

# Legal Commentary

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## First Unconditional Approval Granted to Merger Filing Involving VIE Structure-related Concentration of Undertakings

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On July 16, 2020, the Anti-Monopoly Bureau of the State Administration for Market Regulation (“**SAMR**”) granted **unconditional approval** for the concentration of undertakings arising from a joint venture established between Shanghai Mingcha Zhegang Management Consulting Co., Ltd. and Huansheng Information Technology (Shanghai) Co., Ltd. (the “**Mingcha Zhegang case**”). The approval decision was published on SAMR’s website on July 22. SAMR, in granting unconditional approval, is seen as having indicated its position that concentrations of undertakings which involve variable interest entity (“**VIE**”) structures can also be reviewed and cleared. In the future, merger filings involving VIE structures may become a “new normal”; so far, however, leading Internet companies in China, which typically have VIE structures, have not been seen making merger filings.

Han Kun has received many inquiries from enterprises since the Mingcha Zhegang case was accepted for merger review on April 20, 2020. Below, we will share our observations in response to five common questions.

### **What makes transactions involving VIE structures so special? Why was widespread interest aroused when the case was accepted for merger review and approval granted?**

As is widely known, VIE structures represent a legal gray area under Chinese foreign investment law. Before the institutional reform in 2018, rumors circulated that the Ministry of Commerce, then the competent review and approval authority for merger filings, was unwilling to approve transactions involving VIE structures, thus indirectly recognizing the legitimacy of VIE structures. The rumors seemed to be verified by several cases, for example: Sina’s proposed acquisition of Focus Media<sup>1</sup> was aborted because

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<sup>1</sup> According to reports, in 2009, Sina finally abandoned the plan to acquire Focus Media because it failed to obtain approval from the Ministry of Commerce for the transaction. Insiders speculated that the reason the Ministry of Commerce delayed acceptance of the declaration of concentration of undertakings was because the transaction involved VIE-structured parties. See: <http://companies.caixin.com/2009-06-10/100052619.html>; <http://tech.163.com/09/0929/16/5KD1LO69000915BF.html>.

it failed to pass antitrust review; and Wal-Mart's acquisition of Yihaodian<sup>2</sup> was granted conditional approval which prohibited Wal-Mart from engaging in value-added telecommunications services through a VIE structure operated by Yihaodian.

Following the 2018 institutional reform, it is generally believed that SAMR is relatively more motivated and capable of resolving issues related to antitrust reviews of VIE structure-related transactions. In the Mingcha Zhegang case, SAMR clearly disclosed in a simple case publicity form that the transaction involved a VIE structure, signaling to the public that enterprises may file VIE structure-related transactions with SAMR.

### **What does the approval of the Mingcha Zhegang case imply? What factors need to be considered going forward when evaluating whether to make a merger filing for a VIE structure-related transaction?**

The approval of the Mingcha Zhegang case increases certainty when making a merger filing for VIE structure-related concentrations of undertakings.

It was popularly believed that transactions involving VIE structures would be subject to a high degree of uncertainty if submitted for antitrust review. Thus, in practice, parties to a VIE structure-related concentration of undertakings transaction would adopt various methods to circumvent antitrust review by preventing the transaction from constituting a notifiable transaction, such as by making a concession in control rights to avoid the transfer of control or by other methods. However, regardless of the method, this approach could increase transaction costs or cause the transaction parties not to fully realize their original transaction objectives.

SAMR, in granting approval for the Mingcha Zhegang case, will undoubtedly bring major benefits to prospective parties to VIE structure-related transactions, because the parties can consider retaining transaction structures which permit the transfer of control and obtain antitrust clearance. Despite the convenience the Mingcha Zhegang case may bring, transaction parties should still keep in mind that the filing process, once initiated, could require considerable time and effort and could also delay the transaction, depending on the circumstances. Thus, transaction parties should account for the time required for the merger filing and review process when designing their transaction timelines.

### **After the Mingcha Zhegang case, will SAMR only focus on competition aspects of a concentration of undertakings and not other compliance aspects? How should such uncertainties be resolved?**

In our understanding, SAMR will focus on competition aspects when reviewing concentrations of undertakings, but this does not mean that SAMR will forgo reviewing other compliance aspects of the transaction. According to the *Notification Form for Anti-trust Review of Concentration of Undertakings*,

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<sup>2</sup> In 2012, the Ministry of Commerce conditionally approved Wal-Mart's acquisition of 33.6% equity in Niu Hai Holdings (i.e. Wal-Mart's acquisition of Yihaodian). According to the Ministry of Commerce's decision for this case, Walmart would obtain control over online direct sales (without involving a VIE structure) to Yihaodian after the transaction was completed, but would be prohibited from engaging in value-added telecommunications services operated by Yishiduo through the VIE structure.

the filer must still explain “the compliance information of the transaction and of the parties to the concentration in China.” Specifically, “the compliance information of the transaction” means “information regarding whether the transaction complies with PRC laws, regulations, rules, and relevant regulations and policies,” and “compliance information of the parties to the concentration in China” means “information regarding whether the parties to the concentration and their affiliates have any pending issues or compliance issues related to entity establishment, operation management, foreign investment approval and industry admittance supervision in China.”

