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## Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations

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# VENTURE CAPITAL INVESTMENTS IN CHINA: THE USE OF OFFSHORE FINANCING STRUCTURES AND CORPORATE RELOCATIONS

Jing Li\*

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*Based on an analysis of the relevant Chinese laws and regulations governing the corporate governance structure of venture capital (“VC”)-invested firms, as well as a discussion on the feasibility of employing different alternatives to make direct and indirect VC investments in Chinese portfolio firms, this article studies a hand-collected sample consisting of the twenty-nine VC-backed Chinese portfolio firms that have been financed and listed from 1990 to 2005 in order to empirically show how these investments were actually made in practice. The findings show that twenty-three out of the twenty-nine firms received their VC investments in various offshore holding entities, while only four firms were financed domestically, reflecting the common practice of using offshore investment structures to invest in Chinese firms.*

*Although using such structures can be technically viewed as relocating VC-financed Chinese firms abroad, doing so is different from strategic corporate relocations motivated by the need to access more efficient legal and economic conditions. Instead of being relocated to the United States, most firms actually move to foreign tax havens, such as the Cayman Islands or the British Virgin Islands. It can be argued that the corporate relocation phenomenon in China’s financings actually reflects more of a contracting technique to circumvent unfavorable Chinese laws and more conveniently implement United States-style contracts. In this sense, and within the particular setting of China, real strategic corporate relocation in VC finance is not really yet an issue.*

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## I. INTRODUCTION

Private equity (“PE”) is an important alternative investment instrument, distinct from public equity (stock markets) and debt (loans). Essentially, PE refers to privately organized pools of capital that explicitly aim at increasing their value through active engagement with the companies in which they invest (usually called “portfolio companies”).<sup>1</sup> As an important sub-type of private equity, venture capital is typically specialized in providing capital to new, growth businesses. Venture Capital (“VC”) investments consist of three phases: first, venture capitalists purchase the shares of a portfolio company and become a shareholder therein.<sup>2</sup> Second, through sophisticated investment contracts, VC investors maintain effective control and monitoring of the portfolio companies<sup>3</sup> and keep their equity positions on average for three to seven years, during which time the portfolio company will grow and expand.<sup>4</sup> Finally, VC investors will exit their investments by selling their shares in the portfolio company to other investors or upon the portfolio company getting floated in a stock market.<sup>5</sup> As VCs play a key role in helping business start-ups obtain funding for their growth, they are considered to be beneficial to national economic development by fostering innovation and entrepreneurship.

Given the wide dispersion of potential outcomes for start-up firms as well as the limited capacity of parties in processing information, dealing with complexity and pursuing rational aims, adverse selection (information) and moral hazard (incentive) problems inevitably surround the VC investment process.<sup>6</sup> Although the ultimate goal of both VC investors and the entrepreneurs they finance is to seek the increase of the market value of portfolio companies, there can be potential conflicts of interest between venture capitalists and entrepreneurs when they both become shareholders in the portfolio company. In order to mitigate these conflicts and reduce associated agency costs, both business parties need to develop

1. See *Guide on Private Equity and Venture Capital for Entrepreneurs*, EVCA, <http://www.evca.eu/entrepreneur/default.aspx?id=3218>.

2. William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 503 (1990) (submitting that “[t]he basic document that governs the relationship between the venture capital firm and the venture is the stock purchase agreement”). See also Vance H. Fried et al., *Strategy and the Board of Directors in Venture Capital-Backed Firms*, 13 J. BUS. VENTURING 493, 494 (1998).

3. See William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 506 (1990); see also Thomas Hellmann, *Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998); and Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

4. Douglas Cumming & Uwe Walz, *Private Equity Returns and Disclosure Around the World*, 41 J. INT’L BUS. STUD. 727, 728 (2010).

5. ALEXANDER HAISLIP, *ESSENTIALS OF VENTURE CAPITAL* 176 (2010).

6. See R. Amit, J. Brander & C. Zott, *Venture Capital Financing of Entrepreneurship: Theory, Empirical Evidence and a Research Agenda*, in *THE BLACKWELL HANDBOOK OF ENTREPRENEURSHIP* (Donald L. Sexton & Hans Landström eds., 2000).

efficient measures to equalize access to information and to align the interests of both sides. This is done by separately allocating the cash flow, board seats, liquidation, and other control rights in the financial contracts entered into by and between the venture capitalist and the entrepreneur, where the venture capitalist typically acquires disproportionately larger control rights than the size of his equity investments.<sup>7</sup> In the United States, whose venture capital industry is always held up as an example for other nations, venture capitalists make extensive use of convertible securities, in particular convertible preferred stock as the investment vehicle of choice.<sup>8</sup>

Thanks to its strong economic growth momentum, China's PE and VC industry has observed tremendous development during the past two decades. From a little-known concept in the early 1990s when the earliest foreign PE investors entered China and led the first wave of such investments,<sup>9</sup> the PE and VC industries are now a critical component of the country's increasingly multi-layered capital market.<sup>10</sup> From 2003 to 2010, the compound growth of China's private equity industry was 40%.<sup>11</sup> Foreign venture capitalists have managed to maintain their leading position as the major player in China's new venture financing market since their first entry in the 1990s. Local venture capitalists claim that foreign venture capital firms represented about eight of the top ten venture investors in China.<sup>12</sup> This only changed in 2009, when the amount of capital newly raised for Renminbi denominated funds exceeded that of foreign currency funds for the first time, mainly because the global financial crisis made it difficult for foreign funds in general to raise money, while fundraising in China benefited from the swelling assets of government agencies such as pension funds and insurance companies.<sup>13</sup> Moreover, the launch of ChiNext in that year also helped to provide an attractive exit channel for Chinese VC financing transactions.<sup>14</sup> As a result of these positive develop-

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7. Andrei A. Kirilenko, *Valuation and Control in Venture Finance*, 56 J. FIN. 565, 565 (2001).

8. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 284 (2003).

9. FENG ZENG, VENTURE CAPITAL INVESTMENTS IN CHINA 51 (2004), available at [http://www.rand.org/pubs/rgs\\_dissertations/RGSD180.html](http://www.rand.org/pubs/rgs_dissertations/RGSD180.html).

10. See Lawrence Zhan Zhang, *The Legal Environment for Foreign Private Equity Firms in China*, 16 FORDHAM J. CORP. & FIN. L. 839, 844-46 (2011).

11. ZERO2IPO RESEARCH CENTER, 2010 STATISTICS FOR THE VENTURE CAPITAL AND PRIVATE EQUITY MARKETS IN CHINA, 13, 16 (2010).

12. David Ahlstrom et al., *Venture Capital in China: Past, Present, and Future*, 24 ASIA PAC. J. MGMT. 247, 251 (2007).

13. Bei Hu, *Chinese Private Equity Firms Take Market Share, McKinsey Says*, BLOOMBERG, Mar. 14, 2011, available at <http://www.bloomberg.com/news/2011-03-24/chinese-private-equity-firms-take-market-share-mckinsey-says.html>.

14. Heda Bayron, *Going Local*, 7 A PLUS 24, 25 (2010).

ments, a new era of “National PE Fad” is said to have unfolded in China,<sup>15</sup> and foreign investors have indicated their continuing confidence in the young, yet rapidly growing market.<sup>16</sup>

Despite the fact China’s VC investment market is highly dynamic, the manner of financing Chinese portfolio companies does not fully follow the highly successful United States (“U.S.”) VC model. Although U.S.-style VC contracts are considered as the efficient solution to agency problems as they are consistent with the prediction of financial contracting theories,<sup>17</sup> Chinese VC investment agreements differ in many respects from those in the U.S. For example, Chinese VC firms differ from their foreign counterparts in terms of using control and incentive mechanisms to enhance performance and manage risks in portfolio companies. In particular, because of the general lack of a share-based system for closely-held companies under the current Chinese corporate law, it is difficult for Chinese VC investment contracts to directly make use of convertible securities. In addition to designing a new model of venture capital financing contracts particularly applicable within the Chinese legal context, more venture capitalists have chosen an indirect approach: relocating Chinese portfolio companies to a foreign jurisdiction, whose legal regime would allow them to use U.S.-style VC contracts to provide the financing. Under such an indirect approach, both the investment and the exit of a VC financing deal are completed outside of China.<sup>18</sup>

The correlation between a country’s “legality” and the structure of venture capital investments has already generated considerable interest in academia. This is especially after the publishing of the seminal LLSV series of “law and finance” papers,<sup>19</sup> which found that the quality of corporate law, particularly in terms of providing shareholder protection, has a positive effect on economic and financial development. More recently, research completed by Professors Cumming, Fleming, and Schwiabacher has approached this issue by specifically studying the corporate relocations

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15. “National PE Fad” is a new phrase which became increasingly popular among Chinese media from 2010 to describe the current prosperity (or even overheating) of the industry. For a general review, see Chen Huiying et al., *Quanmin PE Re* (全民PE热) [*National PE Fad*], 399 XINSHIJI ZHOUKAN (《新世纪》周刊) [CAIXIN CENTURY] (2010), available at <http://magazine.caing.com/2010/cwcs399/>.

16. *China Private Equity Confidence Survey*, Deloitte Financial Advisory Services (Sep. 2010), at 5, [http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Financial%20advisory%20services/cn\\_fas\\_Chinaprivateequityconfidencesurvey2010\\_111110.pdf](http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Financial%20advisory%20services/cn_fas_Chinaprivateequityconfidencesurvey2010_111110.pdf) (demonstrating that between 2008-2010 foreign investors expressed generally positive opinions about long-term confidence in the Chinese PE/VC market).

17. For a short review of the relevant financial contracting theories on VC investment process, see Steven N. Kaplan & Per Strömberg, *Contracts, Characteristics, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2117, 2117-18 (Oct. 2004).

18. Further discussed in *infra* Section 3.3.

19. See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

of VC-financed companies in twelve Asia-Pacific countries.<sup>20</sup> Such relocation involves the incorporation of a new company in the destination country, and the issuing of new private equity to the venture capitalist.<sup>21</sup> According to Cumming, Fleming, and Schwienbacher, venture capitalists' motivations for relocating companies place particular emphasis on legal protections to shareholders and economic conditions to enhance firm value before exiting the investment.<sup>22</sup>

The paper by Cumming, Fleming, and Schwienbacher only focuses on corporate relocations to the U.S.<sup>23</sup> A closer examination at China's venture capital relocations, however, reveals a different picture. In examining twenty-nine VC-financed Chinese firms that were financed and listed during 1990-2005, thirteen firms were found to already have foreign presences before the first round of VC investment, and ten firms were relocated outside of China upon receiving their first round of VC investment.<sup>24</sup> Instead of going to the U.S., the destinations of the relocations (both the ones pre- and upon the first round of VC financing) were offshore tax havens such as the Cayman Islands and the British Virgin Islands. Only four firms were financed within the Chinese border, while twenty-three firms received VC investments in their offshore holding entities.<sup>25</sup> While it may be convincing to hypothesize that venture capitalists move their portfolio companies from developing countries such as China to the U.S. in order to access better legal protection and economic conditions, especially given that the U.S. is the most developed economy in the world with top-tier legal protection available for investors, it is doubtful that this hypothesis still holds if the relocation destinations are other non-U.S. tax haven jurisdictions. A competing argument would emphasize the influence of venture capitalists' past experience. As foreign venture capitalists have been the leading investors in China's new venture financing market, the frequent relocation of Chinese portfolio companies to a foreign jurisdiction can render it practically easier for them to use U.S.-style VC investment contracts, which they are familiar with.

Although it is common knowledge among lawyers specializing in this field of practice in China that many VC investments into Chinese portfolio companies are done by establishing an offshore entity and relocating Chinese firms abroad, academic research on this issue is still scarce and lacks an empirical touch. This paper is the first effort to show on an empirical level how VC investments in Chinese firms are actually made. This paper will analyze which of the two competing arguments mentioned above, either (i) access to better legal protection and economic conditions or (ii)

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20. Douglas Cumming et al., *Corporate Relocation in Venture Capital Finance*, 3 *ENTREPRENEURSHIP THEORY & PRAC.* 1121 (2009).

21. *Id.*, at 1121.

22. *Id.*, at 1123, 1149.

23. *Id.*, at 1130.

24. Further discussed in *infra* Section IV.

25. Further discussed in *infra* Section IV.

past experience of venture capitalists, has more bearing on the current Chinese venture capital investment process.

This paper is structured as follows. Section II provides a brief introduction of the economic problems in the venture capital financing process, together with a review of the relevant literature. Section III discusses the practice of how foreign VC investments are made into non-listed firms in China, focusing particularly on the establishing of an offshore holding structure to contemplate many of such investments. Section IV presents and analyzes the data, and Section V concludes that compared to the influence of legality and economic conditions, the experience of venture capital funds is a better explanation for the corporate relocation phenomenon in China's VC financings, which actually reflects more of a contracting technique to circumvent unfavorable Chinese laws and conveniently implement U.S.-style contracts.

## II. LITERATURE REVIEW

### 2.1 *Economic Problems of Venture Capital Financing*

Consistent with classic agency theory, the VC financing process can be understood from the agency perspective, where venture capitalists are principals and entrepreneurs are agents.<sup>26</sup> The economic problems of the new venture financing process can be observed in two phases, namely, pre-contractual information costs, and post-contractual incentive conflicts.<sup>27</sup> In order to minimize the agency costs resulting from such information and incentive problems, the main strategy for both sides of VC investment transactions is to improve information as well as to align interests.<sup>28</sup> This can be done in three ways: sophisticated financial contracting, pre-investment screening, and post-investment monitoring and advising.<sup>29</sup>

Before entering into financial contracts to invest, VC investors will collect information about a pool of potential firms, usually by conducting "due diligence".<sup>30</sup> Based on the information found, venture capitalists can compare different firms and "screen out" undesirable projects *ex ante*.<sup>31</sup> Once the contracts are concluded and VC investors become shareholders in the portfolio company, the potential opportunism arising from informa-

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26. See Steven N. Kaplan & Per Strömberg, *Venture Capitals as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 426 (2001).

27. JANET KIHOLM SMITH & RICHARD L. SMITH, *ENTREPRENEURIAL FINANCE* 396-405 (2004).

28. See Ronald Gilson et al., *Building Foundations for a Durable Deal*, FIN. TIMES, Oct. 12, 2006, available at <http://www.ft.com/intl/cms/s/2/d4108446-5933-11db-9eb1-0000779e2340.html#axzz1qtARpFs6>.

29. Steven N. Kaplan & Per Strömberg, *Venture Capitals as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 429 (2001).

30. CTR. FOR PRIVATE EQUITY & ENTREPRENEURSHIP, TUCK SCH. OF BUS. AT DARTMOUTH, *NOTE ON DUE DILIGENCE IN VENTURE CAPITAL* (2004) available at [http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/due\\_diligence.pdf](http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/due_diligence.pdf).

31. *Id.* at 3.

tion asymmetry problem<sup>32</sup> is then mitigated by closely monitoring and advising the entrepreneurs during business operation, stressing the incentives to exit, and using proper syndication and staging of financing.<sup>33</sup> These mechanisms fundamentally serve a critical purpose: they help venture capitalists to collect and generate information about the prospects of the start-up firm.<sup>34</sup> Moreover, venture capitalists have also come up with solutions for the so-called hold-up problem<sup>35</sup> by making widespread use of non-compete and vesting provisions.<sup>36</sup> Essentially, these contractual provisions are meant to control founders and other key participants by making it costly for them to leave the firm,<sup>37</sup> thus achieving the purpose of keeping them working diligently for the entrepreneurial firm for a reasonable time after the VC investment.

The world of finance offers few more interesting examples of sophisticated financial contracting than venture capital investment agreements.<sup>38</sup> Incentive conflicts between entrepreneurs and venture capitalists are primarily mitigated by structuring financial contracts so that cash flow rights, liquidation rights, and control rights are efficiently allocated to ensure entrepreneurs' commitment to the firm.<sup>39</sup> By accepting venture capital, entrepreneurs are giving up not only their equity interests but also significant control rights to the venture capitalists,<sup>40</sup> and in order to gradually regain their control, entrepreneurs have to devote time and energy into the portfolio company to improve the firm's performance. In the most ideal scenario, the portfolio performs so well that it finally achieves an initial public

32. See Steven Globerman & Aidan R. Vining, *An Outsourcing Decision: A Strategic Framework*, in GLOBAL OUTSOURCING STRATEGIES: AN INTERNATIONAL REFERENCE ON EFFECTIVE OUTSOURCING RELATIONSHIPS 8 (Peter Barrar & Roxane Gervais eds., 2006) (submitting that "opportunism arising from information asymmetry can occur either at the contract negotiation stage. . . or post-contractually. . . Either party may generate these costs.").

33. See PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 130 (1999).

34. *Id.*

35. For a general explanation of what a hold-up problem is, see William P. Rogerson, *Contractual Solutions to the Hold-Up Problem*, 59 REV. ECON. STUD. 777, 777 (1992). For an explanation of hold-up problems in venture capital financing context, see Steven N. Kaplan & Per Strömberg, *Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2173, 2174 (2004).

36. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 292 (2003).

37. *Id.*

38. William L. Megginson, *Toward a Global Model of Venture Capital?*, 16 J. APPLIED CORP.FIN. 89, 101 (2004).

39. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 282 (2003) (submitting that "cash flow rights and control rights can be separated and made contingent on observable and verifiable measures of performance").

40. Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?* 11 J. APPLIED CORP. FIN. 36, 43 (1999).



offering (“IPO”) with the venture capitalists losing their control rights as a result of convertible securities being automatically converted into common stock, and the negative covenants contained in the investor rights agreement also terminating upon an IPO. Control thus becomes vested in the entrepreneur again.<sup>41</sup> In practice, venture capital is often staged, which serves as an incentive for the entrepreneurs to work diligently in order to obtain further rounds of money, leaving venture capitalists with a valuable option to deny or delay additional funding.<sup>42</sup> Entrepreneurs and venture capitalists usually agree on certain milestones, the achievement of which directly conditions the allocation of control between the two sides. If the firm performs well, venture capitalists will gradually give up their control (e.g., in voting rights and board representation), and only retain cash flow rights (in share value and dividends).<sup>43</sup> On the contrary, if the firm turns out not to run so well, venture capitalists will substantially strengthen their control in the portfolio company, so as to at least secure some returns on their investments. In addition, VC investment contracts are also distinguished by their extensive and sophisticated use of covenants, which serve to limit opportunistic behavior by the entrepreneur.<sup>44</sup> The restrictiveness of the contracts in terms of both the probability of including specific covenants and the number of covenants included are positively related to potential agency costs.<sup>45</sup>

The strategies of contracting, screening, and monitoring are closely related to each other,<sup>46</sup> and need to be taken into account together as a dynamically operating mechanism. This mechanism is most sufficiently reflected in the private ordering nature of financial contracts of VC investments in the U.S., which have served as an important factor contributing to the great success of the Silicon Valley.<sup>47</sup> Other critical factors include: favorable tax laws and legal structures that can accommodate the establishment of PE funds; liberal bankruptcy laws that can provide little or no

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41. *Id.*

42. William L. Megginson, *Toward a Global Model of Venture Capital?*, 16 J. APPLIED CORP. FIN. 89, 102 (2004); *see also* Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461 (1995).

43. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 295 (2003).

44. Ola Bengtsson, *Covenants in Venture Capital Contracts*, 57 MGMT. SCI. 1926, 1927 (2011).

45. Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments* 26 (Sep. 1997) (unpublished manuscript), available at <http://www.people.hbs.edu/pgompers/Convert.PDF>.

46. Steven N. Kaplan & Per Strömberg, *Venture Capitals as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 429 (2001).

47. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003).

time to discharge debts for entrepreneurs;<sup>48</sup> a clustering of venture capital firms at one end and entrepreneurs at the other;<sup>49</sup> simultaneity of capital, specialized financial intermediaries, and entrepreneurs;<sup>50</sup> and most importantly, a strong stock market.<sup>51</sup>

In countries with a common law tradition, particularly the U.S.<sup>52</sup> and the United Kingdom,<sup>53</sup> venture capitalists make investments by extensively using convertible quasi-equity instruments, typically convertible preferred stock.<sup>54</sup> Convertible preferred stock is a type of stock that includes an option for the holders (venture capitalists) to convert the preferred shares into a certain number of common shares.<sup>55</sup> Being preferred, this type of stock carries rights in dividend payments and liquidation that are senior and prior than common stock,<sup>56</sup> so that their holders can be better protected from the potential downside of VC investments. Being convertible, this type of stock also offers venture capitalists with the flexibility to change the level of their control in different situations.<sup>57</sup> Generally, venture capitalists call for conversions in two different types of situations. When the business is under way, conversion is usually based upon the realization of an observable contingency by the portfolio company, such as achieving a certain financial performance.<sup>58</sup> VC investors have to monitor the business and finances of the company so as to determine whether and

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48. John Armour & Douglas J. Cumming, *The Legislative Road to Silicon Valley*, 58 OXFORD ECON. PAPERS 596, 596 (2006).

