NOTE

China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It

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ABSTRACT

U.S. investors have invested over $70 billion in Chinese companies. Many of those investments—by some estimates most—are illegal under Chinese law. Some of China's largest companies, including nearly half of the Chinese companies listed on U.S. stock exchanges, are participants in this scheme to facilitate illegal investment. The illegal status of these investments is abused by corporate insiders in China who steal assets owned by U.S. shareholders with impunity, and there is a constant threat that the Chinese government may crack down on these illegal investments at any time. The situation is unsustainable, and the threats posed to U.S. investors and the global economy are colossal. The mechanism enabling this dysfunctional system of international investing—the "variable interest entity" corporate structure—is at the root of the problem and must be replaced. This can be accomplished through a robust U.S.-China bilateral investment treaty, which will allow the U.S. and Chinese governments to fix this broken system before more U.S. investor money is lost and the global economy is placed in greater jeopardy.

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Introduction

In the early 1980s, the government of the People's Republic of China ("PRC" or "China") broke from decades of centrally planned, socialist economic policy when it began to permit the development of a private-sector economy and the introduction of foreign investment.[1] These reforms produced a surge in economic growth that propelled the Chinese gross domestic product ("GDP") to a remarkable average annual growth rate of over nine percent that persisted from the late 1980s through the early 2000s.[2] Naturally, significant amounts of for-

1 *See* Stanley Lubman, *Looking for Law in China*, 20 Colum. J. Asian L. 1, 4–5 (2006) (explaining the legal environment in the PRC since 1979, when the government "first gave foreign direct investment (FDI) a hesitant welcome"); *see also* Nicholas R. Lardy, China in the World Economy 63 (1994); College of Staten Island's Modern China Studies Group, *China Rises Companion: Movers and Shakers of China's Economy*, N.Y. Times, http://www.nytimes.com/ref/college/coll-china-business.html (last visited Feb. 8, 2016) [hereinafter *Movers and Shakers of China's Economy*].

2 Barry Naughton, The Chinese Economy: Transitions and Growth 140 (2007) (providing data that the average annual GDP growth in China from 1978–2005 was 9.6%); *see also* Lardy, *supra* note 1, at 64 (noting "the long-term rise in foreign direct investment in the 1980s and the surge in the early 1990s"); *Movers and Shakers of China's Economy*, *supra* note 1 (explaining that China's annual growth rate over the past twenty-five years has been over nine percent).

eign investment followed, chasing these robust growth rates could hardly be found anywhere else in the world.[3]

There was a catch, however, for foreign investors—the government of the PRC maintains a list of industries in which foreign ownership (and therefore, equity-based investment) is strictly limited or outright prohibited.[4] This list of restricted and prohibited industries includes any activities the Chinese government considers strategically important—for example, the agricultural, automotive, chemical, financial, and pharmaceutical industries, just to name a few.[5]

As a result of these foreign investment restrictions, certain Chinese companies adopted a corporate structure—known today as a Variable Interest Entity ("VIE") structure—designed to circumvent Chinese law in order to facilitate foreign investment in restricted industries.[6] The VIE structure consists of several corporate entities linked together through a mix of contractual relationships and equity ownership for the purpose of convincing shareholders of an offshore company that they own interest in the Chinese operating business, while simultaneously appearing to the Chinese government as though no illegal foreign ownership of the operating company exists.[7] This scheme is designed to circumvent Chinese law, and is therefore a means to an illegal end.[8] Originally used by two companies, Sina Corporation and Sohu, Inc.,[9] the VIE structure has taken on a life of its own.[10] Today, nearly half of Chinese companies listed on the New York Stock Exchange ("NYSE") and the NASDAQ use the VIE structure to sell stock to foreign investors in contravention of Chinese

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3 *See* LARDY, *supra* note 1, at 64 (discussing how China attracted more foreign investment than any other developing country from 1992 to 1993); NAUGHTON, *supra* note 2, at 145; *Movers and Shakers of China's Economy*, *supra* note 1 (stating that China's GDP has "surpassed some of the G7 countries").