It can thus be seen that filers need to make truthful disclosures to SAMR, regardless of whether the proposed transaction itself or an undertaking to the concentration involves a VIE structure. Among the two, SAMR will more likely challenge a proposed transaction which itself involves a VIE structure as opposed to transactions such as the Mingcha Zhegang case, which involved a VIE-structured undertaking. This is because a VIE-structured transaction could be used to bypass foreign investment restrictions. Note that this conclusion is merely theoretical in nature and remains to be confirmed in practice.

Regarding the uncertainty of compliance issues arising from a transaction itself, when designing a transaction involving a VIE structure, the following factors can be comprehensively considered in determining the final transaction structure and filing with SAMR where the circumstances constitute a notifiable transaction:

1. whether a transfer of control is necessary to realize the purpose of the transaction;
2. whether the transaction meets the merger filing thresholds;
3. the transaction schedule;
4. the competition implications of the transaction;
5. the impact of potential penalties on the validity of the transaction and the reputation and economic interests of the transaction parties, such as fines and revoking of the transaction;
6. the willingness of other transaction parties, etc.

If a transaction encounters insurmountable obstacles during the antitrust review, the filers may consider withdrawing the filing and altering the transaction structure to an extent that no longer requires a filing (for example, the relevant party abandons control), so as to complete the transaction as originally planned.

### **The Mingcha Zhegang case, a simple procedure filing, took 88 days to complete, why did it take so much longer than the average for simple procedure filings?**

The Mingcha Zhegang case took 88 days from case acceptance until SAMR granted unconditional approval, which is far longer than the average review time for simple procedure filings of about 15 days. Does this mean that the review of concentrations of undertakings that involve VIE structures will not be treated normally?

It is understood that the delay in the case review process was mainly due to competition issues, rather than VIE issues. According to the case publicity form, two relevant markets were defined in the case, the

“Chinese catering industry information technology application product and service market” and “Chinese catering service market.” However, it seems that both these relevant markets could be further segmented, considering the fairly ambiguous boundaries of the “Chinese catering industry information technology application product and service market” and the scope of the “Chinese catering services market” exceeds that defined in case precedents<sup>3</sup>. Furthermore, a third party may have raised objections during the publicity period, which would have caused the simple case to enter a second phase of review.

### **What future changes will Mingcha Zhegang case bring to the transactions market?**

After the Mingcha Zhegang case was placed on file and publicized, we observed that companies have closely watched the development of the case. Besides traditional merger and acquisition transactions, investors participating in the financing of emerging companies, which rarely involved filings in the past, are also raising requests for antitrust transaction terms. Another reason for companies to attach greater importance to antitrust filings is due to a proposed increase in penalties for failure to file notifiable transactions, which are raised to 10% of an undertaking’s prior year revenue in a draft amendment to the Anti-Monopoly Law.

Although no new concentrations involving VIE structures have been filed for merger review within the last 88 days after the filing of the Mingcha Zhegang case, we expect that there will be increased and increasingly diverse filings involving VIE structures, to the extent that VIE structure-related filings may even in the near future become a “new normal.” However, it remains unclear and to be further observed how SAMR will handle cases where transaction parties fail to file notifiable transactions due to VIE issues, especially those which have been reported and are under investigation.

As mentioned above, we expect the SAMR’s unconditional approval of the Mingcha Zhegang case to soon bring significant and positive changes to the transactions market, considering the Anti-Monopoly Bureau has achieved remarkable results in accelerating the review of concentrations of undertakings in recent years and because normal review and clearance of VIE structure-related filings will assist enterprises in reducing transaction costs and better realizing their transaction objectives.

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<sup>3</sup> For example, in the case of “Yum China Holdings Co., Ltd.’s acquisition of equity in three companies including Huang Jihuang Group (Hong Kong) Co., Ltd.” publicized in 2019, the relevant market was defined as “hot pot catering services,” a segment further divided from “catering services.”

***Important Announcement***

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