49. Masahiko Aoki & Hirokazu Takizawa, *Information, Incentives, and Option Value: The Silicon Valley Model*, 30 J. COMP. ECON. 759, 761 (2002).

50. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1093 (2003).

51. Ronald J. Gilson & Bernard S. Black, *Does Venture Capital Require an Active Stock Market?*, 11 J. APPLIED CORP. FIN. 36 (1999); Leslie A. Jeng & Philippe C. Wells, *The Determinants of Venture Capital Funding: Evidence Across Countries*, 6 J. CORP. FIN. 241 (2000).

52. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 284 (2003).

53. Mike Wright, *Venture Capital in China: A View from Europe*, 24 ASIA PAC. J. MGMT. 269, 276 (2007).

54. Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q. J. ECON. 223, 223 (2005).

55. See INTERNATIONAL MONETARY FUND, COORDINATED PORTFOLIO INVESTMENT SURVEY GUIDE 144 (2002).

56. See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 882 (2003); see also *id.*, submitting that “[p]referred stock has a claim prior to that of common stock upon the earnings of a corporation and upon the assets of the corporation in the event of its liquidation.”

57. William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 510 (1990).

58. George G. Triantis, *Financial Contract Design in the World of Venture Capital*. 68 U. CHI. L. REV. 305, 317 (2001).

when to call for such conversions. Once a conversion is called and preferred stock is converted into common stock, venture capitalists lose the preferential rights on their shares,<sup>59</sup> thus relinquishing a certain amount of their control of the company.

If the company is eventually listed on a stock exchange, VC investors can sell their shares at the stock market and gain multiplied returns on their investments.<sup>60</sup> Having achieved the goal of their investments to turn profit, they no longer need the economic and contractual protections provided by the convertible preferred stock, all of which will thus be automatically converted into common stock upon the IPO of the company (automatic conversion).<sup>61</sup> On the contrary, if the company fails to perform well and no IPO takes place, VC investors may still secure at least some returns upon their exit by virtue of the redemption rights,<sup>62</sup> preferred dividends,<sup>63</sup> and liquidation preferences<sup>64</sup> provided by convertible preferred stock. In this sense, convertible preferred stock is a highly useful investment instrument, one which efficiently addresses the information and incentive problems between venture capitalists and entrepreneurs.

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59. Timothy J. Harris, *Modeling the Conversion Decision of Preferred Stock*, 58 *BUS. LAW.* 587, 588 (2003).

60. Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?* 11 *J. APPLIED CORP. FIN.* 36, 42 (2005) (arguing that “[t]he potential for an IPO to provide a higher-valued exit than sale of the company must be considered plausible”).

61. Automatic conversion can also happen prior to the IPO, e.g., upon reaching certain profit, sales, and/or performance milestones. In general, venture capitalists would want conversion only when they have positive information that the firm is likely to be successful. See Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments* 16-17 (Sep. 1997) (unpublished manuscript), available at <http://www.people.hbs.edu/pgompers/Convert.PDF>.

62. Redemption clauses give venture capitalists the right to demand that the firm redeem their claim, typically at the price that the VC has originally paid for purchasing equity interests from the firm (or occasionally, at the maximum of the liquidation value and “fair market value”). This is very similar to the required repayment of principal at the maturity of a debt claim. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 *REV. ECON. STUD.* 281, 291 (2003). So when the portfolio firm does not present strong growth and thus cannot bring out lucrative exits for venture capitalists, they can still get back at least their original investment, sometimes even with a moderate return, by exercising the redemption right.

63. Venture capitalists may ask for cumulative dividends in their investment terms, which can make their liquidation rights even stronger. Even though these are dividends that do not have to be paid out, they accumulate and are added to the liquidation claim when venture capitalists eventually exercise their liquidation preference rights. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 *REV. ECON. STUD.* 281, 290 (2003).

64. By virtue of liquidation preference, venture capitalist will be able to share prior to common stock holders upon the earnings of a corporation and upon the assets of the corporation in the event of its liquidation. Therefore, even if the company is doing not very well and there is not much left as of the liquidation, venture capitalists may still secure some of their original investments. See *supra* note 56 and accompanying text.

## 2.2 Venture Capital Investments in China

Venture capital in China is seen as a politically legitimate and necessary means of linking science and technological development with national economic development.<sup>65</sup> Within this system, there are primarily four types of VC firms: governmental VCs, university VCs, corporate VCs, and foreign VCs.<sup>66</sup> Although the very first VC firm was established in China as early as 1985 (with the operation starting in 1986),<sup>67</sup> the modern entrepreneurial finance VC concept was brought into China by foreign VC firms, which differ from Chinese domestic counterparts in several important aspects. Foreign venture capitalists tend to focus on high-growth or high-potential investment projects, which are not necessarily limited to high technology firms.<sup>68</sup> They surpass domestic Chinese VC firms in terms of experience, and thus are poised to provide more value-added services.<sup>69</sup> They are also more actively involved in monitoring and top-level decision-making.<sup>70</sup> However, foreign VCs are more politically vulnerable as they do not have as close connections with governmental bodies as domestic VCs.<sup>71</sup> Moreover, foreign VCs generally also invest more in firms at earlier stages than domestic VCs. This being said, venture capitalists in China generally attach a greater priority to later stages such as growth and pre-IPO.<sup>72</sup>

Previous research on venture capital investments in China has primarily focused on pinning down the possible institutional factors that may explain the difference of venture capitalists' operations here from those in more mature markets. One of the major insights was that while venture capitalists attempted to follow the same model of the West, key institutional and cultural issues strongly impacted the actual actions taken.<sup>73</sup>

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65. Steven White et al., *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RES. POL'Y 894, 901 (2005). See also Justin Tan et al., *Managing Risk in a Transitional Environment: An Exploratory Study of Control and Incentive Mechanisms of Venture Capital Firms in China*, 46 J. SMALL BUS. MGMT. 263, 268 (2008).

66. Steven White et al., *China's Venture Capital Industry: Institutional Trajectories and System Structure*, *International Conference on Financial Systems* 9 (2002), available at <http://knowledge.insead.edu/abstract.cfm?ct=11674>.

67. The firm is named China New Technology Venture Investment Co.

68. Steven White et al., *Financing New Ventures in China: System Antecedents and Institutionalization*, 34 RES. POL'Y 894, 907 (2005).

69. Justin Tan et al., *Managing Risk in a Transitional Environment: An Exploratory Study of Control and Incentive Mechanisms of Venture Capital Firms in China*, 46 J. SMALL BUS. MGMT. 263, 281 (2008).

70. *Id.* at 280.

71. Steven White et al., *China's Venture Capital Industry: Institutional Trajectories and System Structure*, *International Conference on Financial Systems* 10 (2002), available at <http://knowledge.insead.edu/abstract.cfm?ct=11674>.

72. Justin Tan et al., *Managing Risk in a Transitional Environment: An Exploratory Study of Control and Incentive Mechanisms of Venture Capital Firms in China*, 46 J. SMALL BUS. MGMT. 263, 281 (2008).

73. David Ahlstrom et al., *Venture Capital in China: Past, Present, and Future*, 24 ASIA PAC. J. MGMT. 247, 252 (2007).

With weak formal institutions in East Asian economies, existing relationships are an important factor in screening firms and providing funding. Venture capitalists monitor firms through informal ties to entrepreneurs and their families. They create links to customers, the government, and other important allied firms through personal connections.<sup>74</sup> Similarly, entrepreneurs' social capital plays an important role in China's venture capital industry, in that it has a significant effect on both investment selection decisions and investment process decisions of venture capitalists.<sup>75</sup> Venture capitalists weigh human capital factors more heavily in China than in the U.S., but also rely on market information, which augments rather than replaces human capital factors.<sup>76</sup> In particular, both foreign VCs and domestic Chinese VCs exhibit investment behavior based on learned paths to success within different institutional environments.<sup>77</sup> For example, foreign VCs tend to invest in technology-light, service-oriented ventures because based on their previous experience from advanced countries (particularly the U.S.), legal protection of intellectual property is critical to their success while possible intellectual property theft in China still remains a concern.<sup>78</sup>

In summary, previous research efforts so far show that venture capital investments in China are done differently from developed markets as a result of China's unique institutional context. It is in general not the primary concern of existing research efforts to focus on analyzing VC investment practice, although they indeed touch on specific practical issues that are discussed here and there. For example, venture capitalists indicate that they expect to make greater efforts to do due diligence in China than in the West when screening entrepreneurial firms, and they realize that when there is a need for managerial input, it is key to allow managers the opportunity to maintain "face" or respect.<sup>79</sup> Although such findings indeed unveil certain practical behaviors in Chinese VC investments, they do not educate readers on how VC investments are actually made into Chinese entrepreneurial firms. This research thus bridges the gap between theory and practice by painting a picture of the legal arrangements used in the practice of making venture capital and private equity investments in China, and it also discusses the theoretical implications thereof.

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74. David Ahlstrom & Garry D. Bruton, *Venture Capital in Emerging Economies: Networks and Institutional Change*, 30 *ENTREPRENEURSHIP THEORY AND PRACT.* 299, 316 (2006).

75. Bat Batjargal & Mannie (Manhong) Liu, *Entrepreneurs' Access to Private Equity in China: The Role of Social Capital*, 15 *ORG. SCI.* 159, 159 (2004).

76. Andrew L Zacharakis et al., *Venture Capitalists' Decision Policies Across Three Countries: an Institutional Theory Perspective*, 38 *J. INT'L BUS. STUD.* 691, 691 (2007).

77. Douglas B. Fuller, *How Law, Politics and Transnational Networks Affect Technology Entrepreneurship: Explaining Divergent Venture Capital Investing Strategies in China*, 27 *ASIA PAC. J. MGMT.* 445, 455 (2010).

78. *Id.*

79. David Ahlstrom et al., *Venture Capital in China: Past, Present, and Future*, 24 *ASIA PAC. J. MGMT.* 247, 256-260 (2007).

### III. MAKING VENTURE CAPITAL INVESTMENTS IN CHINA

Although China has the world's fastest growing major economy,<sup>80</sup> until recently venture capital and private equity have played a rather trivial role in promoting its spectacular economic development and technological progress.<sup>81</sup> While venture capital is a historically recent financial innovation, the concept was largely unknown in China until the first batch of Chinese Internet firms made their debut in NASDAQ in the early 2000, giving fame to a number of dot-com stars such as which Sohu, Sina and NetEase.<sup>82</sup> As part of these cheery stories of how new college graduates started these firms with their bare hands and ultimately managed to list their businesses in overseas stock markets, foreign (mainly U.S.) venture capitalists, who were the first providers of capital to these young entrepreneurial heroes, entered the sights of the Chinese public.<sup>83</sup> From that time onwards, investments made by both foreign and domestic VC funds became more and more identified by the Chinese media. However, the fact that foreign venture capitalists have led these burgeoning financing activities does not necessarily mean that investments are done in China in the same way as in the developed markets. In addition to the institutional differences summarized in previous research pieces,<sup>84</sup> China's local laws and regulations are the most direct reasons preventing VC investors from using U.S. model contracts to provide financing in China. This gives rise to a unique pattern of venture capital investment practices.

#### 3.1 Practical Difficulties in Using Convertible Preferred Stock

Despite the fact that convertible preferred stock is widely used in the U.S. venture capital industry to obtain special economic rights such as liquidation preferences, anti-dilution adjustments, and other rights that are fundamental to the financial imperatives of venture capital investors,<sup>85</sup> the various regulatory limitations on investing in private companies registered in China do not yet fully reflect such prevailing practice. There are generally two types of companies in China: limited liability companies and joint

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80. See Alan Chau, *Doing Business in Changing China: Seeking Similarities, Respecting Differences*, 13 VIEW: PWC PERSPECTIVES ON CURRENT BUS. ISSUES & TRENDS 14, 15 (2010).

81. Cf. William L. Megginson, *Toward a Global Model of Venture Capital?*, 16 J. APPLIED CORP. FIN. 89, 94 (2004).

82. The three Internet companies are often referred together as China's "Big Three Portal Websites."

83. Su Longfei (苏龙飞), *Minqi Shangshi Beiwanglu Si: Waizi VC Jinru Gongzhong Shiye* (民企境外上市备忘录四: 外资VC进入公众视野) [*Chronicles of Private Companies Going Public (Part Four): Foreign VCs Entering the Public Eye*], COLUMN AT SINO-MANAGER.COM (Aug. 23, 2010), available at [http://www.sino-manager.com/u/2010823\\_18491.html](http://www.sino-manager.com/u/2010823_18491.html).

84. See *infra* Section 2.2.

85. Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 284 (2003).

stock limited companies.<sup>86</sup> Only joint stock limited companies can issue shares<sup>87</sup> and list their shares in stock exchanges upon the approval of the securities regulator,<sup>88</sup> while the equity system of the limited liability companies is based on the percentage of capital contributions by each of the equity holders therein.<sup>89</sup> By virtue of such provisions, a business aiming to attract investments from venture capitalists has to be a joint stock limited company, or otherwise it must be restructured into a joint stock limited company in order to issue convertible preferred stock to VC investors. Thus, as long as VC investors can manage to find firms that are already organized as or are willing to restructure into joint stock limited companies, they can use convertible preferred stock to make their investments. The table 3.1 below briefly summarizes the basic differences between limited liability companies and joint stock limited companies.

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86. *Zhonghua Renmin Gongheguo Gongsifa* (中华人民共和国公司法) [Company Law (P.R.C.)] art. 2 (adopted at the 5th Session of the Standing Committee of the 8th National People's Congress, Dec. 29, 1993) [hereinafter "1993 Company Law"] (amended for the 1st time, Dec. 25, 1999) [hereinafter "1999 Company Law"] (amended for the 2nd time, Aug. 28, 2004) [hereinafter "2004 Company Law"]; (amended for the 3rd time, Oct. 27, 2005, and took effect as from Jan. 1, 2006) [hereinafter "2006 Company Law"].

87. 2006 Company Law, *supra* note 86, art. 126.

88. *Zhonghua Renmin Gongheguo Zhengquan Fa* (中华人民共和国证券法) [Securities Law (P.R.C.)] art. 50 (adopted at the 6th Meeting of the Standing Committee of the 9th National People's Congress, Dec. 29, 1998) (amended Oct. 27, 2005, and took effect as from Jan. 1, 2006).

89. 2006 Company Law, *supra* note 86, art. 3.

TABLE 3.1: LIMITED LIABILITY COMPANIES AND JOINT STOCK LIMITED COMPANIES<sup>90</sup>

Characteristics	Limited Liability Company	Joint Stock Limited Company
<b>Equity System</b>	Equity-interest-based	Share-based
<b>Number of Founders / Initiators</b>	Between 2 – 50	Between 2 – 200
<b>Form of Establishment</b>	Contribution of registered capital by the founders	<b>Promotion:</b> Initiators subscribing for all of the shares to be issued by the company; or  <b>Share Offer:</b> Initiators subscribing for a portion of the shares to be issued by the company and offering the remaining shares to the general public or a particular group of people. <sup>91</sup>
<b>Minimum Capital Threshold</b>	RMB30,000	RMB5 million
<b>Methods for Capital Contribution</b>	Total capital contributions subscribed by all founders as registered with the registration authority	<b>Established by Promotion:</b> Total share capital <b>subscribed</b> by all the initiators as registered with the registration authority;  <b>Established by Share Offer:</b> Total <b>paid-up</b> share capital as registered with the registration authority
<b>Timeframe for Capital Contribution</b>	Within 2 years upon the date of establishment, provided that a minimum of 20% of the total registered capital should have been contributed by the founders	<b>Established by Promotion:</b> Within 2 years upon the date of establishment, provided that a minimum of 20% of the total registered capital should have been contributed by the initiators. Before the registered capital is paid off, no stock may be offered to others for subscription.
<b>Governmental Approvals</b>	Possible approvals from industry administrative authority if the company is in certain industries (e.g. pharmaceutical business); plus registration with the registration authority.	<b>Established by Promotion:</b> Possible approvals from industry administrative authority if the company is in certain industries (e.g. pharmaceutical business); plus registration with the registration authority;  <b>Established by Share Offer:</b> Possible approvals from industry administrative authority if the company is in certain industries (e.g. pharmaceutical business); approval from the State Council for share offer establishment, plus registration with the registration authority.

90. 2006 Company Law, *supra* note 86, §§ 2.1, 4.1.

91. It is worth noting that although a joint stock limited company can be set up by share offer, such method of establishment is virtually not available for start-ups. According to Shouci Gongkai Faxing Gupiao bing Shangshi Guanli Banfa (首次公开发行股票并上市管理办法) [Measures for the Administration of Initial Public Offering and Listing of Stocks] art. 8 (promulgated by China Securities Regulatory Commission, May 17, 2006), establishing a company by share offer is only allowed, upon the



However, things are not as straightforward as they seem. Two general implications can be drawn from the differences between limited liability companies and joint stock limited companies as summarized in table 3.1 above. First, it is more costly and complicated to incorporate joint stock limited companies as compared to limited liability companies, as the former requires much higher minimum capital requirements, and a lengthier and more complex set of approval procedures. Although the statutory stipulations shown in the table may not appear prohibitive as such, it is worth noting that they only came into force from 2006 when the new Chinese Company Law was enacted.<sup>92</sup> During more than a decade after the birth of the Company Law in 1993, entrepreneurs hoping to set-up a joint stock limited company would have needed to obtain approval from at least the provincial government and sometimes even from the central government (which may delegate certain relevant governmental authorities to do so).<sup>93</sup>

One month before the first enactment of China's Company Law in 1993, China's Communist Party explicitly pointed out that reforming "state-owned enterprises as companies is a beneficial exploration along the road of establishing modern enterprise system."<sup>94</sup> In a country where state-owned enterprises ("SOEs") hold the majority of its resources and economic lifelines, it is not hard to imagine that governments would prioritize their approving powers towards (large) SOE reforms.<sup>95</sup> In addition to the formation procedures, the formation costs of joint stock companies were equally, if not more, prohibitive. The minimum share capital required to set up a joint stock companies was RMB10 million.<sup>96</sup> Such a requirement would still be applicable when a limited liability company was

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approval of the State Council, when a limited liability company is to be converted into a joint stock limited company. Conceivably, such State Council approval is to be reserved by those large-scale state-owned enterprises, which will be converted into companies limited by share for further listing.

92. See *supra* note 86.

93. 1993 Company Law, *supra* note 86, art. 77; 1999 Company Law, *supra* note 86, art. 77; 2004 Company Law, *supra* note 86, art. 77.

94. Zhonggong Zhongyang Guanyu Jianli Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding (中共中央关于建立社会主义市场经济体制若干问题的决定) [Decision of the Central Committee of the Communist Party of China on Some Issues Concerning the Establishment of the Socialist Market Economy], art. 2.6 (adopted by the 3rd Plenary Session of the 14th Central Committee of China's Communist Party, June 14, 1993), available at <http://cpc.people.com.cn/GB/64162/134902/8092314.html>

95. Reform of SOEs in China is considered by the Communist Party as the most important and challenging part of China's economic reform and establishment of socialist market economy. Among other things, the goal of such reform is to change SOEs from government-owned-and-run entities to modern shareholding companies. For more information on the topic of SOE reform, see Justin Yifu Lin et al., *Competition, Policy Burdens, and State-Owned Enterprise Reform*, 88 AM. ECON. REV. 422 (1998).