4 *See* MINISTRY OF COMMERCE PEOPLE'S REPUBLIC OF CHINA, CATALOGUE FOR THE GUIDANCE OF FOREIGN INVESTMENT INDUSTRIES, [hereinafter MOFCOM CATALOGUE] http://english.mofcom.gov.cn/article/policyrelease/aaa/201203/20120308027837.shtml (last updated Feb. 21, 2012 7:51 PM); *see also* Kyle Sullivan et al., *Revised Catalogue Brings Few Changes to China's Foreign Investment Regime*, CHINA BUS. REV. (July 1, 2011), http://www.chinabusinessreview.com/revised-catalogue-brings-few-changes-to-chinas-foreign-investment-regime.

5 Sullivan et al., *supra* note 4.

6 *See* PAUL L. GILLIS, ACCOUNTING MATTERS: VARIABLE INTEREST ENTITIES IN CHINA 2–3 (2012), http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf.

7 *Id.* at 1.

8 *See id.* at 3.

9 *Id.*

10 *See* Fredrik Öqvist, *Statistics on VIE Usage*, CHINA ACCT. BLOG (April 11, 2011, 5:20 AM), http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html (reviewing SEC filings of ninety-seven U.S.-listed Chinese companies that use VIEs).

law.[11] As a result, billions and billions of U.S. investor dollars are in jeopardy—illegally invested in Chinese companies, enjoying no legal protections at all.[12]

More than fifteen years after the first use of the VIE structure for foreign investment in China, the situation has become unsustainable.[13] The amount of foreign capital invested in VIE-based Chinese companies is massive—in 2014, a single VIE structure company, Alibaba, raised $25 billion of mostly foreign capital in a NYSE initial public offering ("IPO").[14] At the same time, the magnitude of the threats to U.S. investor capital is also staggering. One threat is that corporate insiders at the VIE company in China will commit fraud or steal U.S. investors' assets with impunity because Chinese courts refuse to protect these illegal investments.[15] Another serious threat is that the Chinese government may crack down on these illegal investments, causing U.S. investors to lose the value of their investments in an instant.[16]

Some U.S. investors have already discovered the risk involved in investing in Chinese VIE-based companies the hard way. One example of insider misappropriation of U.S. investor assets involved the Gigamedia company, which briefly lost control of its VIE when a rogue employee took unauthorized control of the company's Chinese assets.[17] The case ended badly for U.S. investors who ultimately settled with the malfeasor.[18] In another case, investors in FAB Universal

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11 Gillis, *supra* note 6, at 2.

12 *See, e.g.*, Alibaba Grp. Holding Ltd., Registration Statement (Form F-1) 8, 9, 40–43 (May 6, 2014) (providing one example of a VIE in which billions of U.S. dollars are invested and which expressly warns U.S. investors that their investments likely enjoy no legal protection in China and may be rendered valueless by hostile state action without warning).

13 Gillis, *supra* note 6, at 10.

14 Liyan Chen et al, *Alibaba Claims Title for Largest Global IPO Ever with Extra Share Sales*, Forbes (Sept. 22, 2014, 11:51 AM), http://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo-ever-with-extra-share-sales.

15 *See* Donald Clarke, *Who Owns the Chinese Internet?*, Chinese L. Prof Blog (July 7, 2011), http://lawprofessors.typepad.com/china_law_prof_blog/2011/07/who-owns-the-chinese-internet.html.

16 *See, e.g.*, Renren Inc., Registration Statement (Form F-1) 31 (Apr. 15, 2011) (warning investors that, "[i]f the PRC government determines that [Renren's VIE structure] do[es] not comply with applicable laws and regulations, it could: revoke our business and operating licenses; require us to discontinue or restrict our operations; restrict our right to collect revenues; block our websites; require us to restructure . . . or take other regulatory or enforcement actions against us that could be harmful to our business"); *see also* Gordon G. Chang, *China Can Expropriate Alibaba's Business—and It Just Might*, Forbes (May 11, 2014, 6:24 PM), http://www.forbes.com/sites/gordonchang/2014/05/11/china-can-expropriate-alibabas-business-and-it-just-might.

