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## WORTH THE RISK? USING A VARIABLE INTEREST ENTITY (VIE) TO INVEST IN CHINA

Julie was a portfolio manager for an investment firm in New York City. Her firm did not have a position in Chinese technology companies and decided to acquire one. Accordingly, it asked Julie to select a company that could serve as a test case for this enhancement of the firm's investment strategy. Julie had experience managing technology investments, but had never invested in a Chinese company before. But given the continued growth of the Chinese economy and the rapid development of robotics in China, it seemed increasingly irresponsible for Julie's firm to ignore such investment opportunities.

Julie received a research report about West Lake Dynamics,<sup>1</sup> a robotics company based in Hangzhou that would soon issue an IPO on the NASDAQ. The research report had a few extra paragraphs of cautionary language, specifically about how the intellectual property rights of the company were expected to remain strictly within Chinese borders. Accordingly—the research report went on—investors would not own any rights in the technology nor would they have a say in the direction of research or its funding level at any time.

### Who Invented VIEs?

Julie was curious about the cautionary language. There seemed to be something special about West Lake Dynamics; perhaps it held patents that the Chinese government wanted to control? But what about the direction of future research or its funding level? Why would investors be kept out of the decision-making process in these two areas? Julie thought this deserved a call to the firm's research department. Tom, a senior research analyst, was happy to discuss the situation with Julie.

“We have seen this sort of restrictions in previous US Securities and Exchange Commission (SEC) filings by Chinese companies, especially Chinese technology companies,” Tom said, “so we thought that we would include the cautionary language in the report.” [See **Exhibit 1.**]  
“I have never seen language like that before,” Julie replied, “What is the reason for it?”

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<sup>1</sup> A fictitious company. Any similarity or coincidence with an actual company name is unintended.

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*Pedro de Blas prepared this case under the supervision of David S. Lee for class discussion. This case is not intended to show effective or ineffective handling of decision or business processes. The authors might have disguised certain information to protect confidentiality. Cases are written in the past tense, this is not meant to imply that all practices, organizations, people, places or fact mentioned in the case no longer occur, exist or apply.*

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“The target is an SPV<sup>2</sup> based in Cayman,” Tom said, “two steps removed from the domestic company in China; the domestic company is the VIE.”<sup>3</sup>

That was the first time Julie heard the term “VIE.”

“The foreign company is an SPV based in Cayman because Cayman jurisdiction allows for shares issued with no voting rights,” Tom went on. “The Cayman SPV owns 100% of a WFOE<sup>4</sup> in China.”

“Is that West Lake Dynamics?”

“No,” said Tom, “the WFOE is the end of the ownership line. West Lake Dynamics is not owned by the WFOE, but it is tied to it by a series of contractual agreements; that’s why the domestic company is called a VIE. It is a way to invest in sectors that are restricted by Chinese law to foreign investors.”<sup>5</sup>

“Does it work?” Julie asked.

“It has worked fairly well so far. [See **Exhibit 2.**] The specific control requirements for VIEs were established by the US Financial Accounting Standards Board. Also, consolidated statements with the VIE are now required, following the collapse of Enron. In Enron, financial statements were not consolidated between Enron and its SPVs,<sup>6</sup> which allowed it to hide its liabilities.”<sup>7</sup>

“So, we would be using a structure that was defined by US regulators and is currently being used in China in order to comply with restrictions arising from Chinese investment law?” Julie asked.

“That is correct,” said Tom. “We estimate that around a trillion US dollars are currently invested in VIEs in China. US investors have provided the growth money for a lot of Chinese start-ups exactly in this way. [See **Exhibit 3.**] But it is a nonstandard investment strategy, and there are risks involved.”<sup>8</sup>

Julie understood the definition, but that did little to ease some of her major concerns. What were the risks involved?

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<sup>2</sup> SPV stands for special purpose vehicle.

<sup>3</sup> For two good introductions to the topic of VIEs, see Zeng Xainwu et al., “Variable Interest Entity Structure in China,” *China Law Insights*, King & Wood Mallesons, 9 February 2012, <https://www.chinalawinsight.com/2012/02/articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/>, last accessed 1 April 2019; and O’Melveny’s Report on VIEs, 1 November 2011, <https://www.omm.com/resources/alerts-and-publications/publications/omelveny-myers-publishes-paper-vie-structures-in-china-what-you-need-to-know/>, accessed 1 April 2019. The descriptive aspects of VIEs contained in this case rely extensively on these two references.

<sup>4</sup> WFOE stands for wholly foreign owned enterprise. The acronym is used for limited liability corporations established in mainland China that are wholly owned by foreigners, without the need for any percentage of ownership by Chinese nationals.

<sup>5</sup> Sectors in the Chinese economy are categorized as encouraged, restricted, or prohibited to foreign investors. The list for each of them is very long and subject to changes without notice. For the current state of this question, see the list by BENCHAM, Benelux Chamber of Commerce in China, <https://beijing.bencham.org/news/encouraged-restricted-prohibited-industries-china-2018>, accessed 8 April 2019.

<sup>6</sup> Enron called these SPVs special purpose entities (SPEs), although there is no conceptual difference involved.