96. 1993 Company Law, *supra* note 86, art. 78; 1999 Company Law, *supra* note 86, art. 78; 2004 Company Law, *supra* note 86, art. 78.

to convert itself into a joint stock limited company.<sup>97</sup> By comparison, the minimum capital thresholds for limited liability companies as set forth in the older versions of the Company Law were RMB100,000 for scientific and technology development, consulting, and service firms, RMB300,000 for retailing firms, and RMB500,000 for wholesale and manufacturing firms.<sup>98</sup> Although such figures still look quite high as compared to the currently effective minimum capital requirement for limited liability companies (i.e., RMB 30,000 as shown in table 3.1), their cost-saving effect was still obvious if compared to the RMB10 million minimum capital requirement for joint limited companies. Such comparative benefits of limited liability companies are still present in the currently effective Company Law,<sup>99</sup> although one may argue that they do not appear so acute given that the administrative approval burdens have also been significantly lowered for joint stock limited companies.

The second implication is related to the first one and is more practical. Because of the prohibitively high costs, as well as the stringent and hierarchical governmental approval formalities required to establish a joint stock limited company historically, it is natural for entrepreneurs to prefer limited liability companies over joint stock limited companies to operate their business. Empirically this is also true: according to the 2004 statistics from the State Administration of Industry and Commerce, China's top regulator of business firm registrations, China had over 1.3 million limited liability companies while only 8,000 joint stock limited companies (including 1,378 firms that were listed on China's two stock exchanges<sup>100</sup>), the former exceeding the latter by 160 times.<sup>101</sup> Such drastically different rates of using the two business forms have had a direct impact in practice. One consequence arising from the low prevalence of joint stock limited companies among non-listed firms is the difficulty of building up an ample set of legal experience and networks associated with this business form, especially in those less developed regions of the country where lawyers and governmental officials are even less familiar with this sort of business registration applications. This contributes to the unattractiveness of joint

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97. 1993 Company Law, *supra* note 86, art. 98; 1999 Company Law, *supra* note 86, art. 98; 2004 Company Law, *supra* note 86, art. 98; 2006 Company Law, *supra* note 86, art. 9.

98. 1993 Company Law, *supra* note 86, art. 23; 1999 Company Law, *supra* note 86, art. 23; 2004 Company Law, *supra* note 86, art. 23. The current 2006 Company Law no longer imposes different minimum capital requirements for different kinds of firms, but asks for a universal minimum registered capital of RMB 30,000 for all limited liability companies. See 2006 Company Law, *supra* note 86, art. 26.

99. See table 3.1 above.

100. Jiezhì Qunian Niandi Woguo Jingnei Shangshi Gongsì Shangsheng Dao 1378 Jia (截至去年底我国境内上市公司上升到1378家) [As of the End of Last Year, the Number of Domestic Listed Companies Increased to 1,378], XINHUANET (Feb. 15, 2005), available at <http://news.sohu.com/20050215/n224296476.shtml>.

101. Zhou Yang (周阳), *Xin Gongsì Fa de Xuanmiao zhi Men* (新公司法的玄妙之门) [What is Savvy in the New Company Law?], 12 JINGJI (经济) [ECONOMIC MONTHLY] (2005), available at <http://biz.cn.yahoo.com/060223/147/g3pf.html>.

stock limited companies to entrepreneurs and investors, who may be deterred and resort back to limited liability companies even if they have the money to satisfy the statutory minimum capital requirement for joint stock limited companies. For venture capitalists, it is simply much more difficult to locate potential start-ups that are already organized as joint stock limited companies when limited liability companies dominate the menu of corporate business forms in China. Previous research shows that given the highly asymmetric information between venture capitalists and entrepreneurs and the still relatively strong role played by *Guanxi* (i.e., connections) in Chinese business practices, deal sourcing can be particularly difficult for venture capitalists investing in China.<sup>102</sup> Locating potential portfolio companies from firms that use an uncommon business form further increases the difficulty for VC investors to find ideal business start-ups to finance.

Although it can be expensive and even risky for business entrepreneurs to spend several millions of Renminbi just to register a company, it is possible that after a period of development and expansion, some entrepreneurs who originally opted for limited liability companies may feel the need to change the corporate form of their ventures in order to attract venture capitalists, given that the minimum share capital of joint stock limited companies has been halved from RMB10 million to RMB5 million, and that most governmental approval requirements have been abolished under the currently effective Company Law of China.<sup>103</sup> In such a scenario, the entrepreneur may consider converting the business from a limited liability company into a joint stock limited company, so that venture capitalists will be able to use convertible preferred stock in making the investment. Funding businesses that are already on track is actually the preference of most venture capitalists investing in China, as they hope to reduce potential risks about the uncertainties of the business and yield higher return upon exit.<sup>104</sup> Furthermore, since IPOs are generally considered the most lucrative channel of exit and usually the best outcome venture capitalists aim for, forming a joint stock company preemptively upon the entrance of VC investors rather than upon the eve of the IPO might save both cost and time. This is also true in the practice of U.S. venture capital industry, where VC investors may require the invested portfolio company, if still not a C-corporation, to restructure itself into a C-corporation as a closing condition of an investment transaction.<sup>105</sup> Therefore, we

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102. David Ahlstrom et al., *Venture Capital in China: Past, Present, and Future*, 24 *ASIA PAC. J. MGMT.* 247, 255 (2007).

103. See *supra* note 93, 96 and the accompanying texts, as well as table 3.1 above.

104. David Ahlstrom et al., *Venture Capital in China: Past, Present, and Future*, 24 *ASIA PAC. J. MGMT.* 247, 261 (2007).

105. Eric J. Allen & Sharat Raghavan, *Are Venture Capital Investments Inefficiently Organized? Quantifying the Cost of Organizing Loss-Generating Start-up Firms as C-Corporations*, 4 (July 26, 2011) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1759558](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1759558).

can expect that joint stock companies will gradually emerge as an important business vehicle in China, especially given the growing importance and sophistication of China's onshore stock markets.

Despite the fact that joint stock companies are now easier to set-up than before, such regulatory improvement still cannot be enjoyed by foreign investors. If foreign investors enter the shareholding of a joint stock company, this will result in the company being turned into a foreign-invested enterprise, which is mandatorily governed by the relevant foreign direct investment (FDI) laws and regulations in China.<sup>106</sup> Compared to a domestic joint stock company, a foreign-funded joint stock company needs to have at least RMB30 million registered capital, with the shares subscribed and held by foreign shareholders being no less than twenty-five percent thereof.<sup>107</sup> Moreover, the establishment of such companies is subject to the approval of the Ministry of Commerce (MOFCOM), the top regulator of foreign direct investments in China, and not any of its lower-level local counterparts.<sup>108</sup> Such legal stipulations make it even more difficult for foreign venture capitalists to pursue the path of investing directly in joint stock limited companies.

To summarize, the absence of a share-based equity system among non-listed firms in China makes it practically difficult for venture capitalists to make direct use of convertible preferred shares when investing in China,<sup>109</sup> although they are not precluded from doing so *per se* under the relevant Chinese regulations.<sup>110</sup>

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106. 1993 Company Law, *supra* note 86, art. 18; 1999 Company Law, *supra* note 86, art. 18; 2004 Company Law, *supra* note 86, art. 18. Basically, these articles stipulate that foreign-invested enterprises, i.e., Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures, and wholly-foreign-owned enterprises, will be governed by the specific laws and regulations applicable to them, and company law provisions will only apply when these laws and regulations are silent. In the current 2006 Company Law, art. 218, it is stipulated that foreign-invested companies should comply with the Company Law; however, where there are otherwise different provisions in any law regarding foreign investment, such provisions shall prevail.

107. Guanyu Sheli Waishang Touzi Gufen Youxian Gongsi Ruogan Wenti de Zanxing Guiding (关于设立外商投资股份有限公司若干问题的暂行规定) [Provisional Regulations on Certain Issues Concerning the Establishment of Foreign-Funded Joint Stock Companies], art. 7 (promulgated by the Ministry of Foreign Trade and Economic Cooperation Jan. 10, 1995). Note that, unless explicitly approved by the MOFCOM to form a foreign-invested joint stock company, all foreign-invested companies in China must take the business form of limited liability company, thus meaning that they cannot issue shares, either common or preferred.

108. Provisional Regulations on Certain Issues Concerning the Establishment of Foreign-Funded Joint Stock Companies, *supra* note 107, art. 13. See also <http://fgfs.wzs.mofcom.gov.cn/> for a detailed stipulation of the requirements for setting up a foreign-invested joint stock company and selling its shares to the public.

109. Paul McKenzie, *New Venture Capital Measures Reflect Policy to Cultivate Onshore Venture Capital Industry, But Meaningful Adoption Will Require Further Definition and Corporate Law Reform*, MORRISON & FORESTER CHINA L. BULL. (Mar. 2006), available at <http://www.mofo.com/news/updates/bulletins/bulletin02150.html#NewVenture>.

110. Chuangye Touzi Qiye Guanli Zanxing Banfa (创业投资企业管理暂行办法) [Interim Measures for the Administration of Start-up Investment Enterprises], art. 15 (jointly

3.2 *Alternatives to Compensate for Such Difficulty under Chinese Laws*

## 3.2.1 Using convertible debt

Similar to the function of convertible preferred stock, convertible notes are a debt instrument that can be converted into equity upon the occurrence of an acquisition or a significant funding round,<sup>111</sup> or some other event at the option of the note holders, i.e., the investors.<sup>112</sup> Convertible debt and redeemable convertible preferred equity are essentially equivalent in terms of the resulting payoff structure,<sup>113</sup> and the main difference between the two instruments concerns the rights available in the case of a default.<sup>114</sup> While preferred shareholders do not have any particular rights in default, convertible note holders may demand that the company pay back the note together with a reasonable interest so as to secure at least some return, or otherwise force the firm into liquidation.<sup>115</sup> Moreover, as debt is to be repaid prior to either preferred or common stock in the event of a sale or liquidation, convertible notes provide even more senior protection until converted.<sup>116</sup>

Unlike convertible preferred stock, convertible notes are a way for companies to raise capital without having to give up ownership in their company, at least initially. From the investors' perspective, using convertible notes means that they do not have to immediately come up with a valuation to a portfolio firm, which will be postponed to the next major financing triggering conversion.<sup>117</sup> The coupon rate on the convertible securities is typically set at zero, which suggests that venture capitalist structure their investment in this way for contract flexibility reasons rather than

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adopted by the National Development and Reform Commission, the Ministry of Science and Technology, the Ministry of Finance, the Ministry of Commerce, the People's Bank of China, the State Administration of Taxation, the State Administration for Industry and Commerce, China Banking Regulatory Commission, China Securities Regulation Commission, and the State Administration for Foreign Exchange, and promulgated by the State Council, Nov. 11, 2005).

111. Monica Mehta, *Raising Capital with Convertible Notes*, BUSINESSWEEK, Jan. 25, 2011, available at [http://www.businessweek.com/smallbiz/content/jan2011/sb20110125\\_145583.htm](http://www.businessweek.com/smallbiz/content/jan2011/sb20110125_145583.htm).

112. Asheesh Advani, *Raising Money Using Convertible Debt*, ENTREPRENEUR.COM, May 15, 2006, available at <http://www.entrepreneur.com/article/159520>.

113. Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments*, 2 (Sep. 1997) (unpublished manuscript), available at <http://www.people.hbs.edu/pgompers/Convert.PDF>; see also Andreas Bacha & Uwe Walz, *Convertible Securities and Optimal Exit Decisions in Venture Capital Finance*, 3 J. CORP. FIN. 286, 299 (2001).

114. Andreas Bacha & Uwe Walz, *Convertible Securities and Optimal Exit Decisions in Venture Capital Finance*, 3 J. CORP. FIN. 286, 299 (2001).

115. *Id.*

116. Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 902 (2003).

117. Asheesh Advani, *Raising Money Using Convertible Debt*, ENTREPRENEUR.COM, May 15, 2006, available at <http://www.entrepreneur.com/article/159520>.

to earn a positive cash flow on their private company investments.<sup>118</sup> In practice, convertible notes are seldom repaid because the VC investors do not want to only get pennies on the dollar, and if the company is failing, it is unlikely that the entrepreneurs will have the money to repay the note at all.

Given the practical difficulties of using convertible preferred stock in China as explained in section 3.1 above, it is natural to think about using convertible notes, which are also often employed by venture capitalists in their investment transactions. However, this alternative may not work out as smoothly as contemplated. Loan transactions are strictly regulated under Chinese law. Only financial institutions with a license for carrying out lending business are allowed to extend loans.<sup>119</sup> Non-financial institutions, such as VC firms and portfolio companies, are generally prohibited from extending loans to each other,<sup>120</sup> regardless of whether the loan would bear interest or whether the borrower is an affiliate or a third party of the lender.

Given that China's financial system is still dominated by a large but underdeveloped banking sector which is more prone to lend first to state-owned enterprises and that the domestic stock exchanges still need to grow more effectively in allocating resources in the economy, the most successful part of the financial system is a sector of alternative financing channels, which rely on alternative governance mechanisms, such as trust, reputation, and relationships.<sup>121</sup> In practice, it is thus not uncommon to

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118. William L. Megginson, *Toward a Global Model of Venture Capital?*, 16 J. APPLIED CORP. FIN. 89, 103 (2004).

119. Daikuan Tongze (贷款通则) [Lending General Provisions], art. 2 (promulgated by the People's Bank of China, June 28, 1998), available at <http://www.chinalawandpractice.com/Article/2204127/Channel/9950/Peoples-Bank-of-China-Lending-General-Provisions.html>. The term "financial institution" is explicitly defined under Chinese law to include institutions that run financial business under the supervision and administration of China Banking Regulatory Commission, such as policy banks, commercial banks, rural cooperative banks, urban credit cooperatives, rural credit cooperatives, village banks, finance companies, rural fund cooperatives, financial asset management companies, trust companies, enterprise group finance companies, financial lease companies, auto financial companies and currency brokerage companies, etc. See Jinrong Xukezheng Guanli Banfa (金融许可证管理办法) [Measures for the Administration of Financial Licenses], art. 3 (promulgated by China Banking Regulatory Commission, May 31, 2003) (amended on Dec. 28, 2006). Among the abovementioned institutions, financial asset management companies are defined as solely state-owned, non-banking financial institutions that specialize in acquiring non-performing loans from state-owned banks, and administering and disposing of the assets resulted from acquiring such non-performing loans. See Jinrong Zichan Guanli Gongsu Tiaoli (金融资产管理公司条例) [Regulation on Financial Asset Management Companies], art. 2 (promulgated by the State Council, Nov. 10, 2000).

120. See Lending General Provisions, *supra* note 119, arts. 61, 73.

121. Franklin Allen et al., *Law, Finance and Economic Growth of China*, 77 J. FIN. ECON. 57, 59-60 (2005).

see *de facto* intercompany loans among business firms,<sup>122</sup> which may be done through the so-called “shadow banking system”<sup>123</sup> or through various circumventing techniques, such as “entrusted loans.”<sup>124</sup> Recently, even the State Administration of Taxation of China has stepped out and benchmarked such inter-firm loans among non-financial institutions by stipulating that “the interests paid for inter-company loans can be deducted for corporate income tax purposes only to the extent that they do not exceed the amount calculated by reference to the interest rates applicable to the loans of the same category and period made by financial institutions,”<sup>125</sup> indirectly admitting the existence of such lending in practice.

Although inter-firm lending is indeed heavily used in practice, the Chinese courts have repeatedly denied its validity. In two judicial interpretations, the Supreme People’s Court of China explicitly deemed such contracts as null and void – the borrower needs to return the principal and will also be fined the amount equal to the interest that would have been derived from a similar bank loan, while any interest that has accumulated upon the loan will be confiscated from the lender.<sup>126</sup> Although convertible debt is more of a controlling rather than lending mechanism between venture capitalists and portfolio companies, it is doubtful whether VCs can successfully persuade the court on this point, especially when it is illegal to conduct inter-firm lending in the first place. As a result of such legal uncertainty (or even illegality), the attractiveness of convertible notes is rather limited in China. Even if venture capitalists want to use them as an investment instrument, they should be prepared to give up the interest

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122. Tracy Alloway, *Michael Pettis on China’s Very Own Zaitaku*, FIN. TIMES. ALPHAVILLE, Feb. 22, 2011, available at <http://ftalphaville.ft.com/blog/2011/02/22/494571/michael-pettis-on-chinas-very-own-zaitaku/>.

123. Henry Sender, *Chinese Finance, A Shadowy Presence*, FIN. TIMES, Mar. 31, 2011, available at <http://www.ft.com/cms/s/0/76f6ed48-5bc4-11e0-b8e7-00144feab49a.html#axzz1RyoVaBoh>. See also *China’s shadow banking system: Trust belt – Trust companies are growing fast, fuelling fears of excessive credit growth*, THE ECONOMIST, Feb. 10, 2011, available at <http://www.economist.com/node/18118975>.

124. Ernest Mak, *Optimizing Liquidity Management in China*, BANK OF AMERICA, Feb. 15, 2006, available at [http://corp.bankofamerica.com/publicpdf/products/treasury/Optimizing\\_Liquidity\\_Management\\_in\\_China.pdf](http://corp.bankofamerica.com/publicpdf/products/treasury/Optimizing_Liquidity_Management_in_China.pdf).

125. Guojia Shuiwu Zongju Guanyu Qiye Suodeshui Ruogan Wenti de Gonggao (国家税务总局关于企业所得税若干问题的公告) [Announcement on Certain Corporate Income Tax Issues] art. 1 (issued by the State Administration of Taxation, June 9, 2011), available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/11596923.html>.

126. See *Zuigao Renmin Fayuan Guanyu Shenli Lianying Hetong Jiufen Anjian Ruogan Wenti de Jieda* (最高人民法院关于审理联营合同纠纷案件若干问题的解答) [Interpretation of the Supreme People’s Court of China Concerning the Trial of Disputes Arising from Association Contracts] (issued by the Supreme Court of China, Nov. 12, 1990), available at <http://www.law-lib.com/lawhtm/1990/7105.htm>; see also *Zuigao Renmin Fayuan Guanyu Dui Qiye Jiedai Hetong Jiekuanfang Yuqi Bu Guihuan Jiekuan Ying Ruhe Chuli de Pifu* (最高人民法院关于对企业借款合同借款方逾期不归还借款的应如何处理问题的批复) [Reply from the Supreme People’s Court of China on Dealing With Borrower of Inter-Firm Loan Contract Delaying Repayment] (issued by the Supreme Court of China, Sep. 23, 1996), available at [http://www.law-lib.com/law/law\\_view.asp?id=12765](http://www.law-lib.com/law/law_view.asp?id=12765).

return and pay penalty for the loan if the funded portfolio company does not perform satisfactorily and they need to call the notes.

Using convertible notes is even more difficult for foreign venture capitalists, as it will be deemed as foreign debt. The concept of foreign debt is broadly defined under the relevant Chinese laws and regulations to include any obligation or potential obligation to make payments to overseas parties.<sup>127</sup> A domestic Chinese non-financial entity must apply for approval from the State Development and Reform Commission,<sup>128</sup> which lays out the country's comprehensive plan of economic development, including the quota and structure for using foreign capital, in order to incur any foreign debt with a term of one year or longer.<sup>129</sup> The domestic Chinese non-financial entity must also register the debt on a transaction-by-transaction basis with the State Administration of Foreign Exchange ("SAFE"),<sup>130</sup> which is the top administrator of China's foreign capital flows, or else no bank will be able to open a foreign exchange account to remit such capital into China.<sup>131</sup> Foreign debt contracts are deemed valid only upon such registration with SAFE.<sup>132</sup> Furthermore, parties must also obtain approval from the SAFE if they want to convert the foreign debt into Renminbi for use in China, and to convert Renminbi back into foreign currency to repay the debt in the future.<sup>133</sup> Given the existence of these complicated approval and registration procedures, lending foreign money to a domestic start-up firm is far from an easy matter. As it is not a convenient choice for foreign venture capitalists to use convertible debt to carry out a VC transaction in China, it is unlikely to become an effective alternative for convertible preferred stock.

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127. Waizhai Tongji Jiance Zanzing Guiding (外债统计监测暂行规定) [Provisional Regulations on Statistics and Supervision of Foreign Debt], art. 3 (promulgated by the State Administration of Exchange Control, Aug. 27, 1987). See also Waizhai Guanli Zanzing Banfa (外债管理暂行办法) [Interim Measures on the Management of Foreign Debt] arts. 2-5 (jointly promulgated by the State Development Planning Commission, the Ministry of Finance, and the State Administration of Foreign Exchange, Jan. 8, 2003).