17 *See* Clarke, *supra* note 15.

18 *See* Press Release, SEC, GigaMedia Announces Sale of T2CN: All T2CN Civil Litiga-

saw the value of their shares plummet when it came to light that the company's Chinese VIE had issued a $16.4 million bond off the books and engaged in fraudulent retail practices.[19] In both the Gigamedia and FAB Universal incidents, the U.S. investors were unable to enforce their rights in Chinese courts due to the illegal status of the VIE structure.[20]

Taken together, the significance of the risk and the magnitude of the U.S. investor capital at stake amount to an unsustainable threat to U.S. investors, and the federal government of the United States must make an effort to correct the problem before further harm is suffered. This Note argues that it is in the interest of U.S. investors, Chinese companies, and the U.S. and Chinese governments to create a new system based on legal investment and fair and predictable dispute resolution through international arbitration. Part I addresses the background of this issue by presenting a brief history of foreign investment in China, a detailed look at the current legal situation for U.S. investment in China, and an explanation of how the VIE structure works to circumvent Chinese law. Part II examines the problem through examples of recent Chinese VIE controversies and a forward-looking analysis of the risks posed by insider misappropriation and hostile state action. Part III proposes that the U.S. government fix the VIE situation by implementing a U.S.-China bilateral investment treaty conditioned on: (1) enactment of a new Chinese foreign investment law that will allow U.S. investors to invest in all Chinese companies, (2) grandfathering of existing VIE companies into the new regulatory regime, and (3) establishment of an international arbitration commission to resolve U.S.-China investment-related disputes.

I. Investing in China: Before and After VIEs

To understand the contemporary VIE problem, one must look at the history of foreign investment in China that necessitated the creation of the VIE structure, as well as the uncertain climate for such investment that resulted from the VIE structure's widespread adoption.

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tion Resolved (Dec. 14, 2011), http://www.sec.gov/Archives/edgar/data/1105101/000119312511343031/d272014dex991.htm.

19 Paul Gillis, *FU Shows VIE Risk*, China Acct. Blog (Dec. 12, 2013, 6:56 AM), http://www.chinaaccountingblog.com/weblog/fu-shows-vie-risk.html.

20 *See* Clarke, *supra* note 15; *see also* Gillis, *supra* note 19.

A. Pre-VIE Foreign Investment

Over the past thirty-five years, China has experienced tremendous economic growth fueled in part by U.S. investors.[21] But the economic situation in China has not always been so prosperous, or so friendly to foreign investors. In 1949, the Chinese Communist Party ("CCP") ascended to power and established the PRC.[22] Shortly after the CCP took power, the Chinese economy retreated into a strict form of socialism that eliminated the private-sector economy.[23] The new government put virtually all economic activity under state control and foreign investment was prohibited.[24]

The climate for investment in China began to change in the late 1970s, and in 1978, the new leadership of the CCP began pursuing an "Open-Door Policy" toward foreign investment.[25] However, for nearly thirty years, the CCP had ruled China "without any legal codes and with little regard for law at all."[26] This meant that there had been no development—in some areas of the law, *ever*—in modern contract law, property law, business organization law, or foreign investment regulation, among others.[27]

When foreign investment in China began in the early 1980s, China had no existing legal structure to govern most commercial activity, including foreign investment.[28] The institutions and laws required to create a new economic regime from scratch were implemented in a piecemeal fashion, rather than as a coherent whole, by bureaucrats who had no experience with free markets.[29] One result of this irregular process was that foreign-related businesses[30] were situated in an entirely separate legal framework, divorced from ordinary

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21 *See Movers and Shakers of China's Economy*, *supra* note 1.

