Merger Filing Involving a Variable Interest Entity (VIE) Formally Accepted in China for the First Time

Authors:

Michael Han  
Partner, Fangda Partners  
michael.han@fangdalaw.com

Caroline Huang  
Partner, Fangda Partners  
caroline.huang@fangdalaw.com

Bivio Yu  
Associate, Fangda Partners  
bivio.yu@fangdalaw.com
On 20 April 2020, the State Administration for Market Regulation ("SAMR") announced a simple case merger filing with one of the transacting parties structured with a variable interest entity ("VIE"). The announcement was in relation to the "Establishment of a Joint Venture between Shanghai Mingcha Zhegang Management Consulting Co. Ltd. and Huansheng Information Technology (Shanghai) Co., Ltd." ("Mingcha / Huansheng case"). According to the public notice form, one of the joint venture parties - Shanghai Mingcha Zhegang Management Consulting Co. Ltd. ("Mingcha Zhegang") - is structured as a VIE.

This is the first time that SAMR has officially announced a transaction involving a VIE structure. This is a significant milestone as it indicates that the VIE structure may no longer be an obstacle to notifying a transaction to SAMR for merger review.

1

Case Description

The transaction involves the creation of a joint venture between Mingcha Zhegang and Huansheng Information Technology (Shanghai) Co., Ltd. ("Huansheng") to engage in technological development, data processing, artificial intelligence software development, artificial intelligence hardware development and other businesses in the areas of information technology and network technology in the food industry. Mingcha Zhegang and Huansheng will respectively have a 60-40 shareholding in the joint venture, and will have joint control.

Mingcha Zhegang's main business includes providing enterprises with consumer touchpoint measurement and optimization, intelligent analysis and decision-making, and marketing intelligence closed-loop solutions for business and data centers, as well as next-generation human-computer collaborative solutions such as intelligent catering, to provide artificial intelligence solutions for government departments or public utilities.

The Huansheng Group owns in China Kentucky Fried Chicken, Pizza Hut, Taco Bell, East Dawning, Little Sheep and the COFFii & JOY restaurant brands. It is mainly involved in Western fast food, Chinese fast food, hot pot catering, casual dining and other businesses in China. The ultimate controller of Huansheng is Yum China Holdings Inc.

The public notice form specifically mentions that the ultimate controller of Mingcha Zhegang is LEADING SMART HOLDINGS LIMITED, a Cayman-registered company, which controls Mingcha Zhegang through related entities with a series of contractual arrangements. Mingcha Zhegang, therefore, has a VIE structure.
The VIE structure allows for Chinese enterprises to be financed and listed outside China, and for foreign capital to invest in China. Through a series of contracts (rather than shareholding), the VIE structure allows foreign investors to control onshore assets in China that would otherwise have foreign ownership restrictions.

Generally, if a transaction party has a VIE structure, there would usually be difficulties notifying the transaction under China’s merger review process. As part of the notification, transaction parties are required to confirm their standing in China and whether their business complies with applicable laws; this gives rise to problems as the VIE structure is currently a “grey area” under Chinese Law.

Under the Foreign Investment Law of the People’s Republic of China (Draft for comments) issued by the Ministry of Commerce at the beginning of 2015, a wholly foreign-owned entity under a VIE structure is defined as a foreign investor, and any contractual control that it has over an entity in China will be considered a foreign investment. Accordingly, when an entity using the VIE structure carries out a merger notification, the entity would be reviewed as a foreign investor under the corresponding procedure. However, the Foreign Investment Law promulgated on March 15, 2019 limited the scope of the definition of foreign investors and foreign investment, which left the VIE issue unresolved. The longstanding question regarding reviewability of transactions involving VIEs has therefore not been addressed through the legislation of the Foreign Investment Law.

In Sina’s 2009 acquisition of Focus Media, it was reported in the media that the transaction could not be formally accepted for merger review for a long time because of the parties’ VIE structure. The transaction eventually fell apart. In Wal-Mart’s 2012 acquisition of Yihaodian, although the transaction was cleared by the Ministry of Commerce, Wal-Mart was limited to only acquiring Yihaodian’s self-operated e-commerce business, which did not involve the VIE structure. Wal-Mart was prohibited from acquiring Yihaodian’s third-party platform e-commerce business, or from subsequently using the VIE structure to operate a value-added telecommunications business.

China’s Anti-Monopoly Law does not exempt transactions with a VIE structure from having to be notified, and China’s competition authority has never explicitly stated that it will not accept such notifications. However, given the reports on Sina’s failure to acquire Focus Media, it had been widely perceived that transactions involving VIEs would not be accepted for notification under the merger review process.

Past Treatment of the VIE Structure under China’s Merger Review Process

The VIE structure allows for Chinese enterprises to be financed and listed outside China, and for foreign capital to invest in China. Through a series of contracts (rather than shareholding), the VIE structure allows foreign investors to control onshore assets in China that would otherwise have foreign ownership restrictions.

