Client Alert

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PRC Challenge to Variable Interest Entity Structures?

by Thomas M. Shoesmith

Buddha Steel (OTCBB:AGVO) has just withdrawn its registration statement filed in connection with a $38 million underwritten public offering in the United States. The company disclosed in an 8-K filed on March 28, 2011 that the offering was being pulled because the PRC government had disallowed its variable interest entity (VIE) structure. It is not clear whether this is a highly sector-focused event, part of a broader move by the PRC government against VIE structures—or, as we think most likely, a "one-off" event driven by local facts and circumstances. We are watching events closely and will provide updates as they become available.

Background

In April 2010, Buddha Steel, then called A.G. Volney Center, Inc., acquired a Hong Kong company in a share exchange transaction. The Hong Kong company had a wholly-owned subsidiary in China (WFOE), which in turn had a customary suite of VIE, or "variable interest entity," agreements giving it control over and all the economic benefits of a cold-rolled steel company in Hebei Province. These types of arrangements have become common in China, particularly where direct foreign ownership of the operating company is not permitted under PRC law. The arrangements are not typically submitted for approval by the PRC authorities, and there is no reason to believe they were in this case.

In September 2010, Buddha Steel filed a registration statement for a public offering in the US. The reverse merger and the VIE arrangement were fully disclosed, again as customary in these types of transactions. The S-1 registration statement then proceeded into the SEC comment period. There is no indication in the information available to the public that any concerns existed or were raised as to the validity or enforceability of the VIE agreements; again, these types of arrangements are common in China and there are scores of companies now trading in the US that operate in China through VIE structures.

In March 2011, however, the local government authorities in Hebei Province apparently advised the operating company that the VIE agreements "contravene current Chinese management policies related to foreign-invested enterprises and are against public policy." As a result, the company decided to terminate its relationship with the steel company. This ended any operations for Buddha and it reverted to its status as a shell. The steel company in China reverted to 100% control of the original PRC owners. Buddha Steel requested that its S-1 filing with the SEC be withdrawn.

What Does This Mean?

There is probably less here than meets the eye. VIE structures are commonly used by foreign investors in China to obtain a degree of control over, as well as a substantial economic interest in, operations which they are not permitted to own directly. They were first used in the internet sector by companies such as Sina.com, Baidu, Sohu, Netease, and others. Many of these companies are now among the crown jewels of Chinese industry. The use of the structures then spread to other restricted-industry sectors, such as advertising, tourism and education, and eventually into non-restricted sectors as well. No government approval was required to enter into the agreements used to set up these structures, and they did not appear to be prohibited by Chinese law. As time passed, industry players believed the PRC government was at least tacitly approving the use of appropriate VIE arrangements in China.

On two occasions however, PRC authorities issued public statements warning foreign investors against the use of VIE structures in specific industries. The first warning was in 2006, when the PRC Ministry of Information Industries (MII) issued its *Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations*, suggesting it would be taking a close look at VIE structures used by internet companies. The industry took this as a cautionary signal, but not a prohibition, and the use of the structures continued albeit in a more subdued form.

The second warning came in 2009 in the internet game sector. In September 2009, the PRC General Administration of Press and Publication (GAPP), the National Copyright Administration and the National Office of Combating Pornography and Illegal Publications jointly published the *Notice Regarding the Consistent Implementation of the "Stipulations on 'Three Provisions'" of the State Council [relating to] Internet Games, etc.* That Notice was perhaps the clearest official confirmation that the PRC government was well aware of VIE structures and their use, and knew exactly how to prohibit them when it wanted to: the Notice flatly prohibited the use of technology support or other agreements to give foreign investors control over internet game operations services in China.

In both cases, observers believed the target of the PRC government was the specific industry sector, not VIE structures as such. Since Buddha Steel is in an industry currently under comprehensive management by the central macroeconomic authorities in China, it is possible the move by the Hebei local authorities was, like the previous two warning shots, focused on investment in a particular industry and not on VIE structures in general.

It is also possible, and in our view more likely, that the action by the local authorities in Hebei was a "one-off" event motivated by facts peculiar to this situation. A true policy shift is more likely to come from the central government in Beijing, as the two previous warnings did, rather than from local or provincial authorities. In addition, the language used by the local authorities does not have the formality we would expect to see from a national policy pronouncement.

That said, it remains a possibility—though we believe it is unlikely—that this is the first tremor of what would be an earth-shaking change in the PRC government's attitude toward VIE structures generally. If that is the case, it would certainly chill foreign investment in a number of industries, including many high-technology sectors. Given China's ongoing efforts to drive its economy up the technology curve, and the need for capital in this process, it would seem self-defeating for Beijing to take this step. For that and other reasons, we do not think this is what is happening.

China-watchers are called "watchers" because frequently the only way to know what rules will govern events in China is to watch. We will continue to closely monitor developments in this area and update this advisory as the situation develops.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the author:

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