<sup>7</sup> The details of this regulation are available at [https://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true](https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true), accessed 25 April 2019. See also Floyd Norris, “Accounting Rules Changed to Bar Tactics Used by Enron,” *New York Times*, 16 January 2003, <https://www.nytimes.com/2003/01/16/business/accounting-rules-changed-to-bar-tactics-used-by-enron.html>, accessed 25 April 2019.

<sup>8</sup> “A legal vulnerability at the heart of China’s big internet firms,” *The Economist*, 16 September 2017, <https://www.economist.com/business/2017/09/16/a-legal-vulnerability-at-the-heart-of-chinas-big-internet-firms>, accessed 5 April 2019.

### **Governance and Flow of Cash in VIE Structures.**

An investment that left the shareholder without any voting rights in the investment target always deserved a detailed risk assessment—Julie thought—because the lack of control of the corporation exacerbated what was known as the principal-agent problem: “How does one ensure that the parties appointed to work in order to maximize your benefit do in fact work with that objective in mind, and not that of their own benefit?” A lot of the corporate governance mechanisms devised to mitigate or solve the principal-agent problem required the principal to own at least a share of the corporation and to be able to exercise voting rights as well as other rights related to audit and control of the operations.

In the case of VIE structures, the shareholders didn’t own shares in the investment target, which made appointing directors, setting the company’s funding priorities, overseeing expenses, or exercising some aspect of control over the operations very difficult. [See **Exhibit 4.**]

“Tell me more about the contractual agreements between the WFOE and the Chinese companies,” Julie said. She felt certain that there needed to be a good measure of control; otherwise the investment would not make sense.

“We may have to involve the legal department if you want more specific details,” Tom said.

A few hours later, Julie managed to get Antonio from legal on a conference call with Tom and herself. Antonio had spent three years at a major law firm in Shanghai and knew how VIEs worked from the point of view of Chinese law, specifically after the cash from foreign investors has crossed the border and reached the WFOE.

“We don’t have complete visibility on this, and I doubt that the situation will improve in the future,” Antonio began. “But I can tell you from experience and research that the WFOE typically signs a series of agreements with the VIE and often also with a number of individuals that are essential for its funding, operations and management.”

“Who are those individuals?” Tom asked.

“They are PRC individuals who may or may not have formed a partnership for the management of the VIE. It is unclear how or how often these partners are chosen, appointed, or removed. But at least some VIEs do not have directors appointed by any shareholders, but they are instead run by these partnerships of individuals; sometimes they also own part of or the entire VIE: Alibaba is an example of this,” Antonio continued.

The following 30 minutes involved a lot of description by Antonio of the agreements in question. The basic piece was a loan agreement between the WFOE and the PRC individuals. Disbursements under this agreement were used to capitalize the VIE.

“So that is how capitalization works,” Julie interjected. “But what about dividends?”

To ensure the flow of cash to the WFOE during operations, Antonio explained, there was also a consulting and service agreement through which the WFOE provided a range of specific services—strategic or marketing services, for example—to the VIE for a fee. The payment of this fee was, of course, the way the VIE’s profits were paid into the WFOE. If the WFOE had intellectual property assets that might be of use to the VIE, there might also be a license agreement between the WFOE and the VIE. That was an additional source of income for the WFOE.

“I see,” Tom said. “But it sounds like the WFOE should definitely have a measure of control of the VIE. After all, the VIE and the PRC individuals who run it seem to be very dependent on the WFOE.”

Tom was right. Antonio proceeded to explain that there was also a voting rights agreement (also known as a proxy agreement) through which the PRC individuals and the VIE authorized the WFOE to exercise voting rights in the VIE.

“I am missing a guarantee here,” Julie said. “The loan agreement provides funds in lieu of an equity investment, but I have heard nothing in your list of agreements that would protect the WFOE from the PRC individuals or the VIE defaulting on its respective obligations.”

“Well, I wasn’t finished yet,” Antonio responded. “The guarantee you are looking for is provided by an equity pledge agreement among the WFOE, the PRC individuals, and the VIE, through which the PRC individuals pledge their equity in the VIE as a guarantee of their performance under all the agreements I have just told you about.”

“I see,” Julie said, but she sounded only half-convinced by this long list of agreements and the summary description of their contents.

“One more thing, before we finish,” Tom quickly interjected. “What if the earnings per share of the VIE far exceed expectations? The WFOE is only entitled to repayment of the loan, and perhaps a license fee, from the VIE. That may be enough to channel the VIE profits to the WFOE, but it leaves the WFOE out of any increases in share price.”

“Great question, Tom,” Antonio responded before continuing. “The last piece of the architecture is a call option agreement among the WFOE, the PRC individuals, and the VIE. This agreement gives the WFOE the right to have the equity held by the PRC individuals in the VIE transferred to the WFOE or to a designated entity or individual, at the lowest price that is legal in the PRC.”

### **When VIEs Went Wrong**

After the conference call, Julie asked Tom for a follow-up meeting the next day. She had heard a lot of descriptive language so far, but she wanted the research department to look into particular cases to see how VIEs had worked or failed. She now understood the architecture of a VIE, was aware of the risks, and needed to quantify them. The best way to do this was to find cases in which the VIE investment had not worked as anticipated, and to find out the reasons. By now, Tom also wanted to know more about VIEs, and he started his research immediately.

