



SECTOR PRIMERS — INTERNET





The Internet, e-commerce and new media industry sectors in China are highly regulated, and foreign participation is restricted. There are many ways to structure a foreign-invested Internet business in China, including the variable interest entity, or “VIE” structure, which has been used by foreign e-commerce and new media companies seeking to enter the China market and by the founders of indigenous Chinese businesses seeking to raise capital outside China. In determining the optimum structure, foreign investors also must carefully consider the risks and implement a plan to protect their proprietary technology upon entering the China market.

This report provides a brief introduction to the state of the market for foreign investment in the Internet, e-commerce and new media industry sectors in China. Orrick has advised dozens of leading U.S., European and Asian companies in structuring and operating businesses in these dynamic sectors, and this report draws from our wealth of practical, on-the-ground experience.

#### **REGULATION OF THE INTERNET, E-COMMERCE AND NEW MEDIA SECTORS IN CHINA**

Commercial entities with foreign investment are permitted to operate only within a scope of business that is authorized by the relevant government administrative department(s) and in conformity with the Catalogue for Guiding Foreign Investment in Industry (Foreign Investment Catalogue). The Foreign Investment Catalogue divides foreign investment projects by industry sector into three categories: encouraged, restricted and prohibited. Prohibited projects are not open to foreign investment. Restricted projects are open to foreign investment but may be subject to foreign equity ownership caps, higher approval thresholds or other limitations.

Foreign investment projects in the Internet, e-commerce and new media sectors, i.e., those that provide what is referred to as “value-added telecommunications services” (VATS), are categorized as restricted under the Foreign Investment Catalogue, and foreign equity ownership is capped at 50%. VATS includes online data and transaction processing services, domestic multiparty communications services, domestic Internet virtual private network (IP-VPN) services, Internet data center (IDC) services, store and forward services, call center services, Internet access services, and information

services such as the provision of content, entertainment/online gaming, commercial information, positioning information and similar services.

A company with foreign investment is commonly referred to as a foreign-invested enterprise (FIE). An FIE that engages in the provision of VATS is referred to as a foreign-invested telecommunications enterprise (FITE) and is required to obtain a VATS operating license from the Ministry of Industry and Information Technology (工业和信息化部) (MIIT). As a practical matter, however, the MIIT rarely issues a VATS operating license to an FITE. If an FITE operates within a sector where an FIE is also required to obtain approval from another industry regulator, such as news, publishing, education, medicine, medical devices or health care, it must also obtain the relevant regulatory approval.

#### **STRUCTURING INTERNET, E-COMMERCE AND NEW MEDIA BUSINESSES IN CHINA**

There are several ways to structure an Internet, e-commerce or new media business in China, including the acquisition of an existing VATS business or its assets, the establishment of a Greenfield FITE, the use of various contractual and/or nominee shareholding arrangements to exert control over and to extract revenue from an existing or Greenfield domestic invested VATS business and various licensing arrangements. As VATS is a restricted sector under the Foreign Investment Catalogue, however, no one option is ideally suited to all situations.

Market entry by means of an acquisition may involve a cross-border acquisition of a domestic invested VATS business by a foreign company, an onshore acquisition of a domestic-invested VATS business by an FIE or an offshore acquisition of a foreign company that directly or indirectly holds one or more VATS businesses in China. In each case, a business in China that directly engages in the provision of VATS is required to obtain a VATS operating license and any other relevant regulatory approvals. Moreover, when a domestic-invested VATS operator undergoes a change in shareholding, it is required to report such change to the MIIT, which is empowered to revoke its VATS operating license.

To enter China by establishing a Greenfield FITE, a foreign investor must complete a mandatory government examination and approval procedure and obtain a business license. The approval process is time

consuming, document intensive and normally involves a number of government administrative agencies. Upon issuance of a business license, the newly established FITE must carry out a series of ancillary registration procedures with the other relevant government agencies in charge of the administration of the entity (e.g., the finance, foreign exchange control, customs and tax authorities).

Due to the restrictions on VATS, various permutations of the VIE structure have been used by foreign Internet, e-commerce and new media companies seeking to enter the China market. The VIE structure, also known as the “Sina model” and the China-China-foreign, or “CCF” structure, functions by using a foreign entity to establish an FIE in China and causing the FIE to enter into a series of contracts with a domestic entity and its shareholders. The domestic entity holds the licenses and other qualifications required to lawfully operate in the restricted sector in China, and the contracts give the FIE effective control over, and the right to extract revenue from, the domestic entity. The reliability of the VIE structure, however, is questionable under Chinese law as a VATS provider is prohibited from “using any method” to transfer a VATS operating permit to a third party and as the contracts that underpin a VIE structure could be held invalid under the PRC’s Contract Law. The structure presents myriad challenges depending on the particular circumstances of each transaction.

Alternatively, a foreign investor may consider entering the China market via a cross-border technology licensing arrangement with a domestic-invested VATS operating company. Technology may be imported to China pursuant to a registration or approval procedure involving a “technology import contract.” Technology imports include an assignment or license of patents, technical secrets, software or other proprietary technology; the provision by a foreign supplier of technical services; and cooperative arrangements between Chinese and foreign parties for technology design, research and development or co-development.

#### **PROTECTING INTERNET BUSINESSES IN CHINA**

In addition to the regulatory restrictions, foreign Internet, e-commerce or new media, investors must carefully consider a wide range of potential threats and develop a coordinated plan to protect their proprietary

technology upon entering the China market. Patents and trademarks (including Chinese language marks) should be registered in China, even if they are protected elsewhere. Where possible, less valuable proprietary technology may be used in China, and access to core technology may be rigidly restricted. Staff, customers, partners and licensees should be carefully vetted, trained and monitored, and localized confidentiality and intellectual property rights assignment agreements should be put in place.

Foreign investors must also understand and address several distinct features of Chinese law. For example:

- The “work-for-hire” doctrine is not recognized in China, and unless an employer and employee expressly agree otherwise, copyright in employee-created work is held by the employee creator.
- Licensees are generally permitted to make and own improvements and to reverse engineer proprietary technology, unless a licensee is properly compensated and contractually bound by certain negative covenants in a valid license agreement.
- China has not enacted comprehensive legislation governing data protection and privacy rights, but various rules protect an individual’s communications, portrait or reputation, obligate organizations to maintain the privacy of personal information and restrict the disclosure and transfer (particularly a cross-border transfer) of personal information.

Finally, a foreign investor must consider an efficient means for resolving disputes. Foreign court judgments are seldom recognized or enforced in China, the court system is hampered by poor training, and both local protectionism and corruption have been frequently reported. Arbitration in China is available for an FIE, and arbitration in a foreign tribunal is available to a foreign contracting party, but a successful claimant seeking to enforce an arbitration award in China must file an action in a People’s Court where the defendant’s assets are located. Interim relief is available upon proving that the continuation of the alleged infringing conduct will cause “irreparable harm” to the interests of a proprietary rights holder.



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Orrick's Greater China team of more than 100 lawyers and legal professionals offers clients one of the most comprehensive and experienced international law practices in the region.

With an unmatched 40-year track record advising regional and international clients on a broad range of China-related legal matters, our lawyers work from offices in Beijing, Hong Kong and Shanghai to provide clients with complete transactional and dispute resolution legal services in Greater China and the major markets around the world.

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