128. Interim Measures on the Management of Foreign Debt, *supra* note 127, art. 15.

129. Guanyu Duanqi Duiwai Jiekuan Shixing Yue Waizhai Guanli de Tongzhi (关于短期对外借款实行余额外债管理的通知) [Announcement on Administrating Short-Term Foreign Debt Quotas], art. 1 (issued by the People's Bank of China, Oct. 5, 1990), available at [http://www.law-lib.com/law/law\\_view.asp?id=52341](http://www.law-lib.com/law/law_view.asp?id=52341). Short-term foreign debt is defined as debt borrowed by a domestic entity from a foreign entity within or equal to the term of one year.

130. Interim Measures on Statistics and Supervision of Foreign Debt, *supra* note 127, art. 5.

131. *Id.* at art. 6.

132. Interim Measures on the Management of Foreign Debt, *supra* note 127, art. 22.

133. Jiehui Shouhui Ji Fuhui Guanli Guiding (结汇、售汇及付汇管理规定) [Provisions on the Settlement and Sale of and Payment in Foreign Exchange], arts. 27, 30 (promulgated by the People's Bank of China, June 20, 1996). See also Interim Measures on Statistics and Supervision of Foreign Debt, *supra* note 127, arts. 6-7.



## 3.2.2 Separability of cash flow and control rights from equity ownership

Given the tremendous agency conflicts embedded in entrepreneurial financing, it is not optimal to allocate ownership proportionate to residual value, as is done in the case of common equity.<sup>134</sup> Therefore, the central benefit of convertible preferred stock to venture capitalists is that it allows the separate allocation of rights of cash flow, voting, board representation, and liquidation, etc., so that venture capitalists can have control rights without necessarily also having the majority equity ownership in the start-up firm.

A basic prerequisite for an arrangement similar to convertible preferred stock to function in China is for the Chinese Company Law to separate cash flow rights, control rights, and liquidation rights from equity ownership. By virtue of such separability, venture capitalists will then be able to, through contractual agreements, stipulate certain preferential rights over their equity interests in the company. This will allow venture capitalists to effectively monitor and control entrepreneurs to ensure that their investments are secured with some priority if the portfolio company does not perform well, even when they do not have a majority equity stake in the portfolio company. By doing so, venture capitalists can achieve similar results as if they had invested with convertible preferred stock,<sup>135</sup> which is not practical for use in China.

Fortunately, according to the current Company Law of China, cash flow rights and control rights are generally separable from equity ownership. To begin with, the profits of a company do not have to be distributed among shareholders in proportion to the corresponding percentages of contributed capital. Instead, parties are allowed to agree otherwise, and the agreement will prevail over the default rules in the law.<sup>136</sup> The mandatory requirement that shareholders only exercise their voting rights at the shareholders' meeting on the basis of their respective percentages of the capital contributions<sup>137</sup> is also lifted in the currently effective Company Law as compared to its previous versions.<sup>138</sup> Moreover, parties can freely agree on the circumstances to liquidate the company, which does not have to be triggered by the insolvency or bankruptcy of the com-

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134. Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments* 4 (Sep. 1997) (unpublished manuscript), available at <http://www.people.hbs.edu/pgompers/Convert.PDF>.

135. Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 882 (2003) (submitting that "other securities can easily duplicate the control features of convertible preferred stock").

136. 2006 Company Law, *supra* note 86, art. 35.

137. 1993 Company Law, *supra* note 86, art. 41; 1999 Company Law, *supra* note 86, art. 41; 2004 Company Law, *supra* note 86, art. 41.

138. 2006 Company Law, *supra* note 86, art. 43.

pany.<sup>139</sup> However, as to liquidation rights, the Company Law does not allow preference over certain group of shareholders, meaning that the remaining assets and proceeds must be distributed corresponding to the percentages of capital contribution.<sup>140</sup>

For foreign venture capitalists, there is another statutory alternative offering the separability of cash flow rights and control rights from equity ownership. The Chinese company law system can be characterized by a so-called “legal dualism.”<sup>141</sup> It involves a separate package of legal provisions applicable only to Chinese-foreign joint ventures and wholly foreign-funded firms, while the general company law will only step in if the special stipulations are silent. Among other things, there is a business form termed “cooperative joint venture,” which can be used by foreign investors who intend to form a joint venture with Chinese partners. Cooperative joint ventures confer a high degree of contractual freedom for the two sides to negotiate and design the corporate governance structure of the joint venture in their agreement, which will be the highest governing authority of the firm to the extent permitted by law.<sup>142</sup> Negotiable items include, but are not limited to, the distribution of earnings or products, and the sharing of risks, losses, and remaining assets in the company,<sup>143</sup> which do not need to be the same as the capital contribution percentage.

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139. 2006 Company Law, *supra* note 86, art. 181. According to this provision, a company may be dissolved under any of the following circumstances:

(1) The duration of business operation as stipulated by the articles of association expires or any of the matters for dissolution as stipulated in the articles of association of the company appears;

(2) The shareholders' meeting or the general shareholders' meeting decides to dissolve it;

(3) It is necessary to be dissolved due to merger or division of the company;

(4) Its business licence is revoked or it is ordered to close down or to be cancelled according to law; or

(5) The people's court decides to dissolve it upon the request of more than 10 per cent of the shareholders holding voting rights.

140. 2006 Company Law, *supra* note 86, art. 187.

141. Knut Benjamin Pissler & Junhai Liu, *Corporate Governance of Business Organizations in the People's Republic of China: The Legal Framework After the Revision of the Company Law in 2005* (Oct. 22, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1695888>.

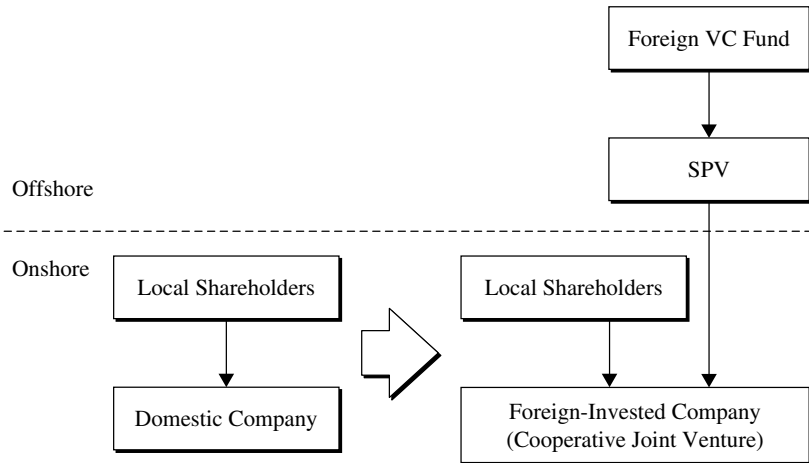
142. See *Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa* (中华人民共和国中外合作经营企业法) [Law on Sino-Foreign Cooperative Joint Ventures (P.R.C.)] art. 11 (adopted at the 1st Session of the 7th National People's Congress, Apr. 13, 1988) (revised on Oct. 31, 2000) (stipulating that “a cooperative joint venture shall operate in accordance with the approved JV contract and articles of association”). Moreover, in case there is a discrepancy between the JV contract and JV articles of association, the JV contract shall prevail. See art. 10 of *Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa Shishi Xize* (中华人民共和国中外合作经营企业法实施细则) [Detailed Rules on the Implementation of the Law on Sino-foreign Cooperative Joint Ventures (P.R.C.)] (promulgated by the Ministry of Foreign Trade and Economic Development, Sep. 4, 1995).

143. Arts. 2 and 21 of *Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa* (中华人民共和国中外合作经营企业法) [the Law on Sino-foreign Cooperative Joint Ventures (P.R.C.)] (adopted at the 1st Session of the 7th National People's Congress, Apr. 13, 1988) (revised on Oct. 31, 2000).

The major potential drawback to cooperative joint ventures is that they are subject to a more stringent governmental review process – the joint venture agreement and articles of association, including any material change(s) thereto, must be approved by the relevant governmental authorities before they can take effect.<sup>144</sup> Since the requirement of governmental review is mandatory and substantive, officials may refuse to grant the approval if the submitted documentation look very different from the conventional joint venture contracts that they are familiar with.<sup>145</sup> As such, even when an approval is finally granted, it is not certain that foreign venture capitalists will definitively obtain all the desired contractual provisions they want to have in the agreement, as the officials may ask them to amend certain parts in ways they see fit.

The chart below outlines how foreign venture capitalists can make direct investments into a Chinese portfolio company.

FIGURE 3.2.2: DIRECT PORTFOLIO INVESTMENT BY FOREIGN VENTURE CAPITALISTS



### 3.3 Prevalent Offshore Investment Structure

The possibility of separating cash flow rights and control rights from economic ownership, which was largely made possible by the currently effective Company Law (amended in 2005 and took effect as from 2006), was not available to venture capitalists before then. Given the impracticability of using convertible preferred stock in China as explained above,

144. Arts. 5 and 7 of Sino-foreign Cooperative Joint Ventures of the People's Republic of China, *id.*

145. In China, it is almost standard practice for lawyers to write the contract and articles of association of cooperative JVs in a way so as to mirror the structure of the Law on Sino-foreign Cooperative Joint Ventures. Arguably, the legal documents so written may appear clear and straightforward in the eyes of government officials, thus may help smoothen the approval process.

many foreign VC funds in practice have chosen to finance their China deals via an “offshore investment structure,” in which the capitalization actually happens outside China while the target portfolio company inside China only serves as an operating entity. Logically, with such offshore funding structures, venture capitalists expect to exit from their investments outside China, either by floating on offshore stock exchanges, or by selling the business to other foreign acquirers. Although this offshore structure is particularly relevant to the VC industry, it is useful for other purposes as well. Many conventional foreign investors, such as transnational companies, also heavily rely on this structure to enter industries with restrictions on foreign direct investment according to Chinese laws.<sup>146</sup>

This section describes “offshore investment structures,” and relevant related laws and regulations.

### 3.3.1 Introduction to offshore investment structures

Offshore investment structures originate and derive from the “Chinese-Chinese-Foreign” (“CCF”) financing structure, which was first invented and implemented in 1994 by China Unicom, the country’s second largest telecommunication operator, to circumvent China’s long-standing prohibition on foreign ownership, operation, and management of telecommunication enterprises.<sup>147</sup> The very first company using the offshore investment structure was reported to be Beijing Yuxing, a computer technology firm went public in Hong Kong Stock Exchange in August 1999 via a holding company established in Bermuda.<sup>148</sup> In the simplest form, the structure is an offshore holding company with a Chinese subsidiary, in which the investments are actually made into the offshore company and the subsidiary is the operating company. For the purposes of easy and cheap formation, tax efficiency, as well as facilitating prospective exits in offshore capital markets such as those in the U.S., Hong Kong and/or Singapore, the holding company is usually incorporated in offshore tax havens such as the Cayman Islands or the British Virgin Islands.<sup>149</sup> More

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146. See Fred Gregura & Carol Li, *Investment and Operating in Restricted Industries in China*, FENWICK & WEST LLP, available at [http://www.fenwick.com/FenwickDocuments/Invest\\_Operating\\_In\\_China.pdf](http://www.fenwick.com/FenwickDocuments/Invest_Operating_In_China.pdf).

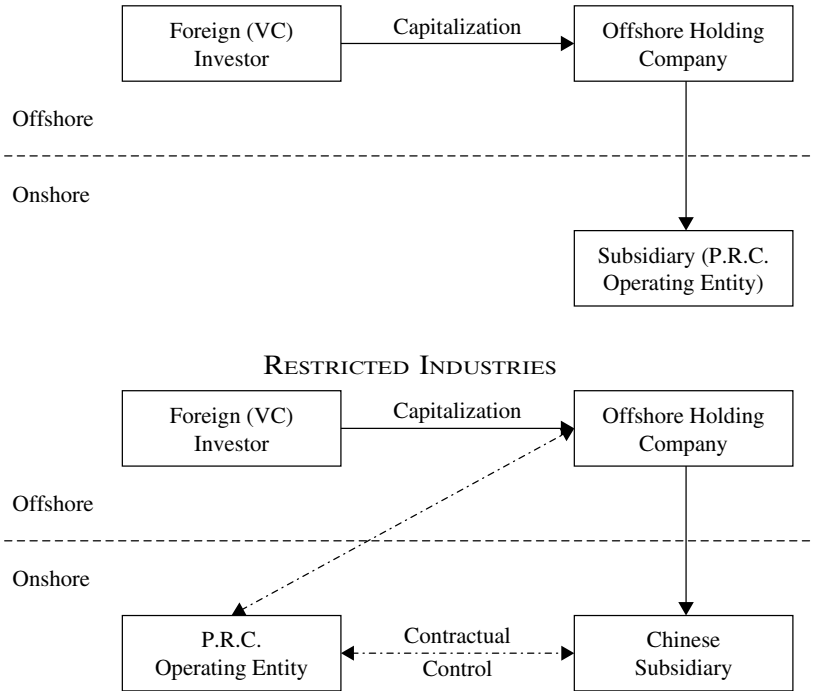
147. LAURENCE J. BRAHM, CHINA AFTER WTO 219 (2002).

148. Shiyi Hao Wen Jinghun – Yitiao Fagui de Zhongguo Zhi Zaoyu (11号文“惊魂”一条法规的中国式遭遇) [*The Notice No 11 Panic: A Regulation’s Story with Chinese Characteristics*], 10 SHANGWU ZHOUKAN (商务周刊) [BUSINESS WATCH] (2005), available at <http://finance.sina.com.cn/stock/hkstock/hkstockresearch/20051020/15012049945.shtml>. This Yuxing incident was considered the direct cause for the China Securities Regulation Commission to impose the “non-objection letter” requirement for Chinese firms seeking overseas listing. See table 3.3.2 below.

149. Fred Greguras et al., *2008 Update to Doing Business in China via the Cayman Islands*, FENWICK & WEST LLP, available at [http://www.fenwick.com/docstore/Publications/Corporate/2008\\_Update\\_Business\\_China.pdf](http://www.fenwick.com/docstore/Publications/Corporate/2008_Update_Business_China.pdf). For a more detailed account of the benefits of using an offshore SPV to invest in China, see Greg Knowles, *Cayman and BVI: The Benefit for China in Times of Regulatory Change*, 9 HONG KONG LAWYER (2010), available at <http://www.maplesandcalder.com/fileadmin/uploads/maples/Documents/PDFs/CAYMAN%20>

complex forms of this structure are widely used in restricted industries in China, in which foreign investors are not allowed to hold majority or controlling stakes. In such complex forms, the *de facto* control from the offshore holding company over the operating entity in the People’s Republic of China (P.R.C.) is materialized via contractual arrangements rather than via direct equity stake in the latter. The charts below show how both the two structures operate.

FIGURE 3.3.1: OFFSHORE INVESTMENT STRUCTURES



Such offshore structures are usually set up in practice as follows: at the time of seeking foreign investment, the Chinese founders who have been operating a Chinese business firm will set up a holding company in an offshore jurisdiction and then use it to acquire equity interests in the local company, thus converting it into a Chinese subsidiary of the offshore entity.<sup>150</sup> This subsidiary will serve as the operating unit in China. As to the more complicated structure that is used in investments into restricted industries, the offshore holding company will provide necessary funds to its key directors or officers who are residents in China to capitalize or acquire

AND%20BVI%20THE%20BENEFIT%20FOR%20CHINA%20IN%20TIMES%20OF%20REGULATORY%20CHANGE%20.pdf.

150. Peter Feist et al., *China’s Private Equity Landscape*, WEIL GOTSHAL PRIVATE EQUITY ALERT (Jun. 2008), available at [http://www.weil.com/files/Publication/9fc526ef-91f0-4258-afb0-98e6e268fc8d/Presentation/PublicationAttachment/4884527e-a1dd-4ac1-a68a-a7cac78eb6da/PEA\\_June\\_08.pdf](http://www.weil.com/files/Publication/9fc526ef-91f0-4258-afb0-98e6e268fc8d/Presentation/PublicationAttachment/4884527e-a1dd-4ac1-a68a-a7cac78eb6da/PEA_June_08.pdf), at 1.

a Chinese business entity, which will hold the required Chinese government-issued licenses and approvals.<sup>151</sup> The directors or officers will act as equity holders of the Chinese operating entity for the benefit of the offshore holding company.<sup>152</sup> The offshore holding company does not have any direct ownership interest in the Chinese entity; rather, the holding company will establish a subsidiary in China,<sup>153</sup> which will enter into various agreements with the Chinese entity, which normally include loan agreements, power of attorney agreements (voting agreements), exclusive service agreements, share pledge agreements, and other operating agreements.<sup>154</sup> Taken together, these agreements provide the offshore company with effective financial and operational control over the Chinese operating entity.<sup>155</sup>

### 3.3.2 IMPORTANT BENEFITS OF THE OFFSHORE STRUCTURE WITHIN THE VENTURE CAPITAL INVESTMENT CONTEXT

Over the years, foreign investors, particularly global venture capitalists, have become comfortable with the offshore structure as they understand and use it. From a technical point of view, the advantage of this offshore investment structure is that it helps to circumvent the unfavorable laws and regulations of China. Such an advantage results from the possibility of choosing the ideal governing law of the transaction. Normally, if foreign VC investments are made directly within China, thus turning a Chinese firm into a Sino-foreign joint venture, the governing law will have to be the law of China.<sup>156</sup> By contrast, if the transaction is structured off-

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151. See Fred Greguras & Jianwei Zhang, *2008 Update to Investment and Operating in Restricted Industries in China*, FENWICK & WEST LLP, available at [http://www.fenwick.com/docstore/Publications/Corporate/Invest\\_Operating\\_In\\_China\\_2008.pdf](http://www.fenwick.com/docstore/Publications/Corporate/Invest_Operating_In_China_2008.pdf), at 1.

152. *Id.*

153. This Chinese subsidiary may be wholly owned by the offshore holding company, or may be a joint venture between the offshore holding company and the PRC operating company, as applicable in different situations.

154. Paul Gillis, *Explaining the VIE Structures*, CHINA ACCT. BLOG, available at <http://www.chinaaccountingblog.com/weblog/explaining-vie-structures.html>.

155. See Fred Greguras & Jianwei Zhang, *2008 Update to Investment and Operating in Restricted Industries in China*, FENWICK & WEST LLP, available at [http://www.fenwick.com/docstore/Publications/Corporate/Invest\\_Operating\\_In\\_China\\_2008.pdf](http://www.fenwick.com/docstore/Publications/Corporate/Invest_Operating_In_China_2008.pdf), at 1. For a more detailed description of the more complex contractual structure, and especially the function of the contracts entered into between the entities, see Paul Gillis, *Explaining the VIE Structures*, CHINA ACCT. BLOG, available at <http://www.chinaaccountingblog.com/weblog/explaining-vie-structures.html>.

156. Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa (中华人民共和国中外合作经营企业法) [Law on Sino-Foreign Equity Joint Ventures (P.R.C.)] art. 2 (adopted by the 2nd Session of the 5th National People's Congress, July 1, 1979) (amended for the first time, Apr. 4, 1990) (amended for the second time, Mar. 15, 2001); Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Fa Shishi Xize (中华人民共和国中外合作经营企业法实施细则) [Implementing Measures for the Law on Sino-Foreign Cooperative Joint Ventures (P.R.C.)] art. 55 (promulgated by the Ministry of Foreign Trade and Economic Cooperation, Sep. 4, 1995); see also Zhonghua Renmin Gongheguo Waishang Duzi Qiye Fa Shishi Xize (中华人民共和国外商独资企业法实施细则)

shore in which the capital is actually injected into the holding company outside China, the parties will have the liberty to mutually choose from other laws than the Chinese law. It could be the law of a developed jurisdiction with substantial relation with the transaction, such as where the firm aims to list on in the future or where the foreign venture capitalist comes from.<sup>157</sup> It has to be noted that, thus far, China still primarily relies on imposing direct administrative approvals and technical restrictions, such as those on foreign equity ownership, foreign exchange transfer, and conversion approvals, to control the value and quality of foreign inward capital flows.<sup>158</sup> This means that under Chinese law, the relevant governmental authority needs to review and approve investment contracts before any investments in foreign currency can be converted into Renminbi and made into China. With the aid of the offshore investment structure, foreign investors can conveniently enter the Chinese market without having to try their luck with the government, which may reject the investment contracts or call for unfavorable revisions to them.