The research turned up several interesting cases of companies listed in the US that had experienced problems with their VIE structures in China: in the case of some companies, like Sina or Agria Corporation, the relationship between the PRC individuals and the respective VIEs had experienced problems because of changes in the identity of the individuals and an ensuing less-than-optimal performance by the VIE of its contractual obligations, although in both cases, the situation was resolved out of court. These cases dated back to the 2000s.<sup>9</sup>

In some later cases dated after 2010, like GigaMedia or Alipay, the problems had been more severe. GigaMedia faced a situation in which the founder of the VIE was removed from management against his will, and he retained documentation and certain other means of

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<sup>9</sup> For further background on these cases, see Zeng Xianwu et al., “Variable Interest Structure in China”; and Xu Ping, “Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge,” *China Law Insights*, King & Wood Mallesons, 20 October 2011, <https://www.chinalawinsight.com/2011/10/articles/corporate/foreign-investment/variable-interest-entity-vie-structure-for-foreign-investment-in-the-prc-may-face-challenge/>, accessed 1 April 2019.

authentication that made the day-to-day running of the company very difficult. This forced GigaMedia to sue in local courts. However, since the VIE held an online gaming license, the tribunal held that the VIE agreement was invalid, since it gave control to a foreign corporation over an activity that was prohibited to foreigners in the PRC.<sup>10</sup>

In the case of Alipay, the situation was more complex. In a nutshell, Yahoo, SoftBank, and other shareholders (including Jack Ma) owned Alibaba Group Ltd., whose main source of revenue was the operations that took place in China through the VIE Zhejiang Alibaba, of which Jack Ma was a cofounder. Alibaba Group Ltd. also owned a substantial share of Alipay, which was a separate company in China. The online payment aspect of Zhejiang Alibaba's business—to be provided by Alipay—required a special license from the PRC authorities, which could not be given to a company under foreign control. For that reason, Jack Ma claimed that Alipay had to be transferred into the VIE Zhejiang Alibaba, and he effected that transfer in 2011, allegedly without bringing the decision to the board of Alibaba Group Ltd.<sup>11</sup> Foreign shareholders saw the value of their investment negatively affected by a decision over which they had no effective control. Of course, if the VIE Zhejiang Alibaba had instead been owned by the foreign shareholders, the transfer might not have taken place, but the decision to acquire Alipay was an internal matter of the VIE, and therefore outside of foreign investors' control. The issue was eventually resolved by providing monetary compensation to the foreign shareholders of Alibaba Group Ltd.

In 2012, New World Oriental, a Beijing WFOE that operated VIEs throughout China, announced the replacement of its chief executive, and subsequently an SEC investigation followed due to accounting irregularities.<sup>12</sup> Apparently, the accounting consolidation of the VIE had not been done correctly, because the agreement between New World Oriental and the VIEs was insufficient in covering all profits generated by the VIEs. There was also a lack of clarity regarding the actual ownership of some schools in China. Given the lack of equity in the VIEs, the residual profits were very difficult to channel to the WFOE, and therefore it was hard to decide whether those residual profits could be consolidated. The announcement of the SEC investigation made New Oriental stock plummet more than 30% in one day. Eventually the ownership issue was clarified, and the SEC was satisfied with New Oriental's filings, but the stock price did not recover.

At this point, it was clear to Julie that none of these cases were reassuring about the stability or even the regular operation of VIE structures. She believed that the problem resided mainly in the ease with which PRC individuals could step in or out of involvement with the management of the VIE, their limited accountability toward foreign investors, and the inadequacy of using a service agreement to arrange for the payment of fees in an amount that will match exactly the profits of the VIE. One could add to those problems the difficulty of obtaining financial information about the VIE when the foreign investors were excluded from corporate control and had no voting rights in the WFOE.

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<sup>10</sup> D. Harris, "Gigamedia and the Perils of VIEs; Dude, Where's My Chop?," Harris/Bricken, 30 June 2011, <https://www.chinalawblog.com/2011/06/vie.html>, accessed 3 April 2019; and C. Comey et al., "China VIEs: Recent Developments and Observations," Morrison Foerster, 19 August 2013, <http://www.mondaq.com/unitedstates/x/258650/Contract+Law/China+VIEs+Recent+Developments+And+Observations>, accessed 3 April 2019.

<sup>11</sup> See P. Gillis, "Alibaba and the Disappearing VIE," *China Accounting* (Blog), 16 May 2011, <http://www.chinaaccountingblog.com/weblog/alibaba-and-the-disappearin.html>, accessed 1 April 2019; and Xu Ping, "Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge."

<sup>12</sup> "What is VIE issue surrounding New Oriental?," China.org.cn, 31 July 2012, [http://www.china.org.cn/business/2012-07/31/content\\_26075616.htm](http://www.china.org.cn/business/2012-07/31/content_26075616.htm), last accessed 8 April 2019.