22 Susan V. Lawrence & Michael F. Martin, Cong. Research Serv., R41007, Understanding China's Political System 1 (2013).

23 Serena Y. Shi, Comment, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 Fordham Int'l L.J. 1265, 1270–71 (2014).

24 *See id.*

25 *Id.* at 1271; *see also* David Schindelheim, Note, *Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for Foreign Investors Part of China's Economic Development Plan?*, 21 Cardozo J. Int'l & Comp. L. 195, 197 (2012).

26 Lubman, *supra* note 1, at 7.

27 *See id.* at 7–11.

28 *See id.*

29 *See id.* at 8, 11.

30 Foreign-related businesses are those arising out of foreign-related contracts. *See generally* Herbert Smith Freehills, Dispute Resolution and Governing Law Clauses in China-Related Commercial Contracts 6–7 (5th ed. 2012) (explaining that a contract is "foreign-related," according to China's Supreme People's Court, if (1) at least one party is for-

Chinese corporate law.[31] As a result of this segregated treatment, foreign-related businesses and investments are subject to overview by dedicated agencies, the most important of which is the Ministry of Commerce ("MOFCOM").[32]

MOFCOM has the power to regulate foreign investment in China, and since such investing resumed in the early 1980s, the agency has exercised its power by restricting or prohibiting foreign investment in many industries.[33] It was MOFCOM's broad restrictions on investment that would eventually prompt enterprising foreign investors to devise the illegal VIE workaround.

Under MOFCOM's rules, every financing or purchase of equity in a China-based company by a non-Chinese citizen is subject to governmental review and approval.[34] The process is often a significant bureaucratic endeavor, with many agencies playing different roles in supervising foreign investments.[35] The process of getting any particular foreign investment enterprise approved may involve (depending on the industry) up to eight different types of approval, including: anti-monopoly approval, national security approval, enterprise registration, local site-related opinion letters, project approval, foreign investment approval, regulatory approval, and approval of strategic investment in a Chinese publicly traded company.[36] The question for many foreign investors, however, is not whether they can navigate the myriad agencies involved in the various approval processes, but whether they are permitted to attempt the process at all.[37] In every case, the answer is found in MOFCOM's guide for foreign investors: the Catalogue for the Guidance of Foreign Investment Industries ("Foreign Investment Catalogue" or "Catalogue").[38]

The Foreign Investment Catalogue is a framework that divides Chinese industries into three categories: "encouraged," "restricted,"

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eign, (2) "the subject matter of the contract is outside mainland China," or (3) if the "contract is executed, amended or terminated outside mainland China").

31 *See* Jianfu Chen, Chinese Law: Context and Transformation 475 (2008).

32 *See* Schindelheim, *supra* note 25, at 199–200.

33 *See* MOFCOM Catalogue, *supra* note 4; *see also, e.g.*, Gillis, *supra* note 6, at 3.

34 *See* Kelly Fisher & Sophie Smyth, *U.S. Private Equity Investment in Emerging Economies*, 12 J. Int'l Bus. & L. 223, 230 (2014).

35 *Id.*

36 U.S. Chamber of Commerce, China's Approval Process for Inbound Foreign Direct Investment: Impact on Market Access, National Treatment and Transparency 9–18 (2012), https://www.uschamber.com/sites/default/files/legacy/reports/020021_China_InboundInvestment_Cvr.pdf.

37 *See id.* at 8.

38 *See generally id.*; MOFCOM Catalogue, *supra* note 4.

or "prohibited."[39] Industries that appear on the "encouraged" schedule, or that do not appear in the Catalogue, generally do not face limits on foreign investment, are subject to less stringent government review, and may receive tariff exemptions.[40] Examples of "encouraged" industries include certain types of agriculture, power production and supply, and education.[41] "Restricted" industries are subject to more extensive government review of everything from antitrust to national security impact and to subjective government judgments of whether the company will benefit China or infringe on the territory of a favored domestic Chinese company.[42] Foreign investors in restricted industries are often successful in obtaining the proper approval, but are typically limited to holding a minority shareholder position only.[43] These "restricted" industries include mining, food processing, and banking.[44] Finally, "prohibited" industries, as the name implies, are entirely off limits to foreign investors—meaning a non-Chinese citizen cannot invest, or otherwise own equity, in a "prohibited" industry company under any circumstances without being in clear violation of the law.[45] Examples of "prohibited" industries include those pertaining to the military, mass media, and telecommunications.[46]

