laws in connection with statements made in public filings related to the transaction. Such claims might be asserted under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as well as Section 13(e) of the Exchange Act and Rule 13e-3 thereunder.

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11 *See, e.g.*, *DFC Global Corp*. v. *Muirfield Value Partners, L.P*., 172 A.3d 346 (Del. 2017); *Dell, Inc.* v. *Magnetar Glob. Event Driven Master Fund Ltd*, 177 A.3d 1 (Del. 2017); *Verition Partners Master Fund Ltd.* v. *Aruba Networks, Inc*., 210 A.3d 128 (Del. 2019).

12 *See In the Matter of Integra Group* [2016 (1) CILR 192] (17% premium); *In the Matter of Shanda Games Limited* (CICA 12 of 2017, 9 March 2018) (80% premium); *In the Matter of Qunar Cayman Islands Ltd.* [2019 (1) CILR 611] (2.7% premium); *In the Matter of Nord Anglia Education, Inc* (unreported judgment dated 17 March 2020, Kawaley J.) (16% premium); *In the Matter of Trina Solar Limited* (unreported judgment dated 8 December 2021, Segal J.) (1.29% premium); *In the Matter of FGL Holdings* (unreported judgment dated 20 September 2022, Parker J.) (0% premium).

13 Section 1782 allows the "district court of the district in which a person resides or is found" to order the person to produce documents or give testimony through depositions for use in a foreign proceeding.

14 Documents and data related to Chinese take-private transactions are, not surprisingly, often located in China, and the party responding to discovery would need navigate the new Chinese data laws and regulations discussed above before collecting and producing any information (should it be permitted under Chinese law), imposing additional costs and burden on the producing party.

15 Fed. R. Civ. P. 45(d)(1), (d)(2)(B)(ii); *see also In re Batbold*, 2021 WL 4596536, at *4 (S.D.N.Y. Oct. 6, 2021) (applying Rule 45 to non-party subpoena issued pursuant to Section 1782).

In recent years, shareholders have frequently brought putative class action securities lawsuits in U.S. courts against Chinese issuers following take-privates.[16] The shareholders' claims often allege that the company made false statements to induce shareholders to vote in favor of the merger, which would result in the company being delisted from the U.S. stock exchange and shareholders being cashed out, while secretly planning to relist the company or its affiliates in China or Hong Kong at a higher valuation.

For example, in *Altimeo Asset Management* v*. Qihoo 360 Technology Co.*, 19 F.4th 145, 146 (2d Cir. 2021), the Second Circuit vacated the dismissal of claims against a company and its founders, concluding that the shareholders had adequately alleged that the defendants misleadingly "represented to shareholders that there were no plans to relist the company following a shareholder buyout, when in fact the company had such a plan at the time of the buyout." The court concluded that the shareholders had alleged facts from which it could be inferred that, in order for the company to be relisted when it was, the plan to relist must have commenced by the time of the vote on the merger, a theory supported by contemporaneous media reporting. *See id*.

These lawsuits have sometimes included, in addition to claims against the target company and its directors, claims against members of the buyer consortium. For example, in *In re E-House Securities Litigation*, 2021 WL 4461777 (S.D.N.Y. Sept. 29, 2021), the plaintiffs asserted that statements in the proxy materials that each member of the buyer group believed the merger was substantively and procedurally fair and had no plans for the issuer to enter into any subsequent transactions were false and misleading because they had a plan to relist the company on a stock exchange in Asia after the deal closed. The district court dismissed the claims because the defendants had disclosed the possibility of relisting in the proxy materials and the plaintiffs had not plausibly alleged that there was a concrete plan to relist at the time of the statements. *See id.*

IV. Implications for Private Fund Managers

In light of the growing regulatory risks surrounding Chinese VIEs, fund managers should examine their portfolio to understand the extent of their potential exposure to VIE structures and to evaluate the protections and exit provisions for their investment. Investors should monitor the current legislative, regulatory and other policy trends in both the U.S. and China within the specific industry of their investment and related to overseas listings generally. And as many newly enacted Chinese laws and regulations remain vague and subject to further implementation and refinement by the relevant government agencies, investors should also consider conducting anonymous consultations with national and local government authorities in China to better understand government opinions and trends to determine the potential risks to their investments.

As Chinese government legislation and regulation continues to emphasize data security and privacy, investment managers operating in China should also tighten their own data governance and practices and pay heightened attention to the data security and privacy practices of their existing and potential portfolio companies to better assess the risks that their investment will be forced to delist or otherwise undertake burdensome compliance in order to gain access to foreign capital.

Finally, in the event of a take-private of a portfolio company, investment managers involved as buyers should exercise care to ensure the fairness of the company's valuation and the transaction process. Acquirers should be prepared for potential disputes by dissenting shareholders and anticipate potential discovery requests directed at their U.S. affiliates or employees through Section 1782 proceedings in U.S. courts, and thus should make sure that the transaction is defensible and adequately documented at every stage. Acquirers should also consider, where appropriate, disclosing to shareholders the possibility of subsequent transactions, such as relisting on a Chinese or Hong Kong exchange, including identifying any concrete plans to do so at the time of the deal.

16 *See, e.g.*, *Fasano* v*. E-Commerce China Dangdang Inc.*, 16-cv-8759(KPF) (S.D.N.Y.); *ODS Capital LLC* v. *JA Solar Holdings Co. Ltd*, 1:18-cv-12083-ALC (S.D.N.Y.); *Altimeo Asset Management* v*. Wuxi Pharmatech*, 1:19-cv-01654-AJN (S.D.N.Y.); *In re Shanda Games Limited Securities Litigation*, 1:18-cv-02463-ALC (S.D.N.Y.).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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