## **VIEs and the Government of the PRC**

By now, Julie had started to wonder whether investing in Chinese VIEs was a good idea. She remembered from previous conversations that VIEs were developed to get around the restriction by the PRC government of foreign investment in some sectors. When did that happen? Was the PRC government going to change its position about any of those sectors, or about the legality of VIEs?

Some more research by Tom, and another call to Antonio in legal, yielded some valuable information. Initially, the PRC government seemed to be indifferent to the use of VIEs as legal architecture that would formally respect the prohibitions and yet allow for significant influx of capital into new Chinese companies. The Sina VIE in 2000 was probably the beginning of the story in this respect. However, because more than 100 Chinese-listed companies in the US used the VIE structure and the level of investment was then around USD1trn, the PRC government started to pay specific attention to the VIE structures.

The PRC government's position seemed to permit VIEs, but the situation was far from stable and there could be changes in the future. [See **Exhibit 5**.]

## **Should We Use VIEs?**

Julie spent most of her week considering the risks associated with investment in VIEs. She developed a good understanding of the VIE structure and was aware of a few problems that already developed. She also knew that a sizable percentage of all US investment in China relied on VIE structures. Furthermore, the VIE structure was the only option available for investment in some sectors of the Chinese economy, most notably, the technology sector.

As a portfolio manager, Julie didn't really like to have long discussions with risk officers, but perhaps this had to be the next step in this process. However, the absence of data regarding the reliability of the VIE structure, particularly regarding the enforceability of the contracts in Chinese courts and the accountability of the PRC individuals who effectively controlled the VIEs, seemed to be difficult to overcome. What were the avenues to quantify risk when it was unclear what all the risks were and whether they could be effectively mitigated or dispelled?

At the same time, the Chinese economy continued to grow, and many interesting Chinese technology and other start-ups would undoubtedly seek capital from overseas markets in the future. Excluding such investment opportunities was simply not going to be possible moving forward. And, of course, with the West Lake Dynamics IPO approaching quickly, Julie was under time pressure to decide for or against the investment.

At least now she knew some of the questions that needed to be answered: Should investing in a VIE be considered without regard to the prospects of the relevant sector becoming liberalized and therefore open to foreign ownership in the future? How should she think about risk when traditional corporate governance principles did not seem applicable? What was the level of risk associated with the background of the PRC individuals who founded and/or owned the VIE? Were there mechanisms that could be developed to ensure accountability of the PRC individuals toward foreign investors?

**EXHIBIT 1: EXCERPT FROM ALIBABA GROUP HOLDINGS IPO FILING (2014)****Risks Related to Our Corporate Structure**

***The Alibaba Partnership and related voting agreements will limit your ability to nominate and elect directors.***

Our articles of association, as we expect them to be amended and become effective upon completion of this offering, will have the effect of allowing the Alibaba Partnership to nominate a simple majority of our board of directors. In addition, we expect to enter into a voting agreement that will take effect upon the completion of this offering, pursuant to which both SoftBank and Yahoo will agree to vote their shares in favor of the Alibaba Partnership director nominees at each annual general shareholders' meeting. Furthermore, we expect the voting agreement to provide that SoftBank will have the right to nominate one director to our board and that right will also be reflected in our articles of association that will become effective upon completion of this offering. In addition, pursuant to such voting agreement, Yahoo, Jack Ma and Joe Tsai will agree to vote their shares (including shares for which they have voting power) in favor of the election of the SoftBank director nominee at each annual general shareholders meeting and SoftBank will agree to grant the voting power of any portion of its shareholdings exceeding 30% of our issued and outstanding ordinary shares to a voting trust to be voted at the direction of Jack and Joe. This governance structure and contractual arrangement will limit your ability to influence corporate matters, including any matters determined at the board level. In addition, the nomination right granted to the Alibaba Partnership will remain in place for the life of the Alibaba Partnership unless our articles of association are amended to provide otherwise by a vote of shareholders representing at least 95% of shares that vote at a shareholders meeting. The nomination rights of the Alibaba Partnership will remain in place notwithstanding a change of control or merger of our company. These provisions could have the effect of delaying, preventing or deterring a change in control, and could limit the opportunity for our shareholders to receive a premium for their ADSs, and could also materially decrease the price that some investors are willing to pay for our ADSs. Immediately after the completion of this offering, the partners of the Alibaba Partnership will hold approximately % of our ordinary shares (including unvested shares and shares underlying vested and unvested awards). See "Alibaba Partnership."

***Our articles of association contain anti-takeover provisions that could adversely affect the rights of holders of our ordinary shares and ADSs.***

Our articles of association, as we expect them to be amended and become effective upon completion of this offering, contain certain provisions that could limit the ability of third parties to acquire control of our company, including:

- a provision that grants authority to our board of directors to establish from time to time one or more series of preferred shares without action by our shareholders and to determine, with respect to any series of preferred shares, the terms and rights of that series;

- a provision that grants the Alibaba Partnership the right to nominate a simple majority of our board of directors notwithstanding a change of control or merger of our company; and
- a classified board with staggered terms that will prevent the replacement of a majority of directors at one time.