Today, foreign investment is primarily governed by MOFCOM and the Catalogue.[47] The Catalogue's regulations are set by the highest levels of the Chinese government and reflect how the highest state planners view the priorities of economic growth and the national security interests of the country.[48] VIEs disrupt these plans by allowing foreign investors to invest in companies in restricted and prohibited industries in violation of the law and without the requisite approval process—resulting in myriad hazards for the U.S. and Chinese governments, investors, and businesses.[49]

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39 U.S. CHAMBER OF COMMERCE, *supra* note 36, at 8.

40 *Id.*

41 *See* MOFCOM CATALOGUE, *supra* note 4.

42 U.S. CHAMBER OF COMMERCE, *supra* note 36, at 8–18.

43 *Id.* at 38–40.

44 MOFCOM CATALOGUE, *supra* note 4.

45 *See* U.S. CHAMBER OF COMMERCE, *supra* note 36, at 8.

46 MOFCOM CATALOGUE, *supra* note 4.

47 *See* Fisher & Smyth, *supra* note 34, at 230–31.

48 U.S. CHAMBER OF COMMERCE, *supra* note 36, at 8–9.

49 *See generally* GILLIS, *supra* note 6 (explaining how VIEs tell Chinese regulators that a business is owned by the Chinese while telling foreign investors that the business is owned by the foreign investors).

B. Post-VIE Foreign Investment

By the early 2000s, some Chinese companies and U.S. investors were so eager to get around the Catalogue restrictions on investment in certain industries that they were willing to make use of an illegal workaround.[50] In order to bypass the Catalogue prohibitions, companies came up with the VIE structure so that they could seemingly present investors with an opportunity to invest in a company in a restricted or prohibited industry, while at the same time representing to the Chinese government that the company was still entirely under Chinese ownership.[51]

A VIE structure is formed when a company divides into at least three entities that are linked together by contracts which mimic ownership, disguising the fact that foreign shareholders have a claim of ownership to the underlying Chinese business.[52] The first entity is the actual Chinese business ("RealCo") selling the product or providing the service.[53] RealCo is legally owned by a Chinese citizen with no foreign partners or shareholders, meaning the company is legally allowed to do business in an industry in which foreign investment is restricted or prohibited.[54] The second company is a shell based in China ("ChinaCo"), which exists only for the purpose of serving as a bridge between RealCo and the third, offshore entity ("CaymanCo").[55] The third entity, CaymanCo, a Cayman Island shell company, then offers its shares to foreign buyers.[56]

The first part of the bridge, between RealCo and ChinaCo (both in China), is built on Chinese contracts dictating that RealCo will give all profits and liabilities to ChinaCo in exchange for financing and various consulting services.[57] These contracts effectively mimic an ownership relationship wherein ChinaCo is the parent company and RealCo is the subsidiary.[58] The second part of the bridge links ChinaCo to CaymanCo.[59] This relationship consists of CaymanCo owning ChinaCo outright.[60] This ownership is legal because ChinaCo

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50 *See id*. at 1, 3.
51 *See id.* at 1, 3, 6.
52 *See id.* at 4.
53 *See id.* at 4–5.
54 *See id.* at 1, 3, 5.
55 *See id.* at 4–5.
56 *See id.* at 4.
57 *See id.* at 1, 5–6.
58 *See id.* at 3.
59 *See id.* at 4.
60 *See id.* at 4–5.