In addition to the possibility of circumventing governmental scrutiny over foreign investments, parties may get access to more efficient legal rules that are not entirely available in China. As argued above, the general lack of a share-based equity system in Chinese non-listed firms makes it difficult for venture capitalists to use convertible preferred stock, which is an efficient investment tool widely employed in the U.S. VC community to obtain special economic rights such as liquidation preferences, anti-dilu-

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[Implementing Measures for the Law on Wholly Foreign-Owned Enterprises (P.R.C.)] art. 2 (promulgated by the Ministry of Foreign Trade and Economic Cooperation, Dec. 12, 1990) (amended, Apr. 12, 2001). See Zuigao Renmin Fayuan Guanyu Shenli Shewai Minshi Huo Shangshi Hetong Jiufen Anjian Falü Shiyong Ruogan Wenti de Guiding (最高人民法院关于审理涉外民事或商事合同纠纷案件法律适用若干问题的规定) [Rules of the Supreme People's Court on the Relevant Issues Concerning the Application of Law in Hearing Foreign-Related Contractual Dispute Cases in Civil and Commercial Matters] art. 8 (promulgated by the Supreme Court of China, July 23, 2007), available at [http://www.court.gov.cn/qwfb/sfjs/201006/t20100628\\_6412.htm](http://www.court.gov.cn/qwfb/sfjs/201006/t20100628_6412.htm).

157. As an example, the series A convertible preferred shares purchase agreement between Sequoia Capital, a US venture capital firm and China Linong International Limited, a BVI holding entity of China LandV Group, a leading Chinese agricultural company, chose the Laws of California as the governing law. See <http://contracts.onecle.com/le-gaga/linong-spa-2007-02-14.shtml>. Similarly, in a share purchase agreement where Softbank, a Japanese venture capital firm, exited from Taobao Holding Limited, a Cayman Islands holding company of a leading Chinese online shop website, which is also a subsidiary of the Alibaba group, by selling its shares there to Yahoo! Inc., the parties agreed on the law of the State of New York as the governing law. See <http://contracts.corporate.findlaw.com/planning/purchase/5474.html>. This kind of practice is not only identifiable for venture capitalists in China. Venture capitalists in Taiwan have similarly stated that they use California law to draft contracts for locally funded firms. By doing this, they can unofficially import U.S. venture capital law to their countries. See David Ahlstrom & Garry D. Bruton, *Venture Capital in Emerging Economies: Networks and Institutional Change*, 30 ENTREPRENEURSHIP THEORY AND PRACT. 299, 313 (2006).

158. See Donald Kimball & Fengjuan Xiao, *Effectiveness and Effects of China's Capital Controls*, 4 CHINA & WORLD ECON. 60, 61 (2005).

tion adjustments and other rights in the investment contracts, as well as to effectively monitor the invested company. The same also holds for employee incentive plans such stock options, which are important to VC investing in that they give entrepreneurs long-term incentives to stay and serve the company, but are again difficult to use in China as a result of the lack of share-based equity system. By structuring the VC investment offshore, in contrast, parties will be able to make use of such investment instruments in the holding company outside China without being deterred by the regulatory limitations in the Chinese law, which would no longer be mandatorily applicable.

Third, and perhaps most importantly, the offshore investment structure also provides parties to foreign investment transactions with feasible, flexible, and usually profitable exit options. Exit strategies are as crucial as entry strategies, as they determine profits for investors. Typically, VC investors can exit from investments by selling their shares or equity interests in the invested company on a public stock exchange after the portfolio company is listed, or to a third party acquirer in a private sale. Either way, if the investors or entrepreneurs want to seek exit abroad, using an offshore structure may be preferable to investing directly onshore, as Chinese law imposes substantive and time-consuming approval procedures for any Chinese company seeking foreign listing or foreign-financed merger and acquisitions (“M&A”). Table 3.3.2 below summarizes the major laws and regulations governing overseas stock issuance, listing, and mergers & acquisitions from 1993 when China first adopted its company law code. It can be seen from below that direct access to overseas stock exchanges has been largely limited to those well-scaled companies (particularly state-owned ones), and such access is only granted after going through lengthy and complex review and approving processes. Rather, indirect access via an offshore special purpose vehicle (“SPV”) was comparatively easier, especially during the period between 2003 and 2005, in which the “non-objection letter” requirement was lifted while new regulatory restrictions were still not put in place.



TABLE 3.3.2: BRIEF SUMMARY OF CHINESE REGULATIONS REGARDING OVERSEAS STOCK ISSUANCE, LISTING, AND M&amp;A

Time	Regulation	Significance	Remark
29 December 1993	Company Law	Companies may list abroad upon the approval of the state securities regulation authorities.	
17 June 1996	Notice from the Securities Commission of the State Council on the Prerequisites, Procedures, and Documentation Needed for Recommending Pre-Selection Enterprises for Overseas Listing	Companies first need to be recommended by provincial governmental authorities as the pre-selection enterprises in order to list abroad. Only 1 – 2 enterprises may be recommended per province.	Repealed as from 21 December 1999. <sup>159</sup> Companies can apply for overseas listing directly at the CSRC without being limited by the recommendation quota.
20 June 1997	Notice from the State Council on Further Strengthening the Administration of Overseas Stock Issuance and Listing	All major efforts for the purposes of listing a domestic company on a foreign stock exchange, including but not limited to acquisition, stock swap, or appropriation, should be approved by provincial governmental authorities and reviewed by the state securities regulation authorities.	
29 December 1998	Securities Law	Approval from the state securities regulation authorities must be obtained before a domestic company trades or offers shares abroad, either directly or indirectly. <sup>160</sup>	
14 July 1999	Notice from China Securities Regulation Commission Concerning the Relevant Issues on Enterprises Applying For Overseas Listing	A company qualifying for overseas listing should, among other things, have at least RMB400 million net assets, RMB60 million post-tax profits for the past year, and will raise at least US\$50 million upon listing.	

159. See Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Feizhi Bufen Zhengquan Bumen Guizhang de Tongzhi (中国证券监督管理委员会关于废止部分证券部门规章的通知) [Notice from China Securities Regulation Commission on Abolishing Certain Securities Related Government Departmental Rules] (promulgated by China Securities Regulation Commission, Dec. 21, 1999), available at <http://www.fdi.gov.cn/pub/FDI/zcfg/fzflfgml/P020060619698849539195.pdf>.

160. However, the Securities Law does not spell out what activities shall constitute “indirectly trading or offering shares abroad,” and thus would need the approval from securities regulation authorities.

Time	Regulation	Significance	Remark
9 June 2000	Notice from China Securities Regulation Commission Concerning Several Issues on Stock Issuance and Listing of Overseas Companies with Domestic Interests	A legal opinion from Chinese legal counsel is required if a firm seeks to issue stock or list abroad. Such legal opinion will be reviewed by China Securities Regulation Commission ("CSRC"). In order to enable the contemplated overseas stock issuance or listing, a "non-objection letter" must be obtained from the CSRC regarding the legal opinion.	Repealed as from 1 April 2003. <sup>161</sup> No "non-objection letter" from the CSRC is required for overseas stock issuance and listing.
24 January 2005	Notice from the State Administration of Foreign Exchange Concerning the Relevant Issues on Improving the Foreign Exchange Administration of Foreign-Funded M&As (Hui Fa [2005] No. 11) ("Notice No. 11")	If a domestic resident sells his domestic assets and/or stock in exchange for overseas shares or equity interest, he must obtain the prior approval from the State Administration of Foreign Exchange ("SAFE").	Repealed by Notice No. 75.
8 April 2005	Notice from the State Administration of Foreign Exchange Concerning the Relevant Issues on Registration of Overseas Investments by Domestic Individual Residents and Foreign Exchange Registration of Foreign-Funded M&As (Hui Fa [2005] No. 29) ("Notice No. 29")	If a domestic resident transfers his domestic assets and/or equity into an overseas entity and directly or indirectly holds the equity interests or shares of the overseas entity, a registration with the SAFE is required. Similarly, any subsequent capital increase, decrease, equity transfer, merger, separation, equity investment, and incurring encumbrance with domestic assets, should all be registered with the SAFE.	Repealed by Notice No. 75.

161. See Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Quxiao Di'er Pi Xingzheng Shenpi Xiangmu Ji Gaimian Bufen Xingzheng Shenpi Xiangmu Guanli Fangshi de Tonggao (中国证券监督管理委员会关于取消第二批行政审批项目及改变部分行政审批项目管理方式的通告) [Announcement of China Securities Regulatory Commission on Canceling the Second Group of Administrative Approval Items and on Changing the Management Methods of Some Administrative Approval Items] (promulgated by China Securities Regulation Commission, Apr. 1, 2003).

<b>Time</b>	<b>Regulation</b>	<b>Significance</b>	<b>Remark</b>
21 October 2005	Notice from the State Administration of Foreign Exchange Concerning Relevant Issues about Foreign Exchange Control on Domestic Residents' Corporate Financing and Round-Trip Investment Through Offshore Special Purpose Vehicles (Hui Fa [2005] No. 75) ("Notice No. 75")	Domestic residents can set up SPVs, and use such vehicles to engage in equity financing activities. Registration with the SAFE is required prior to the establishment or gaining control of any offshore holding entity by Chinese residents. Moreover, SAFE also requires for retrospective compliance of pre-existing offshore holdings.	
8 August 2006	Provisions on Foreign-Funded Mergers and Acquisitions of Domestic Enterprises (MOFCOM Ordinance [2006] No. 10) ("Ordinance No. 10")	Approval from the Ministry of Commerce is needed before any Chinese individuals or companies can establish an offshore SPV, use the SPV to acquire the domestic operating company and turn it into the subsidiary of the SPV. The subsidiary domestic company will hold a special business license valid only for one year. Overseas listing must be completed within one year after the issuance of such special business licence. Approval by CSRC is needed as a pre-requisite for an offshore SPV that holds assets in China to undertake a listing outside China.	

As can be seen in table 3.3.2 above, the promulgation of the Provisions on Foreign-Funded Mergers and Acquisitions of Domestic Enterprises ("Ordinance No. 10"),<sup>162</sup> which followed the three Notices from the State Administration of Foreign Exchange (Notices No. 11, 29, and 75 as summarized in the table above) earlier in 2005, finally and conclusively draws the practice of using an offshore SPV to acquire and own domestic interests under regulatory supervision. Consequently, governmental approval becomes a prerequisite for such a SPV to be set up and used, e.g., for VC financing and further overseas listing. The reality is, however, since Ordi-

162. Waiguo Touzizhe Binggou Jingnei Qiye Guiding (外国投资者并购境内企业规定) [Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors] (jointly promulgated by the Ministry of Commerce, State-Owned Assets Supervision and Administration Commission of State-Council, State Administration of Taxation, State Administration of Industry and Commerce, China Securities Regulation Commission, and State Administration of Foreign Exchange, Aug. 8, 2006) (amended on June 22, 2009).

nance No. 10 came into force, there has not been even one successful precedent that has managed to obtain approval from the Ministry of Commerce.<sup>163</sup> Rather, an alternative is used even more often to circumvent the requirements of Ordinance No. 10. As mentioned above, there are two models of offshore investment structure (see figure 3.3.1). The key difference between them is that, while the first achieves direct control by the offshore SPV holding equity stake of the onshore operating entity, in the second model it is the contractual agreements between the offshore SPV's Chinese subsidiary and the real operating entity in China that help to establish indirect control by the offshore SPV. Given the possibility of using the first and simpler model, the more complicated contractual model was mainly employed when investing in restricted industries before 2006.<sup>164</sup> After Ordinance No. 10, however, its usage was incidentally pushed even further into those industries that do not prohibit majority foreign ownership because the contractual arrangements in such a model make it unnecessary for the offshore SPV to acquire and own equity interests in Chinese companies, thus rendering Ordinance No. 10 no longer applicable.<sup>165</sup> This contractual model is often more concisely referred to as the VIE model. VIE stands for "variable interest entity," which is originally a term used by the United States Financial Accounting Standards Board to refer to an entity in which the investor holds a controlling inter-

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163. ZHANG LONG (张龙), ZHONGGUO QIYE JINGWAI SHANGSHI JIANGUAN (中国企业境外上市监管) [SUPERVISION AND REGULATION OF CHINA'S OVERSEAS LISTING] ch. 3.2 (2011), available at <http://lz.book.sohu.com/chapter-20561-116330683.html>; see also Su Jiang (苏江), *Erdü Bianshen de Youhuo – Zhongxiao Gongsi Hongchou Jiagou Huigui Diaocha* (二度变身的诱惑—中小公司红筹架构回归调查) [*The temptation to restructure for the second time – an investigation into the disentanglement of the "red chip" structure of Chinese SMEs*], 21 SHIJI JINGJI BAODAO (21世纪经济报道) [21ST CENTURY BUSINESS HERALD] Sep. 17, 2010, available at [http://www.21cbh.com/HTML/2010-9-20/20MDAwMDE5ODI2OQ\\_6.html](http://www.21cbh.com/HTML/2010-9-20/20MDAwMDE5ODI2OQ_6.html); and Greg Knowles, *Cayman Islands and BVI: The benefit for China in times of regulatory change*, 9 HONG KONG LAWYER (2010), available at <http://www.maplesandcalder.com/fileadmin/uploads/maples/Documents/PDFs/CAYMAN%20AND%20BVI%20THE%20BENEFIT%20FOR%20CHINA%20IN%20TIMES%20OF%20REGULATORY%20CHANGE%20.pdf>, pointing out that "[s]uch approval has proved difficult to obtain and is unlikely to be forthcoming for anything other than the largest of deals."

164. Wang Shanshan et al. (王姗姗等), *Zhifubao Kaoyan: Haiwai Shangshi Gongsi VIE Moshi Zao Tiaozhan* (支付宝考验：海外上市公司VIE模式遭挑战) [*The Test Facing AliPay: VIE Model of Overseas Listed Companies Challenged*], 455 CAIXIN XINSHIJI (财新《新世纪》) [CAIXIN CENTURY] (2011), available at <http://news.qq.com/a/20110620/000543.htm>.

165. To be sure, using the contractual model is not the only option to circumvent Ordinance No. 10, while arguably is the most heavily used one. For the introduction of other possible alternatives, see Li SHOUSHUANG & SU LONGFEI (李寿双 & 苏龙飞), HONGCHOU BOYI: SHIHAO WEN SHIDAI DE MINQI JINGWAI SHANGSHI (红筹博弈：十号文时代的民企境外上市) [RED-CHIP GAME: OVERSEAS LISTING OF CHINESE PRIVATE COMPANIES IN THE TIMES OF ORDINANCE No. 10] (2011). See also Greg Knowles, *Cayman Islands and BVI: The Benefit for China in Times of Regulatory Change*, 9 HONG KONG LAWYER (2010), available at <http://www.maplesandcalder.com/fileadmin/uploads/maples/Documents/PDFs/CAYMAN%20AND%20BVI%20THE%20BENEFIT%20FOR%20CHINA%20IN%20TIMES%20OF%20REGULATORY%20CHANGE%20.pdf>.

est that is not based on the majority of voting rights.<sup>166</sup> This is exactly the essence of the contractual model that is widely used by (foreign) investors in many Chinese firms (most typically in Internet firms<sup>167</sup>).

Other than the benefits within the context of VC investments as mentioned above, using offshore investment structures can also serve other purposes, which are not directly related to the VC investment process. Among other things, one important motive for some Chinese entrepreneurs to set up an offshore holding company and to use it to acquire the Chinese interests is to reduce their tax obligations. By doing so, the original Chinese firm would be turned into a foreign-invested enterprise (“FIE”), and under the then applicable Chinese taxation law regime, a foreign investor was exempt from paying Chinese income tax for the dividends received from an FIE.<sup>168</sup> Moreover, Chinese law used to also grant FIEs with various tax holidays and tax deductions, depending on such factors as their lines of business and locations, etc.<sup>169</sup>

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166. For more explanation of VIE, see *Summary of Interpretation No. 46 (revised December 2003): Consolidation of Variable Interest Entities—an interpretation of ARB No. 51 (Issued 12/03)*, FINANCIAL ACCT. STANDARDS BD., available at <http://www.fasb.org/st/summary/finsum46r.shtml>.

167. Jing Linbo & Wang Xuefeng (荆林波&王雪峰), *Waizi Dui Woguo Hulianwang Shichang Yingxiang de Yanjiu (外资对我国互联网业市场影响的研究) [A Research on the Influence of Foreign Capital on China's Internet Market]*, 5 CAIMAO JINGJI (财贸经济) [FINANCE & TRADE ECONOMICS] 97 (2009), available at <http://www.lvzaiyi.com/wp-content/uploads/downloads/2011/06/外资对我国互联网业市场影响的研究.pdf>.

168. *Zhonghua Renmin Gongheguo Waishang Touzi Qiye He Waiguo Qiye Suodeshui Fa (中华人民共和国外商投资企业和外国企业所得税法) [Income Tax Law for Foreign-Funded Enterprises and Foreign Enterprises (P.R.C.)]* art. 19 (promulgated by the National People's Congress, Apr. 9, 1991). Such preferential taxation treatment offered particularly to foreign investors in FIEs was no longer available as from 2008, when China's new Enterprise Income Tax Law started to take effect. Under the new Enterprise Income Tax Regime, non-resident firms are obliged to pay a reduced enterprise income tax at 10% for the dividends they gained from FIEs. See *Zhonghua Renmin Gongheguo Qiye Suodeshui Fa (中华人民共和国企业所得税法) [Enterprise Income Tax Law (P.R.C.)]* arts. 3, 4, 19 (adopted at the 5th Session of the 10th National People's Congress, Mar. 16, 2007); see also art. 91 of *Zhonghua Renmin Gongheguo Qiye Suodeshui Fa Shishi Tiaoli (中华人民共和国企业所得税法实施条例) [Regulation on the Implementation Rules of Enterprise Income Tax Law (P.R.C.)]* (adopted by the State Council at the 197th executive meeting, Nov. 28, 2007). In case the foreign investor is an individual, see *Caizhengbu, Guojia Shuiwu Zongju Guanyu Geren Suodeshui Ruogan Zhengce Wenti de Tongzhi (财政部，国家税务总局关于个人所得税若干政策问题的通知) [Circular from the Ministry of Finance and State Administration of Taxation on Some Policy Issues Concerning Individual Income Tax]* art. 2 (promulgated by the Ministry of Finance and State Administration of Taxation, May 13, 1994).

169. *Income Tax Law for Foreign-Funded Enterprises and Foreign Enterprise (P.R.C.)*, *supra* note 168, arts. 6-9. Again, as a result of the consolidating the two separate tax regimes applicable respectively to domestic-funded companies and FIEs into a universal one in the new Chinese Enterprise Income Tax Law as from 2008, such FIE exclusive tax advantages are now largely diminished.

Therefore, in order to take advantage of these FIE-exclusive tax benefits,<sup>170</sup> some Chinese residents made use of the offshore SPV structure to conduct so-called “round-trip investments,” where the offshore SPV was set-up entirely for the purposes of turning the Chinese operating entity into an FIE so that it can qualify for the relevant preferential FDI policies, while actually no foreign investment is made into the offshore SPV.<sup>171</sup> In order to maximize tax saving effects, the foreign holding entity is usually established in an offshore financial center, as corporations established there typically only have to pay domestically very low income tax, or even no income tax at all.<sup>172</sup> Comparatively, it is neither necessary nor ideal to go to developed jurisdictions such as the U.S. to set up the foreign holding entity there for the same purpose.

Given that such practice has resulted in the loss of tax revenues,<sup>173</sup> the new Chinese Enterprise Income Tax Law imposes more strict scrutiny over the offshore SPV structure and round-trip investments, which are generally included into the Chinese taxation regime and are subject to the relevant taxes.<sup>174</sup> Consequently, it is now not only more difficult to set up the offshore investment structure as a result of the series of regulations after 2005, particularly the Ordinance No. 10, but also more expensive to maintain it, as a result of the now consolidated taxation regime which largely removed the competitive tax advantages that used to be exclusively applicable to foreign-invested firms.