Generally, if a transaction party has a VIE structure, there would usually be difficulties notifying the transaction under China’s merger review process. As part of the notification, transaction parties are required to confirm their standing in China and whether their business complies with applicable laws; this gives rise to problems as the VIE structure is currently a “grey area” under Chinese Law.

Under the Foreign Investment Law of the People’s Republic of China (Draft for comments) issued by the Ministry of Commerce at the beginning of 2015, a wholly foreign-owned entity under a VIE structure is defined as a foreign investor, and any contractual control that it has over an entity in China will be considered a foreign investment. Accordingly, when an entity using the VIE structure carries out a merger notification, the entity would be reviewed as a foreign investor under the corresponding procedure. However, the Foreign Investment Law promulgated on March 15, 2019 limited the scope of the definition of foreign investors and foreign investment, which left the VIE issue unresolved. The longstanding question regarding reviewability of transactions involving VIEs has therefore not been addressed through the legislation of the Foreign Investment Law.

In Sina’s 2009 acquisition of Focus Media, it was reported in the media that the transaction could not be formally accepted for merger review for a long time because of the parties’ VIE structure. The transaction eventually fell apart. In Wal-Mart’s 2012 acquisition of Yihaodian, although the transaction was cleared by the Ministry of Commerce, Wal-Mart was limited to only acquiring Yihaodian’s self-operated e-commerce business, which did not involve the VIE structure. Wal-Mart was prohibited from acquiring Yihaodian’s third-party platform e-commerce business, or from subsequently using the VIE structure to operate a value-added telecommunications business.

China’s Anti-Monopoly Law does not exempt transactions with a VIE structure from having to be notified, and China’s competition authority has never explicitly stated that it will not accept such notifications. However, given the reports on Sina’s failure to acquire Focus Media, it had been widely perceived that transactions involving VIEs would not be accepted for notification under the merger review process.
This includes (1) merger of undertakings; (2) an undertaking acquiring control over other undertakings by acquiring their shares or assets; (3) an undertaking acquiring control over another undertaking or is able to exert decisive influence over other undertaking by contact or any other means.

The notification thresholds are met if either of the following are satisfied (1) the worldwide turnover of all undertakings involved in the concentration exceeds RMB 10 billion in the last accounting year, and the turnover in China of at least two undertakings among them each exceeds RMB 400 million in the last accounting year; (2) the turnover in China of all undertakings involved in the concentration exceeds RMB 2 billion in the last accounting year, and the turnover in China of at least two undertakings among them each exceeds RMB 400 million in the last accounting year.

The notification of transactions involving a VIE has long been an important issue in the enforcement of the Anti-Monopoly Law in China. The VIE structure is common among businesses in the internet sector. As of May 2018, 42% of Chinese companies listed in the United States have utilized a VIE structure. If mergers and acquisitions by these companies are not notifiable in China due to their use of VIEs, this brings uncertainty to the legality of the transactions and these companies’ compliance with applicable laws.

Since its establishment, SAMR has been pushing for a solution to the VIE issue. As the first transaction involving VIE formally accepted by SAMR for notification, the Mingcha / Huansheng case is a milestone as it suggests that VIE structure issue is expected to eventually be resolved, such that transactions involving the VIE structure can be reviewed and approved in a similar way to other transactions.

Once the VIE issue is resolved, we expect SAMR to gradually tighten its enforcement against transactions involving VIEs that cross the notification thresholds in China but have not been notified. It is, therefore, necessary for enterprises using the VIE structure to review any existing strategy they might have of not filing their M&A transactions with the SAMR. Rather, they should evaluate all mergers and acquisitions to determine if these transactions qualify as a notifiable concentration that meet the notification thresholds – in these circumstances, it will be necessary to file the transaction or risk investigations and sanctions.
The Mingcha / Huansheng Case leaves unanswered various questions relating to the VIE structure, due to the limited information in the public notice form. For example:

- It is unclear whether the VIE structure in the Mingcha / Huansheng Case has been used to avoid foreign investment restrictions contained in the Catalogue of Industries for Guiding Foreign Investment (i.e. whether Mingcha Zhegang’s business is in an industry with restrictions or prohibitions on foreign investment). It is therefore uncertain if transactions involving such use of the VIE structure can be notified and reviewed in the usual manner;

- The transaction notified in the Mingcha / Huansheng Case itself does not involve the VIE structure (i.e. the parties’ proposed joint venture does not have a VIE structure). It remains unclear if a case can be notified and reviewed in the usual manner if the notified transaction involves a VIE structure in itself (e.g. the purchaser obtains control over a target via a VIE arrangement);

- The Mingcha / Huansheng Case does not address whether SAMR will investigate and enforce against past transactions involving the VIE structure that were notifiable but had not previously been notified. SAMR’s treatment of such past transactions requires further clarification.

Notwithstanding these uncertainties, the Mingcha / Huansheng Case is still significant as it demonstrates that SAMR will continue to push for a solution to the VIE issue. We will continue to pay close attention to the developments in this space.