is not itself *in* a prohibited industry; rather, it only touches the prohibited industry by contract.[61] With the bridge complete—RealCo to ChinaCo by contract, and ChinaCo to CaymanCo by ownership—CaymanCo becomes entitled to RealCo's profits and liabilities.[62] Through the ownership of ChinaCo, CaymanCo's shareholders are therefore ultimately entitled to RealCo's profits and liabilities, making the illusion of owning RealCo complete.[63]

This VIE structure purports to satisfy both U.S. investor and Chinese government needs. U.S. investors believe they own RealCo by way of the bridge because they are effectively entitled to all profits and losses from RealCo, just as they would be through direct equity ownership.[64] On the other side, the Chinese government believes RealCo is legitimately doing business in a restricted or prohibited industry because a Chinese citizen legally owns the company without foreign partners or shareholders.[65] For the moment, both U.S. investors and the Chinese government carry on in the shadow of this obvious incongruity, ignoring the bridge and the risks involved in the shaky status quo of massive illegal investment in China.

II. The Hazards of Investing Outside the Law: Insider Misappropriation and Hostile State Action

Such a complex, deceptive practice as investing through the Chinese VIE structure naturally comes with significant risks beyond those associated with ordinary investing. There are two potential hazards in particular that raise serious concerns for U.S. investors: (1) the potential for insider misappropriation that leaves the company with no legal recourse; and (2) the possibility of a government crackdown on the VIE scheme.[66]

A. *Insider Misappropriation*

In cases involving VIEs, Chinese courts do not protect shareholder interests.[67] Chinese courts recognize that VIEs are an attempt to do something illegal and, like U.S. courts, Chinese courts will not enforce contracts that clearly attempt to violate the law and under-

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61 *See id.*

62 *See id.*

63 *See id.*

64 *See id.* at 5.

65 *See id.* at 3, 6, 10.

66 *See id.* at 6–8 (discussing regulatory and shareholder misappropriation risks in addition to growing operational risks).

67 *See* Schindelheim, *supra* note 25, at 220–22.

mine public policy.[68] Because, in a VIE structure, foreign investors actually own stock in CaymanCo while the valuable assets of the operating company reside in the distant RealCo, there is essentially nothing a foreign investor can do about it if an insider misappropriates the RealCo's assets.[69] The examples of (1) Gigamedia, (2) FAB Universal, and (3) Alibaba, illustrate the risks of allowing insider misappropriation of VIE companies to proceed unchecked.[70]

1. Gigamedia

In 2010, Gigamedia Limited developed a serious problem with its RealCo and ChinaCo companies in China.[71] Gigamedia had planned to restructure its leadership, in part by removing head China executive Wang Ji from his executive positions in the company's ChinaCo and RealCo.[72] However, when Wang Ji became aware of his imminent dismissal, he responded by seizing the ChinaCo and RealCo "company seals, financial chops[,] and business registration certificates"—all of which are absolutely essential to operating a business in the formal, document-based Chinese business environment.[73] As a result, "Wang Ji's actions essentially prohibited Gigamedia from controlling its PRC operations through the contracts between its [ChinaCo] and [RealCo], [and] 'Gigamedia [was not] able to share in the profits of the

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68 *See* Neil Gough, *In China, Concern About a Chill on Foreign Investments*, N.Y. TIMES: DEALBOOK (June 2, 2013, 2:15 PM), http://dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments; Sue-Lin Wong, *China Court Ruling Could Threaten Foreign Investments in Country*, N.Y. TIMES: IHT RENDEZVOUS (June 17, 2013, 3:09 AM), http://rendezvous.blogs.nytimes.com/2013/06/17/china-court-ruling-could-threaten-some-foreign-invested-companies/?_r=0 (reporting on a statement of the Supreme People's Court in China, which said that contracts written to avoid Chinese law requirements are void and unenforceable).

69 *See, e.g.*, Ciara Linnane, *Alibaba's Structure Is 'Dangerous': Mark Mobius*, MARKETWATCH (Sept. 18, 2014, 3:08 PM), http://www.marketwatch.com/story/alibabas-structure-is-dangerous-mark-mobius-2014-09-18.