These provisions could have the effect of delaying, preventing or deterring a change in control, and could limit the opportunity for our shareholders to receive a premium for their ADSs, and could also materially decrease the price that some investors are willing to pay for our ADSs.

***SoftBank will continue to own more than 30% of our issued and outstanding ordinary shares after the completion of this offering and its interests may differ from those of our other shareholders.***

Immediately after this offering and assuming no exercise by the underwriters of their option to purchase additional shares, SoftBank will own approximately % of our issued and outstanding ordinary shares. SoftBank has agreed to grant the voting power of any portion of its shareholding exceeding 30% of our issued and outstanding ordinary shares to a voting trust to be voted at the direction of Jack Ma and Joe Tsai. Under the terms of the voting agreement we expect to enter into, SoftBank will also have the right to nominate one member of our board of directors, and Yahoo, Jack and Joe will agree to vote their shares (including shares for which they have voting power) in favor of the SoftBank director nominees at each annual general shareholders meeting. SoftBank's director nomination right will also be reflected in our amended articles of association that will become effective upon the completion of this offering. Except with regard to shareholder votes relating to the Alibaba Partnership director nominees, SoftBank will have significant influence over the outcome of matters that require shareholder votes and accordingly over our business and corporate matters. SoftBank may exercise its shareholder rights in a way that it believes is in its best interest, which may conflict with the interest of our other shareholders. These actions may be taken even if SoftBank is opposed by our other shareholders, including those who purchase ADSs in this offering.

For more information, see “Related Party Transactions — Transactions and Agreements with Yahoo and SoftBank — Voting Agreement.”

***If the PRC government deems that the contractual arrangements in relation to our variable interest entities do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties or be forced to relinquish our interests in those operations.***

Foreign ownership of certain types of Internet businesses, such as Internet information services, is subject to restrictions under applicable PRC laws, rules and regulations. For example, foreign investors are generally not permitted to own more than 50% of the equity interests in a value-added telecommunication service provider. Any such foreign investor must also have experience and a good track record in providing value-added telecommunications services overseas.

While the significant majority of our revenue was generated by our wholly-foreign owned enterprises in the nine months ended December 31, 2013, we provide Internet information services in China, which are critical to our business, through a number of PRC incorporated variable interest entities. The variable interest entities are owned by PRC citizens who are our founders or senior employees or by PRC entities owned by such PRC citizens, or the variable interest entity equity holders, with whom we have contractual arrangements, or the contractual arrangements. The contractual arrangements give us effective control over each of the variable interest entities and enable us to obtain substantially all of the economic benefits arising from the variable interest entities as well as consolidate the financial results of the variable interest entities in our results of operations. Although the structure we have adopted is consistent with longstanding industry practice, and is commonly adopted by comparable companies in China, the PRC government may not agree that these arrangements comply with PRC licensing, registration or other regulatory requirements, with existing policies or with requirements or policies that may be adopted in the future.

In the opinion of Fangda Partners, our PRC counsel, the ownership structures of our material wholly-foreign owned enterprises and our material variable interest entities in China, both currently and immediately after giving effect to this offering, do not and will not violate any applicable PRC law, regulation or rule currently in effect; and the contractual arrangements between our material wholly-foreign owned enterprises, our material variable interest entities and their respective equity holders governed by PRC law are valid, binding and enforceable in accordance with their terms and applicable PRC laws and regulations currently in effect and will not violate any applicable PRC law, rule or regulation currently in effect. However, Fangda Partners has also advised us that there are substantial uncertainties regarding the interpretation and application of current PRC laws, rules and regulations. Accordingly, the PRC regulatory authorities and PRC courts may in the future take a view that is contrary to the opinion of our PRC legal counsel.

It is uncertain whether any new PRC laws, rules or regulations relating to variable interest entity structures will be adopted or if adopted, what they would provide. If we or any of our variable interest entities are found to be in violation of any existing or future PRC laws, rules or regulations, or fail to obtain or maintain any of the required permits or approvals, the relevant PRC regulatory authorities would have broad discretion to take action in dealing with such violations or failures, including revoking the business and operating licenses of our PRC subsidiaries or the variable interest entities, requiring us to discontinue or restrict our operations, restricting our right to collect revenue, blocking one or more of our websites, requiring us to restructure our operations or taking other regulatory or enforcement actions against us. If we are not able to restructure our ownership structure and operations in a satisfactory manner, we would no longer be able to consolidate the financial results of our variable interest entities in our consolidated financial statements. Any of these events would have a material adverse effect on our business, financial condition and results of operations.

***Our contractual arrangements may not be as effective in providing control over the variable interest entities as direct ownership.***

We rely on contractual arrangements with our variable interest entities to operate part of our Internet businesses in China and other businesses in which foreign investment is restricted or prohibited. For a description of these contractual arrangements, see “Our History and Corporate Structure — Contractual Arrangements among Our Wholly-foreign Owned Enterprises, Variable Interest Entities and the Variable Interest Entity Equity Holders.” These contractual arrangements may not be as effective as direct ownership in providing us with control over our variable interest entities.