#### IV. HOW ARE TRANSACTIONS DONE IN PRACTICE?

After discussing the various alternatives of making VC investments in China, including using offshore investment structures, I turn to real life

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170. As indicated by a practitioner in the business of helping Chinese firms registering their offshore holding entities, the offshore SPV structure can be used for multiple purposes, such as investing, trading, or simply tax evasion, depending the clients' particular business needs. See Nan Yan (南焱), *Kaiman Huangyan: Zhongguo Qiye Li'an Mishi* (开曼谎言: 中国企业离岸秘史) [*Lies in the Cayman Islands: A Secret History of Chinese Companies Moving Offshore*], 30 *ZHONGGUO JINGJI ZHOUKAN* (中国经济周刊) [CHINA ECONOMIC WEEKLY] (2011), available at <http://www.ceweekly.cn/html/Article/201108018821967638312.html>.

171. See Stefan Kaiser et al, *Foreign Direct Investment in China: An Examination of the Literature*, in *GREATER CHINA: POLITICAL ECONOMY, INWARD INVESTMENT, AND BUSINESS CULTURE* 55 (Chris Rowley & Mark Lewis eds., 1996). See also JAMES LAURENCESON & JOSEPH C. H. CHAI, *FINANCIAL REFORM AND ECONOMIC DEVELOPMENT IN CHINA* 99 (2003).

172. Craig M. Boise, *Regulating Tax Competition in Offshore Financial Centers*, in *OFFSHORE FINANCIAL CENTERS AND REGULATORY COMPETITION*, 1 (Andrew P. Morriss, ed. 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1266329](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266329).

173. Jin Renqing, *Explanation on the Draft Enterprise Income Tax Law of the People's Republic of China* (speech delivered at the 5th Session of the 10th National People's Congress), Mar. 8, 2007, available at [http://news.xinhuanet.com/fortune/2007-03/08/content\\_5819131.htm](http://news.xinhuanet.com/fortune/2007-03/08/content_5819131.htm).

174. Enterprise Income Tax Law (P.R.C.), *supra* note 168, arts. 2, 3, 45; Regulation on the Implementation Rules of Income Tax Law (P.R.C.), *supra* note 168, art. 4.

cases to see how transactions are done in practice, and try to answer the questions of how often the offshore investment structure has been used, and what implications can be made. In order to answer these questions, I looked at the corporate ownership and control structures of venture capital-financed Chinese firms with a particular focus on the location of the entities actually receiving the venture capital funding. Because of the difficulty of getting complete and accurate information about the corporate ownership and control structures of non-listed firms, I only focused on publicly listed firms in this paper. The paragraphs below elaborate this data exercise.

#### 4.1 *Data Description and Overview*

Data collection started with a full list of 467 private equity and venture capital investment transactions in Mainland China (excluding Hong Kong and Taiwan) from 1990 to 2005 (until May 31, 2005) as covered in the VentureXpert database. I excluded buyout and turnaround transactions, private investment in public equity (“PIPE”) transactions, bridge loan transactions, and fund of funds transactions, but included early-stage (seed, start-up, early, and expansion stages) as well as late-stage investments. The resulting sample consists of a total of 419 transactions of different investment rounds by 211 venture capital firms and 290 disclosed funds (both Chinese and foreign) into 304 disclosed Chinese firms (including their offshore holding companies).<sup>175</sup> Within these 304 Chinese firms and by the cut-off date of the original dataset (May 31, 2005), there are 29 companies that either had already gone public, or were under registration procedures with certain stock exchanges waiting to go public. These 29 firms then constitute the final sample that I will start to discuss from *infra*, Section 4.2.

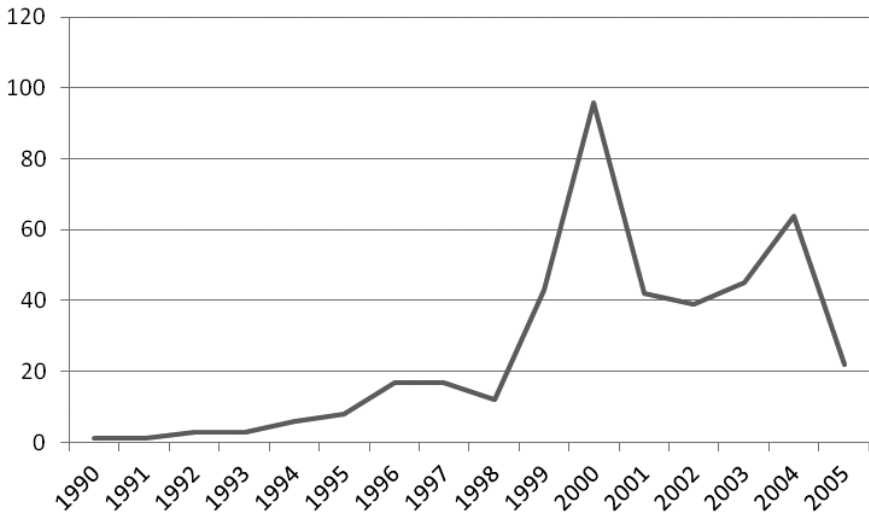
In order to provide a general overview of VC investment transactions in China, the following figures and tables first present the descriptive statistics of the 419 VC transactions before the paper further continues with the final sample of 29 public firms. As can be seen from figure 4.1.1 below, VC investments were made in China throughout the 1990s, but the outburst of transactions was only witnessed around the turn of the century. The data demonstrate two peaks in the number of deals, one lasting from 1999 to 2001 and the other from 2003 to the first half of 2005. The first peak is directly explained by the dotcom bubble period when everybody wanted to list on NASDAQ and take a share of the soaring market. Taken together with table 3.3.2 above, one can see that the second peak corresponds with the regulatory changes that took place during that period. Because there was largely no regulatory obstacle impeding the usage of offshore investment structure after the 2003 repeal of the “non-objection letter” and before the promulgation of the series of SAFE notices in 2005,

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175. These numbers only cover the funds and firms that have disclosed themselves. There are also a number of other undisclosed investors and Chinese investee firms, but they are not included here.

relocating (i.e., using an offshore SPV to acquire and hold) the Chinese VC-invested firm outside of the country was technically easier to accomplish then than at any other time.

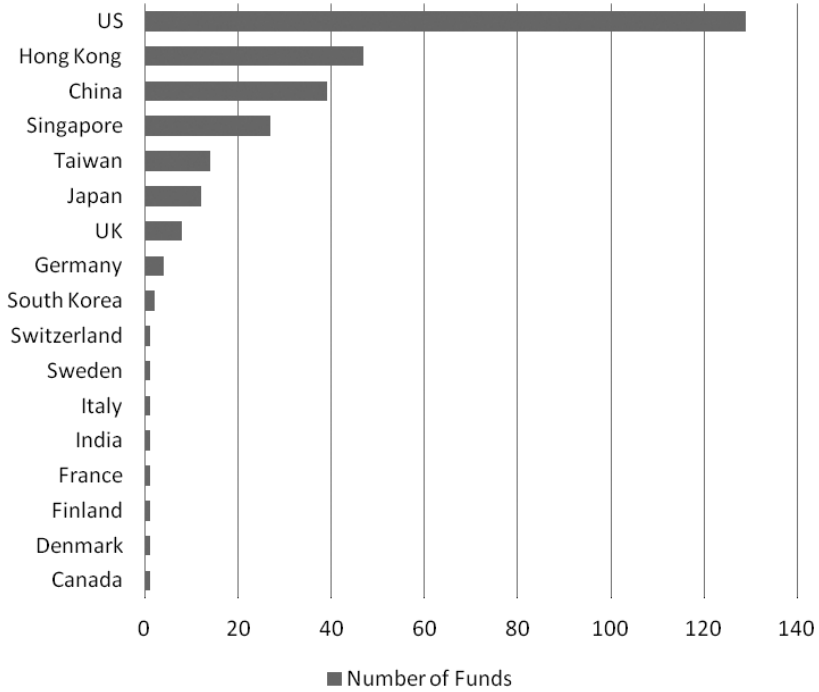
FIGURE 4.1.1: NUMBER OF CHINA'S VC TRANSACTIONS BY YEARS



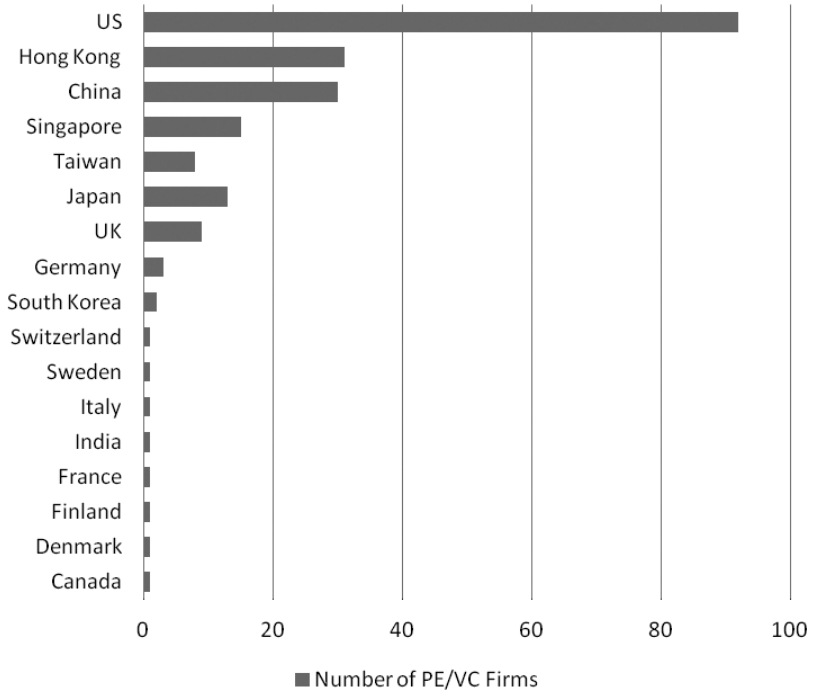
As to the origin of investors, it is obvious from figure 4.1.2 that most of them are foreign venture capitalists. Being the unquestionable leader in the global venture capital industry, the U.S. also excelled in the Chinese market in the sense that 129 out of the total of 290 VC funds, and 92 out of the total of 211 VC firms came from the U.S. Comparatively, there were only 39 VC funds and 30 VC firms that were domestic Chinese ones. Other major foreign investors came from jurisdictions geographically near Mainland China, such as Hong Kong and Singapore.



FIGURE 4.1.2: ORIGIN OF VC INVESTORS



ORIGIN OF PE/VC FIRMS



## 4.2 *Usage of Offshore Investment Structures in VC Investment practice*

### 4.2.1 Is it used or not?

It is obvious that in order to use the offshore investment structure, regardless of the simple form or the more complicated VIE form, a new company (the offshore holding company) must be established in a foreign jurisdiction in the first place, unless the Chinese firm has already had a foreign presence existing to serve that purpose. After that, the offshore holding company will then either acquire an equity stake or indirect contractual control of the operating company in China. Technically, this process can be viewed as the entrepreneurial firm being relocated to a foreign jurisdiction. Following the paper of Cumming, Fleming, and Schwiendbacher, corporate relocation is deemed to have happened when the invested entrepreneurial firm was initially based in the Asia Pacific region (in this paper, China) as of the time of the first round of VC investment, but later relocated to another foreign jurisdiction.<sup>176</sup>

In this paper, I examine the usage of the offshore investment structure by Chinese firms once they were invested in by VC investors, i.e., whether the Chinese entrepreneurial firms had been relocated to a foreign jurisdiction upon receiving VC financing or not. To elaborate, I consider an invested firm as already having a foreign presence at the time of the first round investment, if the foreign presence was established at least one year prior to the date of the financing. To be on the safe side, it is wise to allow for such one-year gap in this respect, as the offshore investment structure itself needs some time to be established for relocation. This means that it would be more reasonable to consider a foreign SPV established several weeks or a few months before the date of first round VC financing as corporate relocation, instead of an already existed foreign presence.

Except for those companies that successfully got listed, whose corporate holding structures are disclosed and thus available to the public, it is not easy to locate the equivalent for non-listed firms. Doing so often requires plenty of assuming and guessing, and the information so found is not always reliable. As such, out of the 304 disclosed Chinese firms, I only focus on those that finally managed to achieve IPOs or at least submitted their registration documents to the securities regulatory authority in certain jurisdictions within the time window covered by the VentureXperts database (i.e., until May 31, 2005). Furthermore, I only focus on the first round of VC transactions in these firms, not the later rounds, nor the buyout and turnaround transactions, private investment in public equity (“PIPE”) transactions, bridge loan transactions, and fund of funds transactions (I already excluded them out of the scope of this paper in Section 4.1), even if they happened as the first round of investments. Taken these factors all into consideration, the final sample consists of 29 firms, as shown in table 4.2.1.

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176. See Douglas Cumming et al., *Corporate Relocation in Venture Capital Finance*, 3 *ENTREPRENEURSHIP THEORY AND PRACTICE* 1121, 1130 (2009).

In table 4.2.1, the dates of IPO and investment rounds are given by the VentureXpert database, which were double-checked and corrected (where necessary)<sup>177</sup> by comparing with the information as recorded in the companies' registration documents as well as in their official websites. Moreover, the VentureXpert database also provides information on the identity and location of VC investors, so one is directly able to tell whether a transaction was totally funded by foreign venture capitalists or not. Other items, such as the founding time of the original company, listing entity, and entity receiving VC investments, were hand-collected. I looked at the firms' publicly disclosed documents as filed with the relevant stock exchanges, as well as their company websites and anecdotal reports to find out the needed information.

It can be easily seen from table 4.2.1 that VC invested Chinese firms tend to list abroad. Among all the 29 firms, there is only one domestically-listed firm, namely, Guangdong Kelon Electrical Holdings Co. Ltd., which was listed on the Shenzhen Stock Exchange. But even this single case was actually part of a dual-listing strategy – the company's IPO was first done in Hong Kong in 1996, and the Shenzhen listing was three years later than that. According to table 4.2.1, the U.S. was obviously the most popular listing destination among VC financed Chinese firms – 17 among all the 29 firms chose to trade their shares on stock exchanges located there, mostly on the NASDAQ. Overall, Chinese firms did not seem to have a diversified choice pattern in terms of choosing listing venues, and they are only found to list in Hong Kong and Singapore other than the U.S.

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177. For example, according to the VentureXpert database, the date of first round of VC investments into Focus Media (China) Holdings Co., Ltd. was January 1, 2003. However, the official website of Focus Media records June 2003 for the same fact. As such, I take the June 2003 as the correct date and thus use it in my sample.

TABLE 4.2.1: USAGE OF OFFSHORE INVESTMENT STRUCTURE IN VC-FINANCED CHINESE FIRMS  
(LISTED PRIOR TO MAY 31, 2005)

Company Name	Company IPO Date	Listing Venue	Round Date	Round Number	Original Company Location	Original Company Founding Time	Listing Entity Location	All Foreign VC?	Relocation or		Founding Time of the Entity Receiving VC Financing
									Already Foreign Existence'	Entity where VC Investment was made	
51Job, Inc. (AKA: 51Net.com)	29-Sep-2004	NASDAQ	7-Jun-2000	1	Shanghai	Mar-1997	Cayman Islands	Y	R	Listing Entity	24-Mar-2000
AsiaInfo Holdings, Inc.	3-Mar-2000	NASDAQ	1-Dec-1997	1	Dallas	17-Jun-1993	Delaware	Y	A	Original Company	17-Jun-1993
Beijing Watch Data System Company, Ltd.	N/A <sup>b</sup>	NASDAQ	19-Jun-2000	1	Beijing	Nov-1994	Cayman Islands	Y	N	Original Company	Nov-1994
Central Semiconductor Manufacturing Corp (CSMC Technologies)	13-Aug-2004	HKEX	1-Jan-1998	1	Hong Kong	15-Sep-1997	Cayman Islands	Y	A	Original Company	15-Sep-1997
China Finance Online (DBA: CF99)	15-Oct-2004	NASDAQ	1-May-2000	1	Hong Kong	Nov-1998	Hong Kong	Y	A	Listing Entity	Nov-1998
China Netcom Corporation, Ltd.	16-Nov-2004	HKEX, NYSE	19-Feb-2001	1	Beijing	Aug-1999	Hong Kong	Y	A	Listing Entity	22-Oct-1999
China Techfaith Wireless Communication Technology Limited	6-May-2005	NASDAQ	27-Apr-2004	1	Beijing	Jul-2002	Cayman Islands	Y	R	TechFaith BVI	8-Jul-2003
China Wireless Technologies Ltd	10-Dec-2004	HKSE	15-Aug-2003	1	Shenzhen	29-Apr-1993	Cayman Islands	Y	A	Listing Entity	11-Jun-2002
Ctrip.com International, Ltd.	9-Dec-2003	NASDAQ	Mar-2000	1	Shanghai	Jun-1999	Cayman Islands	Y	R	Listing Entity	3-Mar-2000
Eagle Brand Ceramics, Inc. (AKA: Eagle Brand International)	8-Feb-1999	Singapore	16-Sep-1997	1	Foshan	1974	Bermuda	Y	A	EBIL (BVI)	28-Apr-1995
eLong, Inc.	28-Oct-2004	NASDAQ	29-Aug-2003	1	Beijing	Aug-1999	Cayman Islands	Y	A	eLong BVI	4-Apr-2001
Focus Media (China) Holdings Co., Ltd.	13-Jul-2005	NASDAQ	June-2003	1	Shanghai	Sep-1997	Cayman Islands	Y	R	Focus Media BVI	11-Apr-2003

Company Name	Company IPO Date	Listing Venue	Round Number	Original Company Location	Original Company Founding Time	Listing Entity Location	All Foreign VC?	Relocation or Foreign Existence?	Entity where VC Investment was made	Founding Time of the Entity Receiving VC Financing
Fuji Forunite (AKA: FUJI Food and Catering Services)	17-Dec-2004	HKSE	1	Suzhou	Jul-1999	Cayman Islands	Y	A	Sky Achieve (BVI)	2-Jan-2003
Guangdong Kelon Electrical Holdings Co. Ltd.	23-Jul-1996	HKSE (1996), SZSE (1999)	1	Foshan	1984	Foshan	Y	N	Original Company	1984
Harbin Songjiang Brewery Co.	1-Jun-2002	HKSE	2 <sup>c</sup>	Harbin	1900	Cayman Islands	Y	R	Listing Entity	23-Feb-2001
Hongguo International Holdings Limited	5-Jun-2003	Singapore	1	Nanjing	27-Dec-1995	Bermuda	Y	Not Known	Not Known	Not Known
Hurray!, Solutions Ltd.	4-Feb-2005	NASDAQ	1	Beijing	1-Sep-1999	Cayman Islands	Y	A	Listing Entity	23-Apr-2002
IIN Networks International, Ltd	26-Nov-2001	HKEX	2 <sup>c</sup>	Hunan	10-Apr-1997	Cayman Islands	Y	Not Known	Not Known	Not Known
Kingdee International Software Group Company Limited	9-Feb-2001	HKEX	1	Shenzhen	1993	Cayman Islands	N	N	Original Company	1993
KongZhong Corporation (FK A: Communication Over The Air Inc)	9-Jul-2004	NASDAQ	1	Beijing	18-Mar-2002	Cayman Islands	Y	R	Listing Entity	6-May-2002
Linktone Ltd.	4-Mar-2004	NASDAQ	1	Cayman Islands	10-Nov-1999	Cayman Islands	Y	A	Original Company	10-Nov-1999
NetEase.com, Inc. (DBA: 163.com)	30-Jun-2000	NASDAQ	1	Guangzhou	24-Jun-1997	Cayman Islands	Y	R	Listing Entity	6-Jul-1999
Ping An Insurance Company of China, Ltd.	24-Jun-2004	HKEX <sup>d</sup>	1	Shenzhen	21-Mar-1988	Shenzhen	Y	N	Listing Entity	16-Jan-1997
Ports Design	31-Oct-2003	HKEX	1	Xiamen	1993	Bermuda	Y	R	A BVI holding company	29-Apr-1997

Company Name	Company IPO Date	Listing Venue	Round Date	Round Number	Original Company Location	Original Company Founding Time	Listing Entity Location	All Foreign VC?	Already Foreign Existence <sup>a</sup>	Relocation or	Entity where VC Investment was made	Founding Time of the Entity Receiving VC Financing
Semiconductor Manufacturing International Corp. (AKA: SMIC)	12-Mar-2004	NYSE	Sep-2001	1	Cayman Islands	3-Apr-2000	Cayman Islands	Y	A		Listing Entity	3-Apr-2000
Shanda Interactive Entertainment (AKA: Shanda Networking)	13-May-2004	NASDAQ	1-Mar-2003	1	Shanghai	1-Dec-1999	Cayman Islands	Y	R		Shanda BVI	Jul-2002
Sina Corporation (FKA: Sina.com)	13-Apr-2000	NASDAQ	Aug-1997	1	Hong Kong	Mar-1993	Cayman Islands	Y	A		Original Company	Mar-1993
Sohu.com	12-Jul-2000	NASDAQ	1-Apr-1998	1	Delaware	Aug-1996	Delaware	Y	A		Original Company	Aug-1996
Tencent Technology Limited	16-Jun-2004	HKEX	1-Mar-2000	1	Shenzhen	11-Nov-1998	Cayman Islands	Y	R		Tencent BVI	23-Nov-1999

a. "R" stands for relocation, "A" stands for already has foreign presence, and "N" means neither has happened.

b. Beijing Watch Data System Company, Ltd. filed its registration statement to the SEC on December 22, 2004, but never got to sell their shares to the public. Their registration at the SEC terminated as of June 30, 2006.

c. Two second round transactions are included here because the first round investments into these two companies were actually buyout/acquisition transactions, according to the VentureXpert database. As such, I disregarded them and looked at their second rounds where VC investors were first involved.

d. Ping An Insurance Company of China, Ltd. was also listed in Shanghai Stock Exchange, but because that happened in 2007, it falls out of the time window of the VentureXpert database, and thus is not included in this table.