If we had direct ownership of the variable interest entities, we would be able to exercise our rights as an equity holder directly to effect changes in the boards of directors of those entities, which could effect changes at the management and operational level. Under our contractual arrangements, we rely on the variable interest entities and the variable interest entity equity holders to perform their obligations in order to exercise our control over the variable interest entities. The variable interest entity equity holders may have conflicts of interest with us or our shareholders, and they may not act in the best interests of our company or may not perform their obligations under these contracts. We may replace the equity holders of the variable interest entities at any time pursuant to the contractual arrangements. However, if any dispute relating to these contracts remains unresolved, we will have to enforce our rights under the contractual arrangements through the operations of PRC law and courts, which will be subject to uncertainties in the PRC legal system. Consequently, the contractual arrangements may not be as effective in ensuring our control over the relevant portion of our business operations as direct ownership.

***Any failure by our variable interest entities or their equity holders to perform their obligations under the contractual arrangements would have a material and adverse effect on our business, financial condition and results of operations.***

If our variable interest entities or their equity holders fail to perform their respective obligations under the contractual arrangements, we may have to incur substantial costs and expend additional resources to enforce such arrangements. We have entered into call option agreements in relation to each variable interest entity, which provide that we may exercise an option to acquire, or nominate a person to acquire, ownership of the equity in that entity or, in some cases, its assets, to the extent permitted by applicable PRC laws, rules and regulations. We have also entered into equity pledge agreements with respect to each variable interest entity to secure certain obligations of such variable interest entity or its equity holders to us under the contractual arrangements. However, the enforcement of such agreements through arbitral or judicial agencies may be costly and time-consuming. Moreover, our remedies under the equity pledge agreements are primarily intended to help us collect debts owed to us by the variable interest entities or the variable interest entity equity holders under the contractual arrangements and may not help us in acquiring the assets or equity of the variable interest entities.

In addition, although the terms of the contractual arrangements provide that they will be binding on the successors of the variable interest entity equity holders, as those

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successors are not a party to the agreements, it is uncertain whether the successors in case of the death, bankruptcy or divorce of a variable interest entity equity holder will be subject to or will be willing to honor the obligations of such variable interest entity equity holder under the contractual arrangements. If the relevant variable interest entity or its equity holder (or its successor), as applicable, fails to transfer the shares of the variable interest entity according to the respective call option agreement or equity pledge agreement, we would need to enforce our rights under the call option agreement or equity pledge agreement, which may be costly and time-consuming and may not be successful.

The contractual arrangements are governed by PRC law and provide for the resolution of disputes through arbitration or court proceedings in China. Accordingly, these contracts would be interpreted in accordance with PRC law and any disputes would be resolved in accordance with PRC legal procedures. The legal system in the PRC is not as developed as in some other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could limit our ability to enforce the contractual arrangements. Under PRC law, if the losing parties fail to carry out the arbitration awards or court judgments within a prescribed time limit, the prevailing parties may only enforce the arbitration awards or court judgments in PRC courts, which would require additional expense and delay. In the event we are unable to enforce the contractual arrangements, we may not be able to exert effective control over the variable interest entities, and our ability to conduct our business, as well as our financial condition and results of operations, may be materially and adversely affected.

***We may lose the ability to use, or otherwise benefit from, the licenses, approvals and assets held by our variable interest entities, which could severely disrupt our business and harm our growth.***

Although the significant majority of our revenues are generated, and the significant majority of our operational assets are held, by our wholly-foreign owned enterprises, which are our subsidiaries, our variable interest entities hold licenses and approvals and assets that are necessary for our business operations, as well as equity interests in a series of our portfolio companies, to which foreign investments are typically restricted or prohibited under applicable PRC law. The contractual arrangements contain terms that specifically obligate variable interest entity equity holders to ensure the valid existence of the variable interest entities and restrict the disposal of material assets of the variable interest entities. However, in the event the variable interest entity equity holders breach the terms of these contractual arrangements and voluntarily liquidate our variable interest entities, or any of our variable interest entities declares bankruptcy and all or part of its assets become subject to liens or rights of third-party creditors, or are otherwise disposed of without our consent, we may be unable to conduct some or all of our business operations or otherwise benefit from the assets held by the variable interest entities, which could have a material adverse effect on our business, financial condition and results of operations. Furthermore, if any of our variable interest entities undergoes a voluntary or involuntary liquidation proceeding, its equity holders or unrelated third-party creditors may claim rights to some or all of the assets of such variable interest entity, thereby hindering our ability to operate our business as well as harm our growth.

***The equity holders, directors and executive officers of the variable interest entities may have potential conflicts of interest with our company.***

PRC laws provide that a director and an executive officer owes a fiduciary duty to the company he or she directs or manages. The directors and executive officers of the variable interest entities, including Jack Ma, our lead founder and executive chairman, must act in good faith and in the best interests of the variable interest entities and must not use their respective positions for personal gain. On the other hand, as a director of our company, Jack has a duty of care and loyalty to our company and to our shareholders as a whole under Cayman Islands law. As a result, conflicts of interests may arise due to dual roles both as directors and executive officers of the variable interest entities and as directors of our company, and may also arise due to dual roles both as variable interest entity equity holders and as directors of our company.