The use of the VIE structure is also common among the firms in the sample. As shown in table 4.2.1B below, 16 out of the 29 firms are found to have used the VIE structure. This directly results from the fact that most of the Chinese firms that received VC financing and achieved listing engaged in the so-called “value-added telecommunications business.” Under the Chinese law, telecommunication businesses are divided into two broad categories, namely, infrastructure telecommunications and value-added telecommunications businesses.<sup>178</sup> Value-added telecommunications are widely defined as those that utilize public network infrastructure facilities to provide telecommunications and information services.<sup>179</sup> More specifically, such businesses include electronic mail service, voicemail boxes, online database storing and searching, electronic data interchange, online data processing and trading processing, value-added fax, Internet connection service, Internet information service, and audio-visual telephone meeting service.<sup>180</sup>

As such, it can be generalized that basically any so-called “dotcom” firm, or any mobile phone service provider, will be considered as doing one or more of the various telecommunication businesses, and thus will need a license from China’s Ministry of Industry and Information Technology (the “MIIT”) for that purpose.<sup>181</sup> The telecommunications business in general (both the infrastructure and value-added categories) restricts foreign investors from taking majority ownership, and thus the MIIT license will not be given to a firm where foreign investors hold more than 50% of the equity stake therein.<sup>182</sup> This means that foreign venture capitalists, which were the main force of investors in China’s entrepreneurial financing business back then, were not able to retain direct control in Chinese firms doing Internet service or content providing business. In contrast, using the contractual control model offered by the VIE structure turned out to be a good choice for them as it helped to circumvent the direct equity holding limit.

Moreover, given that all the Chinese interests will be indirectly controlled by the holding entity located abroad, the VIE structure also enables the offshore holding entity to consolidate the financials of the Chinese operating companies (variable interest entities) into the group’s

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178. Zhonghua Renmin Gongheguo Dianxin Tiaoli (中华人民共和国电信条例) [Regulation on Telecommunications (P.R.C.)] art. 8 (promulgated at the 31st regular meeting of the State Council, Sep. 20, 2000).

179. *Id.*

180. *See id.* at Appendix.

181. Regulation on Telecommunications (P.R.C.), *supra* note 178, art. 9.

182. Waishang Touzi Dianxin Qiye Guanli Guiding (外商投资电信企业管理规定) [Provisions on the Administration of Foreign-funded Telecommunications Enterprises] art. 4 (promulgated by the State Council on Dec. 11, 2001) (amended on Sep. 10, 2008). To be more precise, the maximum equity holding limit for foreign investors in infrastructure telecommunications business (except wireless paging business) is 49%, and for foreign investors in value-added telecommunications business is 50%.

overall financial statements.<sup>183</sup> By the same token, VIE structure is also often used in firms doing life insurance,<sup>184</sup> advertising,<sup>185</sup> travel and ticketing agency businesses,<sup>186</sup> as these businesses also fall with the scope of “restricted industries” according to the relevant Chinese laws and regulations.<sup>187</sup> Examples of such firms in my sample include Ping An Insurance Company of China, Ctrip.com International, Ltd., 51job, Inc., eLong, Inc., and Focus Media (China) Holdings, Co., Ltd. Because the contractual control concept embodied in the VIE model was first tested successfully in the listing of Sina.com in NASDAQ in 2000,<sup>188</sup> the VIE model is also often referred to as the “Sina model.”<sup>189</sup>

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183. David Roberts & Thomas Hall, *VIE Structures in China: What You Need to Know*, TOPICS IN CHINESE LAW: AN O'MELVENY & MYERS LLP RESEARCH REPORT 2 (2011), available at [http://iis-db.stanford.edu/evnts/6963/TICL\\_-\\_VIE\\_Structures\\_in\\_China.pdf](http://iis-db.stanford.edu/evnts/6963/TICL_-_VIE_Structures_in_China.pdf).

184. Foreign investors are prohibited from holding more than 50% equity stake in a life insurance firm; and such restriction still remains in the latest version of Catalogue for the Guidance of Foreign Investment Industries. See *Waishang touzi changye zhidao mulu* (外商投资产业指导目录) [Catalogue for the Guidance of Foreign Investment Industries] (jointly promulgated by the State Development and Reform Commission and the Ministry of Commerce, Dec. 24, 2011).

185. Foreign investors were prohibited from holding more than 49% in an advertising firm in China. See Catalogue for the Guidance of Foreign Investment Industries, *id.*, at Appendix.

186. The restrictions on foreign-invested travel agencies are not on the percentage of foreign equity holding. Rather, Chinese law prohibits foreign-invested travel agencies from setting up branches in China; and they are only permitted doing domestic travelling business and not overseas travelling business. See *Luxingshe Guanli Tiaoli* (旅行社管理条例) [Regulation on the Management of Travel Agencies] art. 32 (promulgated by the State Council, Oct. 15, 1996) (repealed by Regulation on Travel Agencies on May 1, 2009).

187. *Zhidao Waishang Touzi Fangxiang Guiding* (指导外商投资方向规定) [PROVISIONS ON GUIDING THE ORIENTATION OF FOREIGN INVESTMENT] arts. 3-4 (promulgated by the State Council, Feb. 11, 2002). It is stipulated therein that the government shall use the Catalogue for the Guidance of Foreign Investment Industries, *supra* note 184, to review, approve and police foreign-invested projects, which are divided into four broad categories, i.e., encouraged, permitted, restricted and prohibited.

188. For a recount of how Sina.com came up with the contractual control idea and tested the waters on its implementation with the relevant regulatory authorities in China, see *Hulianwang Jingwai Shangshi Jingdian Anli: Xinlang Boli ICP Yewu Zai Mei Shangshi Licheng* (互联网境外上市经典案例: 新浪剥离ICP业务在美上市历程) [Classic Cases for Overseas Listing of Internet Companies: How Sina.com Has Listed in the US After Stripping Off its ICP Business], CAIFU ZHISHU (财富指数) [WEALTH INDEX], Oct. 25, 2005, available at [http://www.liangongsi.com/News/Internet\\_outside\\_the\\_classic\\_case\\_Sina\\_ICP\\_United\\_States\\_listed/](http://www.liangongsi.com/News/Internet_outside_the_classic_case_Sina_ICP_United_States_listed/).

189. *Who Owns What? The Perils of Investing When the Law is Unclear*, THE ECONOMIST, July 7, 2011, available at <http://www.economist.com/node/18928526>.



TABLE 4.2.1B: USAGE OF VIE STRUCTURE IN VC-FINANCED CHINESE FIRMS

<b>Company Name</b>	<b>Company Business Description as Recorded in VentureXpert Database</b>	<b>VIE Structure Used?</b>
51Job, Inc. (AKA: 51Net.com)	Provides integrated human resource services in China.	Y
AsiaInfo Holdings, Inc.	Provides internet-related information technology and software services.	Y
Beijing Watch Data System Company, Ltd.	Develops software for smartcard use.	Y
Central Semiconductor Manufacturing Corp (CSMC Technologies)	Manufactures semiconductor wafers.	N
China Finance Online (DBA: CF99)	Provides financial and listed company data and information in China.	Y
China Netcom Corporation, Ltd.	Provides services in the broadband telecommunications industry.	N
China Techfaith Wireless Communication Technology Limited	Develops wireless communication terminal products.	Y
China Wireless Technologies Ltd	Provides wireless telecommunications solutions.	N
Ctrip.com International, Ltd.	Provides travel information, reservations and other services.	Y
Eagle Brand Ceramics, Inc. (AKA: Eagle Brand International)	Manufactures and distributes ceramic tiles and sanitary-wares in China.	N
eLong, Inc.	Provides online travel services.	Y
Focus Media (China) Holdings Co., Ltd.	Operates an out-of-home advertising network in China.	Y
Fuji Forunite (AKA: FUJI Food and Catering Services)	Operates as a food and catering service provider.	N
Guangdong Kelon Electrical Holdings Co. Ltd.	Manufactures refrigeration products.	N
Harbin Songjiang Brewery Co.	Operates a microbrewery in the North-Eastern China market.	N
Hongguo International Holdings Limited	Designs, manufactures and sells ladies fashion footwear.	N
Hurray! Solutions Ltd.	Provides wireless value-added services to mobile phone users in China.	Y
IIN Networks International, Ltd	Provides system integration and software development services.	N
Kingdee International Software Group Company Limited	Develops enterprise application software.	N
KongZhong Corporation (FKA: Communication Over The Air Inc)	Provides second generation, or 2.5G, wireless interactive entertainment.	Y
Linktone Ltd.	Provides wireless communication services.	Y
NetEase.com, Inc. (DBA: 163.com)	Provides online services for community building and electronic commerce.	Y
Ping An Insurance Company of China, Ltd.	Provides life, automotive, property, and cargo related insurance services.	N
Ports Design	Provides fashion and luxury goods.	N

Company Name	Company Business Description as Recorded in VentureXpert Database	VIE Structure Used?
Semiconductor Manufacturing International Corp. (AKA: SMIC)	Operates a holding company that establishes semiconductor facilities.	N
Shanda Interactive Entertainment (AKA: Shanda Networking)	Operates as an online gaming company.	Y
Sina Corporation (FKA: Sina.com)	Provides a Chinese-language portal and search engine.	Y
Sohu.com	Provides Internet communications, media and commerce for China.	Y
Tencent Technology Limited	Provides instant messaging service.	Y

Two firms in the table 4.2.1B above, namely China Netcom Corporation and Ping An Insurance Company of China, Ltd., are not found to have used the VIE model when accepting foreign venture capital investments, although the lines of business they engage in are also restricted ones, and they were both listed outside Mainland China. The major reason that they didn't employ the VIE model is that the foreign VC investors only acquired minority stakes in these two firms when investing in them.<sup>190</sup> Both deals were identified in the VentureXpert database as later stage transactions, where foreign investors were brought in to further expand these already sizable firms,<sup>191</sup> and to better prepare them for forthcoming IPOs in overseas stock markets. Arguably, this made it not as

190. As for China Netcom, the Feb. 2001 investment transaction in the amount of US\$325 million resulted in five foreign VC investors, including the News Corporation and Goldman Sachs & Co. (invested through GS Capital Partners III, L.P.), acquiring 12% in the then China Netcom. See *Xinwen Jituan Rugu Zhongguo Wangtong, Jinjun Zhongguo Dianxin Shichang* (新闻集团入股中国网通·进军中国电信市场) [*News Corporation Acquiring Shares in China Netcom: Marching into Chinese Telecommunications Industry*], CHINA BYTE, available at <http://news.chinabyte.com/436/1218936.shtml>; As for Ping An Insurance, the June 1994 transaction in the amount of US\$ 240.3 million resulted in Goldman Sachs (invested through GS Capital Partners, L.P., and GS Capital Partners (Asia)) and Morgan Stanley (invested through Morgan Stanley Leveraged Equity Fund II) acquiring 13.7% stakes in the firm. See *1994 Nian Mogen He Gaosheng Cangu Pingan Baoxian* (1994年摩根和高盛参股中国平安保险) [*Morgan Stanley and Goldman Sachs Acquire Shares in Ping An Insurance*], SINA.COM, available at <http://finance.sina.com.cn/money/insurance/bx/tb/20090922/15306780033.shtml>; Cheng Zhiyun (程志云) GAOSHENG DE ZHONGGUO SHENGYI: GUOJI TOUHANG ZAI ZHONGGUO DE 20 NIAN (高盛的中国生意: 国际投行在中国的20年) [GOLDMAN SACHS'S CHINA BUSINESS: AN INTERNATIONAL INVESTMENT BANKING FIRM'S 20 YEARS IN CHINA] Ch. 1 (2011).

191. As for China Netcom, the money raised by this transaction in 2001, together with the loans from major Chinese banks, was used to build up its optical fiber network in China. See Kao Hongzun (烤虹鱧), *Kaoshi Lishi Disanji: Zhengyi Wangtong – Zijin Xionghou de Tiaozhanzhe, Fuzhai Leilei de Zhengyizhe* (烤氏历史第3集: 争议网通-资金雄厚的挑战者, 负债累累的争议者) [*Kao's History Part 3: Controversial Netcom – Deep-Pocketed Challenger, Deeply-Indebted Controversy*], Jan. 24, 2011, available at <http://bbs.c114.net/viewthread.php?tid=486907>. As for Ping An Insurance, it basically focused on non-life insurance business before 1994, and the capital raised from the transaction was used to expand its life insurance business in China, see Cheng Zhiyun (程志云), *id.*

necessary for foreign VCs to acquire the majority ownership as they normally do when financing small start-ups. More importantly, given the critical status of the two companies in their respective markets,<sup>192</sup> as well as the fact that the state and local governments held significant equity stakes in them,<sup>193</sup> it was unlikely that the two firms would let foreign VC investors acquire their majority equity stakes, as doing so might seriously disturb the state's interests in them. Therefore, because the low foreign ownership would not trigger the foreign investment restrictions applicable in their respective industries, the VIE model was not used to establish indirect controlling rights in these two firms when foreign venture capitalists invested in them.

#### 4.2.2 Where were venture capital investments actually made?

Section 4.2.1, *supra*, briefly examined the usage of the VIE model as well as its direct correlation with industry policies on foreign investment in China. This section continues to offer a closer look at the usage of the offshore investment structure in general, regardless of either the simple form and the VIE form. Normally, information about which entity the VC investments were made into can be found in the introduction of the company and/or the overview of its history of development in the registration documents submitted to the local securities regulatory authorities. Among all the 29 firms in table 4.2.1, only 4 firms received their first round of VC investment within China, while for 23 other firms, VC investments were provided to certain offshore entities. The offshore entities could be the original company if the firm was incorporated out of China when it first started, or the entity that was finally listed in one of the overseas stock markets, or some other offshore holding entity. In most cases, such other holding entity was either reincorporated as the listing entity later in the restructuring prior to listing, or it became a middle-level holding entity

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192. China Netcom was one of the top six telecommunications operators in China in 1999, see Liu Qi (刘奇), *Tietong Tuoli Tiedaobu, Liuda Yunyinshang Jingzheng Geju Yi Xingcheng* (铁通脱离铁道部 六大运营商竞争格局已形成) [*Tietong Spun Off from Ministry of Railways: Competition of Top Six Operators Takes Shape*], JINHUA SHIBAO (京华时报) [JINGHUA TIMES], Dec. 13, 2003, available at <http://telecom.chinabyte.com/450/1749950.shtml>. And Ping An Insurance was already doing very well in 1994 by having an annual premium revenue of RMB280 million, see <http://about.pingan.com/fazhanlicheng/1994.shtml>.

193. China Netcom was completely state-owned as of its incorporation, because all of its shareholders at that time were state-owned or state-controlled entities. See Kao Hongzun (烤虹鱒), *Kaoshi Lishi Disanji: Zhengyi Wangtong – Zijin Xionghou de Tiaozhanzhe, Fuzhai Leilei de Zhengyizhe* (烤氏历史第3集: 争议网通-资金雄厚的挑战者·负债累累的争议者) [*Kao's History Part 3: Controversial Netcom – Deep-Pocketed Challenger, Deeply-Indebted Controversy*], Jan. 24, 2011, available at <http://bbs.c114.net/viewthread.php?tid=486907>. Ping An Insurance was the same: it had only two shareholders as of incorporation, both representing the state. However, the state ownership was more and more diluted as a result of rounds of equity restructurings over the years. See Sheng Dalin (盛大林), “*Zhongguo Ping An*” *Ying Qudiao “Zhongguo” Erzi* (“中国平安”应去掉“中国”二字) [*“China Ping An” Should Only Be “Ping An”*], DONGFANG JINBAO (东方今报) [ORIENTAL WEEKLY], June 24, 2009, available at <http://www.jinbw.com.cn/jinbw/xwzx/jbsb/20090624278.htm>.

between the original Chinese firm and the new listing entity, which was incorporated in the restructuring prior to listing.

As mentioned in the beginning of *supra*, Section IV, using the offshore investment structure to make VC investments can be also viewed from the point of corporate relocation, because establishing an offshore holding entity and using such an entity to acquire or control the onshore interests means that a Chinese firm is technically relocated abroad. As to the question of whether a corporate relocation has happened, I looked at the time of the establishment of the entity into which the VC investments were made. If the entity receiving VC investments was set up within one year prior to the date of the first round of financing or after it, then I consider this situation as relocation. Comparatively, if the entity receiving VC investments was set-up more than one year prior to the first round of financing, I consider the company as already having foreign existence.

Among the 29 firms in table 4.2.1, 10 firms have been relocated to a foreign jurisdiction, 13 firms have already had a foreign presence prior to the first round of financing, 4 firms did not have any relocation, and for the remaining 2 firms, it is difficult to tell as no information can be found about which entity received the first round financing. Similar to Cumming, Fleming, and Schwiendbacher, the relocations in my sample are also partial, meaning that none of the invested firms fully relocated to a foreign country.<sup>194</sup> There are some cases in which the invested firms opened subsidiaries, branches, and/or liaison offices overseas as their business grew bigger,<sup>195</sup> but their primary place of business and production facilities have always remained within China.

A more interesting point is where the offshore entities into which investments were actually made are located. Figure 4.2.2 below shows a distribution of the jurisdictions of the entities receiving VC investments. Except the four cases where the investments were directly made into onshore entities within China, almost all the other entities receiving VC financings were located in offshore tax haven jurisdictions, such as the Cayman Islands, the British Virgin Islands, and Hong Kong. There were only two cases in which the VC investments were identified as happening in the U.S. This was not because the two firms were relocated after ven-

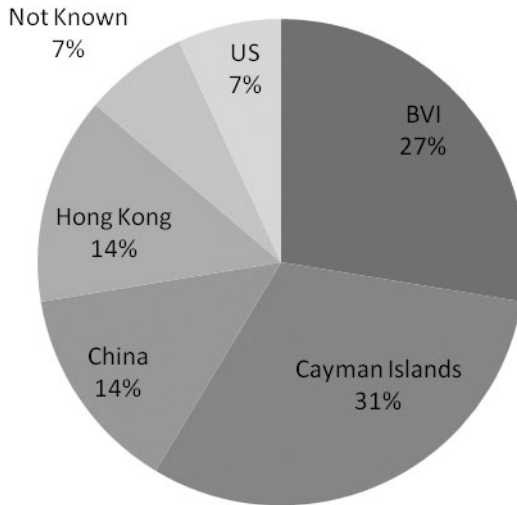
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194. Douglas Cumming et al., *Corporate Relocation in Venture Capital Finance*, 3 *ENTREPRENEURSHIP THEORY AND PRACTICE* 1121, 1134 (2009).

195. For example, Beijing Watch Data System Company, Ltd. has subsidiaries in 12 countries and regions (including China), and it even moved its international headquarters to Singapore, but their primary place of business and production facilities remained in China. See <http://www.watchdata.com/us.jsp>. Similarly, Focus Media had its Asia headquarters in Singapore, but all of its branches that really do the business are scattered around the major cities within China. See <http://www.focusmedia.cn/en/aboutus/contactus.htm>. Sina.com, a leading Chinese web portal, has its US, Hong Kong and Taiwan versions, which are separately run through local offices in these places. See <http://www.sina.com.hk/service/about/about.html>.

ture capitalists' investments from China to the U.S., but because the two firms were first incorporated as US companies from the very beginning.<sup>196</sup>

FIGURE 4.2.2: LOCATION OF ENTITIES ACTUALLY RECEIVING VC INVESTMENTS



#### 4.2.3 Is there really an issue of corporate relocation?

Based on the findings in Section 4.2.2 above, one can see that the corporate relocations described in this paper are of a very different nature than the corporate relocations discussed in the paper by Cumming, Fleming, and Schwenbacher. First, besides those firms that already had foreign presence, all of the destination firms in my sample into which the original firms were relocated were set up within one year prior to the date of the first round of VC investments, rather than thereafter. Technically, it is still correct to regard these cases as relocations instead of already existing foreign presences. Because it takes time to restructure the interests located in the origin country to the destination before the whole relocation can be completed, it makes sense to have the destination firm ready a bit earlier. In other words, it is a necessary preparation step for relocation.

Second, and more importantly, the destination firms of such relocations are all located in offshore tax haven jurisdictions, instead of in the U.S. Similarly, as to those cases where the Chinese firms already had for-

196. As for Asiainfo Holdings, the registration documents filed with the SEC introduces the company as “[w]e started our business in Texas through a predecessor company in 1993 and are now incorporated in Delaware. In 1995, we moved our base of operations from Dallas, Texas to Beijing, China to capitalize on emerging opportunities in the rapidly developing Internet market in China.” As for Sohu.com, its registration documents introduces the company as “[w]e were incorporated in Delaware in August 1996 as Internet Technologies China Incorporated . . . In September 1999, we re-named our company Sohu.com Inc. Substantially all of our operations are conducted through Sohu ITC Information Technology (Beijing) Co., Ltd., or Beijing Sohu, our wholly owned PRC subsidiary.”

eign presences, such foreign presences are also primarily located in off-shore tax haven jurisdictions, except for only two firms that were first established in the U.S. after the founders graduated from their studies in U.S. universities.<sup>197</sup> The empirical examination of corporate relocations in VC-financed Asian firms as conducted in the paper of Cumming, Fleming, and Schwiendbacher has one very important precondition: the destination of corporate relocation was the U.S. Based on that, the authors then argued that the relocations were motivated by economic conditions as well as an improvement in the laws of the country in which the entrepreneurial firm is based. Third, in all of the cases where relocation happened and firms already had foreign presences, the investing VC funds were all foreign.

Taken together, although more firms tend to already have foreign presences or be relocated abroad in Chinese VC financing transactions, the characteristics of such corporate relocations do not fully support the conclusions in the paper of Cumming, Fleming, and Schwiendbacher. Rather, the fact that the foreign destination firms are ready before rather than after venture capital investments are provided, and that the destination firms are located in offshore tax havens rather than the U.S., show that such relocations and already existing foreign existences are just the reflection of the wide usage of the offshore investment structure to make VC investments in China.

Although these relocating practices indeed resulted in providing VC investors with the access to better legal protection by virtue of technically enabling them to conclude U.S.-style VC contracts with entrepreneurs and to enjoy flexibility in terms of choosing applicable laws governing the contracts, they can be at best partially explained by the “legality” argument, if at all. The legality explanation is weak, because venture capitalists could have simply done better to that end if they had relocated the Chinese firms directly to the U.S., rather than to these offshore financial center jurisdictions.<sup>198</sup> Thus, the access to better legality must not be the top concern of venture capitalists when they chose to relocate the Chinese firms to, or default to, their already-existing foreign presences at some third offshore island jurisdictions.

The only plausible legality-related concern of venture capitalists when doing so, if any, might be that the legal systems of many major offshore financial centers, such as Hong Kong, Singapore, Bermuda, BVI and Cayman Islands, were established based on common law principles and re-

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197. The founders of Asiainfo were graduates from UCLA and Texas Tech University, see <http://sec.gov/Archives/edgar/data/1100969/0000950109-99-004557.txt>; and the founder of Sohu.com was a graduate from the MIT, see <http://corp.sohu.com/20060507/n243126051.shtml>.

198. Fred Greguras et al., *2008 Update to Doing Business in China via the Cayman Islands*, FENWICK & WEST LLP, available at [http://www.fenwick.com/docstore/Publications/Corporate/2008\\_Update\\_Business\\_China.pdf](http://www.fenwick.com/docstore/Publications/Corporate/2008_Update_Business_China.pdf), at 2, pointing out that “. . . [n]either [Bermuda or Cayman Islands]’s laws, however, protect shareholders to the same extent as U.S. laws”.

sulted from their historical status as ex-British colonies.<sup>199</sup> Given that most of the VC investors investing in China were from the U.S., it could be that they chose these offshore financial centers as relocation destinations in order to access the common law there, which they are more familiar and comfortable with. But this argument still does not solve the same fundamental question: why not then directly move to the U.S.?

A competing, if not more convincing, explanation has to do with the past experience of venture capital investors. The fact that these firms were exclusively financed by foreign venture capital funds further supports this explanation. I took great lengths in *supra*, Section III to explain the practical difficulties involved in using convertible securities (preferred stock and convertible notes) directly in China. Moreover, the restrictive foreign investment regulations in certain VC-favored industries, as well as the general foreign investment review and approval process and foreign exchange control policies, further exacerbate such difficulties. As of the cut-off date of the VentureXpert database, foreign venture capitalists were still the major investors in China's entrepreneurial financing market, and the largest and most active group of them was from the U.S. Their past experience with doing business was to do it in the "American way."

The findings of Professors Kaplan, Martel, and Stromberg seem to offer support for such an argument.<sup>200</sup> According to them, U.S.-style VC contracts can virtually be replicated across a wide range of legal regimes with enough effort or legal fees, and larger, more experienced VCs, VCs with more exposure to the U.S. are significantly more likely to implement U.S.-style contractual terms.<sup>201</sup> VC investors can still manage to implement the U.S.-type of contract that they are more familiar with, even when they make investments outside the U.S. These strong results for VC experience in their findings contrast with the modest results for legal, tax, and accounting institutions.<sup>202</sup>

As such, compared with the conclusion in Cumming, Fleming, and Schwenbacher, which argues that venture capitalists relocate their portfolio firms to the U.S. in order to gain access to the better legal protection and benefit from the stronger economic conditions there, the conclusion of Kaplan, Martel and Stromberg seems more reasonable and capable of explaining the corporate relocations of VC-financed Chinese firms. Relocating potential Chinese portfolio firms to some third offshore island jurisdiction looks more like a sophisticated contracting technique, which was employed to circumvent the differences between local legal regimes,

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199. G. Scott Dowling, *Fatal Broadside: The Demise of Caribbean Offshore Financial Confidentiality Post USA PATRIOT Act*, 17 *TRANSNAT'L LAW* 259 (2004), available at <http://www.porterscott.com/docs/Caribbean.pdf>. See also Marc Montgomery, *A Portrait of Success: The Rise of the Cayman Islands as an Offshore Financial Center*, 12 *RMC* 33, 67 (2001).

200. Steven N. Kaplan et al., *How do Legal Differences and Experience Affect Financial Contracts?*, 16 *J. FIN. INTERMEDIATION* 273 (2007).

201. *Id.* at 275.

202. *Id.* at 293.

and to enable investors to more conveniently use the U.S.-type of VC contracts and convertible preferred stock that they are familiar with.

The key difference between the “experience explanation” and the “legality explanation” is that simply trying to replicate U.S.-style VC contracts does not necessarily mandate the firms to be relocated to the U.S. (which has the really better laws). Instead, it would be enough if the legal regime of the relocation destinations allow the use of the instruments needed in the U.S.-style VC contracts, such as convertible preferred stock (note), and employee stock options and so on,<sup>203</sup> even if the laws there are not comparable to those in the U.S. in terms of protecting investors.<sup>204</sup> Thus, it is more experience that dictates venture capitalists to do what was most convenient for them, and not really the better law that attracted them to set up these offshore structures and relocate the Chinese firms abroad.

Of course, it cannot be denied that relocating Chinese entrepreneurial firms to offshore financial centers also incurs benefits other than technically facilitating VC investments. To generalize, an offshore financial center or tax haven normally would have the following characteristics: “low or zero taxation, moderate or light financial regulation, and financial secrecy and anonymity.”<sup>205</sup> In addition, offshore financial centers are also attractive due to their usually accessible rules regarding the formation and operation of corporate vehicles.<sup>206</sup> Each of these characteristics can be quite relevant for business parties, including both venture capitalists and entrepreneurs.

To illustrate this point, compared to the firms that were relocated aboard upon the first round of VC, more firms in table 4.2.1 actually already had foreign presences before that. It could have been any of a set of intertwined reasons that drove the entrepreneurs to engage in these relocations before any venture capitalist had emerged. It could be that they were interested in gaining access to one or more of the benefits just mentioned above. Alternatively, and as already discussed in *supra*, Section

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203. Fred Greguras et al., *2008 Update to Doing Business in China via the Cayman Islands*, FENWICK & WEST LLP, available at [http://www.fenwick.com/docstore/Publications/Corporate/2008\\_Update\\_Business\\_China.pdf](http://www.fenwick.com/docstore/Publications/Corporate/2008_Update_Business_China.pdf), at 2, pointing out that “[a] key consideration [in choosing a jurisdiction of incorporating the holding company] for investors is that a conventional security such as preferred stock be available for financing. For employees, stock options and other equity incentives need to look and feel the same as those of a U.S. corporation”.

204. *Id.* at 2, pointing out that “. . . [n]either [Bermuda or Cayman Islands]’s laws, however, protect shareholders to the same extent as U.S. laws”.

205. *Offshore Financial Centers: IMF Background Paper*, IMF, June 23, 2000, available at <http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm>. See also Andrew P. Morriss, *Changing the Rules of the Game: Offshore Financial Centers, Regulatory Competition & Financial Crises*, 15 NEXUS: CHAPMAN’S J. L. & PUBLIC POLICY 15, 20-26 (2009-2010).

206. Joseph McCahery & Erik Vermeulen, *Mandatory Disclosure of Blockholders and Related Transactions: Stringent Versus Flexible Rules*, (24 Sep. 2011) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1937476](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1937476).



3.3.2 above, it could be that the entrepreneurs felt it was important to take advantage of the preferential taxation treatments to FIEs as well as foreign investors thereof, so that they set up holding companies in offshore tax havens to turn their firms into FIEs. Additionally, it could also be that Chinese entrepreneurs intentionally set up the structure and relocated their firms abroad in order to enhance their accessibility towards foreign investors (including venture capitalists), knowing that having a foreign parent company holding their Chinese interests would help to facilitate potential foreign investments from outside China.

The more important message here, however, is not to pinpoint the reason that drove pre-VC relocations. Rather, the key finding is that regardless of the possible reasons, the VC investors in the sample in the end all defaulted to the already established foreign presences and made use of them to invest in Chinese entrepreneurial firms. In other words, although not necessarily set-up as a result of receiving VC investments, such offshore holding structures that were created by relocating the Chinese firms abroad, still pragmatically facilitated foreign VC investors. They were willing to make use of the offshore holding structures, because it would be easier for them to do so compared with doing the transactions directly within China, or relocating the offshore holding firm further to developed jurisdictions, such as the U.S. In this regard, it further underlines that using offshore investment structures and relocating Chinese entrepreneurial firms to some third offshore financial centers is of a pragmatic nature and occurs due to reasons of convenience, rather than being motivated by access to better legality in developed jurisdictions.

According to Cumming, Fleming, and Schwienbacher, in addition to legality related motivations, VC-backed companies located in countries with weaker economic conditions and lower populations are also more likely to relocate to countries with stronger economic conditions and greater populations in order to be closer to potential customers at the time of exit and improve the expected rate of return of the investment.<sup>207</sup> Economic conditions are irrelevant as a motive for relocating from China, which is not only the world's largest market, but also has a vast economy that has been growing with significant rates over past two decades. On the contrary, the very first reason that foreign investors go to China is exactly to gain access to the numerous Chinese customers in the big market, and get their share of the growing economy there. Therefore, the fact that most entrepreneurial Chinese firms were indeed relocated out of China based on the findings from the sample in this paper means that the conclusion of Cumming, Fleming, and Schwienbacher is again not supported here.

The sample in this paper only focused on those firms that managed to list (or at least were in the registration process in order to offer shares to the public) prior to May 2005, and found that offshore investment struc-

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207. Douglas Cumming et al., *Corporate Relocation in Venture Capital Finance*, 3 *ENTREPRENEURSHIP THEORY AND PRACTICE* 1121, 1126, 1149 (2009).

tures were widely used among these firms, with many of them being technically relocated abroad as a result of using such structures. One may argue that limiting the scope of this research only to listed firms can be biased, in a sense that offshore investment structures might be particularly heavily employed by overseas-listed firms than by non-listed firms. Although this may make sense, it is still reasonable to conclude that for those VC-financed firms that were not yet listed, such offshore investment structures were also widely used, at least when a firm was exclusively financed by foreign venture capitalists. The is because, from the very first round of investments into portfolio firms, venture capitalists already think of possible exits, and the way of structuring their investments must also serve that purpose.

It is already widely recognized wisdom that the most ideal exit for VC-backed firms is to achieve an IPO, because it not only tends to generate good returns for both venture capitalists and entrepreneurs in a stock-market-centered capital market, but it also enables entrepreneurs to regain their control over their company, which gives them an important incentive to devote their efforts towards the firm's success.<sup>208</sup> Arguably, one of the important reasons for the remarkable success of U.S. innovation and the VC industry is that the U.S. has a highly active stock market.<sup>209</sup> Although the attractiveness of the U.S. stock market may be somehow discounted nowadays given the impact of the financial crisis in the past few years, as well as due to fierce competition from other stock markets around the world, it was generally considered as a much better exit option for good Chinese firms compared to China's own stock exchanges.

This is because, although having been growing very fast, the Chinese stock market was often seen as illiquid, inefficient, and unreliable, bearing little correlation to China's underlying economic growth,<sup>210</sup> and was not really very open to small and medium enterprises ("SMEs") as opposed to large-scaled, especially state-owned firms. Therefore, it was in line with the interests of both Chinese entrepreneurs and foreign venture capitalists to aim at exiting via IPOs in overseas stock markets, most ideally in the U.S. Because offshore investment structures can also function to facilitate overseas listings, it is reasonable to think that such structures should be widely employed upon first investing in Chinese firms, regardless of whether the invested firm can achieve the desired IPO in the end.

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208. Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?* 11 J. APPLIED CORP. FIN. 36, 43 (2005). See also Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 243 (1998).

209. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 274 (1998).

210. Hua Cai, *Bonding, Law Enforcement and Corporate Governance in China*, 13 STAN. J.L. BUS. & FIN. 82, 85 (2007).

### 4.3 Discussion of the Findings, Caveats, and Future Research

The data discussed in this article ends May 31, 2005. Future research could examine whether the transactions after the first half of 2005 would also show a similarly high rate of relocations towards foreign jurisdictions, particularly with respect to those using an offshore investment structure to access tax havens. Such research could be highly interesting in that it will empirically answer the question of whether corporate relocations among VC investments in China are a sustainable phenomenon driven by deep-rooted economic and legal inefficiencies as suggested by Cumming, Fleming, and Schwiendbacher, or are more a “fad” largely resulting from the tendency among VC investors to replicate their past experiences of using U.S.-style contracts, as suggested by Kaplan, Martel, and Stromberg.

Several new trends emerging after 2005 may contribute to answering this question. From an economic point of view, the attractiveness of the Chinese domestic stock markets towards VC-financed firms has improved considerably relative to before. This is particularly true after the launch of ChiNext,<sup>211</sup> the Chinese equivalent of NASDAQ, which was particularly designed for VC-backed SMEs and has already provided high valuation and high premiums for the firms that were first listed there.<sup>212</sup> From a legal point of view, and as I already show in *supra*, Section 3.3.2, with the enactment of a number of regulations from the second half of 2005 requiring offshore investment structures to be approved and registered with the relevant Chinese governmental authorities, relocating a Chinese firm out to a foreign country is not as easy as it was before.<sup>213</sup> Moreover, the Chinese government has also started to carry out a series of regulatory attempts aiming at promoting onshore VC investments, as well as providing impetuses for foreign venture capitalists to consider creating their Chinese investment funds in China’s own currency.<sup>214</sup>

Put together, faced with the recent developments in China’s own onshore capital market and legal framework, as well as the strengthened regulatory scrutiny over the practice of setting up a special purpose vehicle to acquire Chinese interests, one may expect that offshore listings might become less attractive among Chinese firms both substantively and technically, rendering them more willing to remain in China and seek exits on

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211. ChiNext was launched on Oct. 23, 2009. See Samuel Shen & Fion Li, *China Launches Second Board for Start-ups*, REUTERS, Oct. 23, 2009, available at <http://www.reuters.com/article/2009/10/23/chinext-launch-idUSSHA27095520091023>.

212. David Barboza, *A New Chinese Stock Exchange Opens with a Surge*, N. Y. TIMES, Nov. 2, 2009, at B3.

213. See *supra* note 163 and the accompanying text.

214. Most importantly, such regulatory attempts include, among other things, the promulgation of the Interim Measures for the Administration of Start-up Investment Enterprises, *supra* note 110; and Zhonghua Renmin Gongheguo Hehuo Qiye Fa (中华人民共和国合伙企业法) [Partnership Enterprise Law (P.R.C.)] (promulgated by the Nat’l People’s Cong., Feb. 23, 1997) (amended Aug. 27, 2006) (technically allowing Chinese PE/VC funds to be also set up as limited partnerships).

the China's own A stock market. The legality explanation would predict a lower rate of corporate relocations, resulting from the improvement of the local legal and institutional environment, while the experience explanation would not predict a significant reduction of relocations, as VC funds will still continue to do so (maybe at the cost of even higher legal fees and more complicated techniques) for the purpose of conveniently implementing U.S.-style contracts.

## V. CONCLUSION

Following the economic theory of venture capital financing, a financial contract is economically efficient for VC investments if it can help to reduce agency costs arising from information and incentive problems. The VC investment contracts widely used in the U.S. venture capital industry, which is the most successful in the world, largely achieve these purposes. At the core of these U.S. venture capital investment contracts is the use of convertible preferred stock, which allows venture capitalists to obtain special economic rights such as liquidation preferences, anti-dilution adjustments, and other rights that are fundamental to the financial mandates of VC firms, and also ensures that they can effectively monitor entrepreneurs in portfolio companies. However, due to the lack of a share-based equity system in China's business practice, foreign venture capitalists are actually deterred from directly using convertible preferred stock when investing in China.

Based on the analysis of the relevant Chinese laws and regulations governing the corporate governance structure of VC-invested firms, as well as the discussion over the feasibility of employing a set of different alternatives to make direct and indirect VC investments in Chinese portfolio firms, this article studies a hand-collected sample consisting of the twenty-nine VC-backed Chinese portfolio firms that have been financed and listed from 1990 to 2005 to empirically show how the investments were actually done in practice.

It is found that the financing of most of these firms actually happened outside China in certain offshore entities, which reflects the wide use of offshore investment structures to make VC investments in China. Although using such structures can be viewed as relocating the financed Chinese firms abroad from a technical point of view, doing so is different from strategic corporate relocations motivated by the need to access more efficient legality and economic conditions. For the ten of twenty-nine firms that were relocated as of the first round of VC financing, the destinations of such relocations were not the U.S., but were offshore tax havens such as the Cayman Islands or the British Virgin Islands. Similarly, for the thirteen firms that already had foreign presences, their presences were also mainly located in these offshore financial center jurisdictions.

Based on an analysis of the possible motivations of the Chinese firms and their VC investors to relocate to foreign countries, this article argues that compared to the influence of legality and economic conditions, the

experience of venture capital funds seems to be a better explanation for the corporate relocation phenomenon in China's VC financings, which actually reflects more of a contracting technique to circumvent unfavorable Chinese laws and conveniently implement U.S.-style contracts. In this sense, and within the particular setting of China, real strategic corporate relocation in venture capital finance is not really yet an issue.