We cannot assure you that these individuals will act in the best interests of our company should any conflicts of interest arise, or that any conflicts of interest will be resolved in our favor. These individuals may breach or cause the variable interest entities to breach the existing contractual arrangements. If we cannot resolve any such conflicts of interest or any related disputes, we would have to rely on legal proceedings to resolve these disputes and/or take enforcement action under the contractual arrangements. There is substantial uncertainty as to the outcome of any such legal proceedings. See “— Any failure by our variable interest entities or their equity holders to perform their obligations under the contractual arrangements would have a material and adverse effect on our business, financial condition and results of operations.”

***The contractual arrangements with our variable interest entities may be subject to scrutiny by the PRC tax authorities. Any adjustment of related party transaction pricing could lead to additional taxes, and therefore substantially reduce our consolidated net income and the value of your investment.***

The tax regime in China is rapidly evolving and there is significant uncertainty for taxpayers in China as PRC tax laws may be interpreted in significantly different ways. The PRC tax authorities may assert that we or our subsidiaries or the variable interest entities or their equity holders owe and/or are required to pay additional taxes on previous or future revenue or income. In particular, under applicable PRC laws, rules and regulations, arrangements and transactions among related parties, such as the contractual arrangements with our variable interest entities, may be subject to audit or challenge by the PRC tax authorities. If the PRC tax authorities determine that any contractual arrangements were not entered into on an arm’s length basis and therefore constitute a favorable transfer pricing, the PRC tax liabilities of the relevant subsidiaries and/or variable interest entities and/or variable interest entity equity holders could be increased, which could increase our overall tax liabilities. In addition, the PRC tax authorities may impose late payment interest. Our net income may be materially reduced if our tax liabilities increase.”

**Source: Securities and Exchange Commission, Form F-1, Registration Statement for Alibaba Group Holding Limited, as filed on 6 May 2016, <https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm>, accessed 5 April 2019.**

**EXHIBIT 2: NUMBER OF CHINESE VIE IPOs, 2000–2017**

<b>Number of Chinese VIE IPOs</b>	<b>Year</b>
5	2000
1	2002
1	2003
4	2004
3	2005
1	2006
4	2007
2	2008
4	2009
13	2010
4	2011
2	2012
2	2013
9	2014
7	2015
6	2016
20	2017

Source: B. Whitehill, “Buyer Beware: Chinese Companies and the VIE Structure,” Council of Institutional Investors, December 2017, [https://www.cii.org/files/publications/misc/12\\_07\\_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf](https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf), accessed 5 April 2019.

**EXHIBIT 3: 10 LARGEST LISTED CHINESE FIRMS USING THE VIE STRUCTURE**

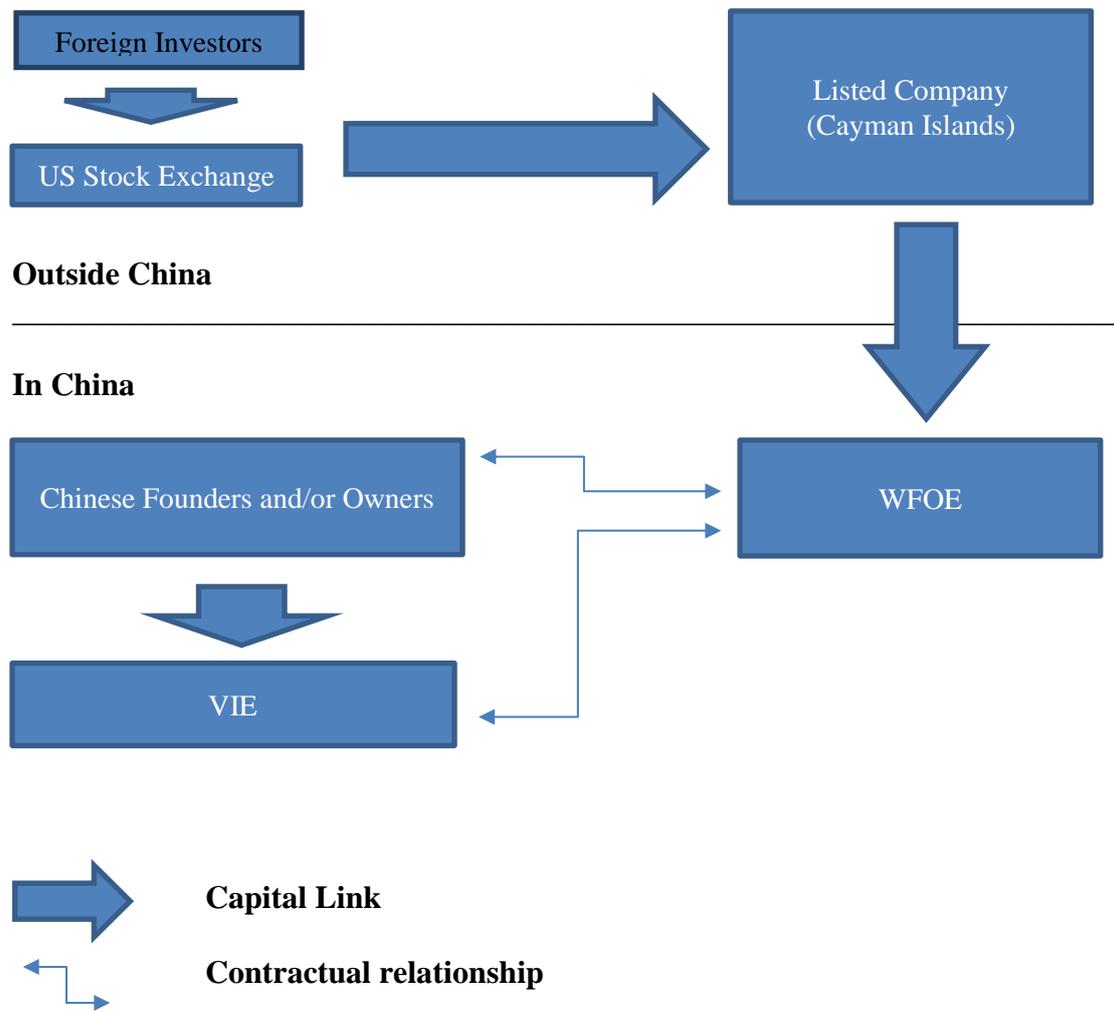
Between 2000 and 2017, 88 Chinese firms using the VIE structure were listed on either the NASDAQ or NYSE, for a cumulative market capitalization close to USD1trn.

The 10 largest are:

<b>Company</b>	<b>Market Capitalization (in \$ Million)</b>	<b>Sector</b>	<b>IPO Year</b>
NetEase, Inc.	39,660.62	Miscellaneous	2000
Ctrip.com International Ltd.	23,860.68	Miscellaneous	2003
Baidu, Inc.	82,448.61	Technology	2005
New Oriental Education and Technology Group, Inc.	13,337.20	Consumer Services	2006
TAL Education Group	14,595.51	Consumer Services	2010
Alibaba Group Holding Ltd.	472,422.40	Miscellaneous	2014
JD.com	58,852.81	Consumer Services	2014
Weibo Corporation	23,741.91	Technology	2014
ZTO Express (Cayman) Inc.	12,147.56	Transportation	2016
Qudian Inc.	8,987.28	Finance	2017

**Source: B. Whitehill, "Buyer Beware: Chinese Companies and the VIE Structure," Council of Institutional Investors, December 2017,**

[https://www.cii.org/files/publications/misc/12\\_07\\_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf](https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf), accessed 5 April 2019.

**EXHIBIT 4: THE VIE STRUCTURE**

**EXHIBIT 5: PRC LAW REGARDING VIES<sup>13</sup>**

The 13 July 2006 Circular of the PRC Ministry of Industry and Information Technology (MIIT) on Strengthening the Administration of Foreign Investment in Value-Added telecommunications Services was the first attempt to regulate VIEs. The circular forbids a Chinese company that holds a telecom license in China to lease or sell that license, and it states that the VIE structure is not favored by the PRC government. In addition, it requires Chinese telecom companies to obtain prior authorization from the government to list abroad. Further regulations establish similar limits for online gaming companies.

In 2011, the State Council approached the issue from a more general perspective and initiated a series of normative measures that seek to regulate mergers and acquisitions of Chinese companies by foreign investors, in the interest of national security, so broadly understood that it includes both defense and economic security. Although VIEs are not explicitly mentioned, the purpose of the norms seems to be to allow the PRC government to intervene in any operation that may result in the control of domestic companies by foreign investors, whether by ownership or by contractual agreements.

The first case involving VIEs was decided by the Supreme Court of the PRC in July 2016 and concerned the sale in 2009 by Changsha Yaxing Property Development Company Ltd. (Yaxing) of a controlling equity interest in a kindergarten and an elementary school in Changsha, Hunan province, to Beijing Normal University Ambow Education Technology Co. Ltd. (Ambow), a VIE of Beijing Ambow Online Software Co. Ltd. (Ambow WFOE).

Yaxing had sued Ambow claiming that the sale was null and void, on the grounds that Ambow is a VIE controlled by Ambow WFOE, and foreign entities cannot have controlling interests in the sector of compulsory education. The PRC Supreme Court upheld the sale as a sale to the Ambow VIE, but it did not rule on the legality of the agreements between Ambow WFOE and Ambow VIE. Instead, it deferred that question to the Ministry of Education, which must ensure that foreigners do not control operations in this sector. It would therefore be wrong to see this PRC Supreme Court decision as an unqualified endorsement of the VIE structure.

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<sup>13</sup> The content of this exhibit relies heavily on information contained in Zeng Xainwu et al., “Variable Interest Entity Structure in China”; M. Schaub et al., “China: VIEs Alive and Well,” *China Law Insights*, King & Wood Mallesons, 4 March 2019, <https://www.chinalawinsight.com/2019/03/articles/investment-management/china-vies-alive-and-well/>, accessed 1 April 2019; and J. Y. Liu et al., “VIE Validity Still Unsure,” Pillsbury, 22 March 2017, <https://www.pillsburylaw.com/en/news-and-insights/vie-validity-still-unsure.html>, accessed 4 April 2019. These references contain a much more detailed and nuanced discussion of this topic.