70 *See supra* notes 14, 20 and accompanying text.

71 *See* Clarke, *supra* note 15; Dan Harris, *Gigamedia and the Perils of VIEs. Dude, Where's My Chop?*, CHINALAWBLOG (June 30, 2011), http://www.chinalawblog.com/2011/06/vie.html.

72 Schindelheim, *supra* note 25, at 221.

73 *Id.*; *see also* Deb Weidenhamer, *Mastering the Chinese Chop System*, N.Y. TIMES: YOU'RE THE BOSS (Dec. 17, 2013, 2:00 PM), http://boss.blogs.nytimes.com/2013/12/17/mastering-the-chinese-chop-system (explaining the Chinese legal system's reliance on formal documents and seals).

Gigamedia [RealCo].'"[74] Despite the magnitude and brazen nature of the insider's misappropriation, Gigamedia settled with Wang Ji.[75]

Though this outcome left no definitive evidence about whether a court would have acknowledged the legitimacy of Gigamedia's claim over the RealCo, it is telling that the company would rather settle with a manager who effectively took the company assets hostage than take the chance of having a court declare the entire operation illegal.

2. *FAB Universal*

In 2012, China-based and NYSE-listed FAB Universal Corp. offered its securities to the public using a VIE structure.[76] Over the course of several months, U.S. short sellers brought to light several alleged abuses that were occurring at the Chinese RealCo.[77] These alleged fraudulent practices included issuing a $16.4 million off-the-books bond, dealing in pirated video retail, and claiming to own non-existent retail locations.[78] The NYSE responded by suspending trade of FAB Universal's stock pending further information from the company.[79] Eventually, the company disclosed that the bond-related allegation had been true.[80] As a result, many U.S. investors lost a great deal of money.[81] Several lawsuits are now pending against the com-

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74 Schindelheim, *supra* note 25, at 221 (fourth alteration in original) (quoting CADWALADER, WICKERSHAM & TAFT LLP, UNDERSTANDING THE VIE STRUCTURE: NECESSARY ELEMENTS FOR SUCCESS AND THE LEGAL RISKS INVOLVED 8 (2011), http://www.cadwalader.com/uploads/cfmemos/a6415b15f2ab1795be964c203f513215.pdf).

75 *See id.* at 222; *see also* Clarke, *supra* note 15 (stating that Gigamedia "has apparently not been able to enforce the contracts that purported to give it control").

76 *See* Gillis, *supra* note 19. According to FAB Universal, the company "operates through its two subsidiaries, Webmayhem, Inc. (Libsyn), a Pennsylvania corporation, which operates [its] podcast hosting and distribution services [and] Digital Entertainment International Ltd. (DEI), a company incorporated under the law of the Hong Kong Special Administrative Region, [which] is also a wholly owned subsidiary of FAB Universal." *About*, FAB UNIVERSAL, http://www.fabuniversal.com/about (last visited Feb. 8, 2016).

77 Gillis, *supra* note 19; *see also* ALFREDLITTLE.COM, FAB UNIVERSAL: "BEST BUY MEETS ITUNES MEETS REDBOX" MEETS FRAUD 5–12 (2013), https://labemp.files.wordpress.com/2013/11/fab-universal-final-11-14-2013.pdf; *FAB Universal Failure to Disclose 100 Million RMB Debt Adds to Problems*, GEOINVESTING (Nov. 18, 2013), http://geoinvesting.com/fab-universal-failure-to-disclose-100-million-rmb-debt-adds-to-problems.

78 Gillis, *supra* note 19.

79 *Id.*; *see also* Press Release, Intercont'l Exch., NYSE MKT to Suspend Trading Immediately in FAB Universal Corp. and Commence Delisting Proceedings (Aug. 11, 2014), http://ir.theice.com/press/press-releases/nyse-regulation/2014/nyse-mkt-to-suspend-trading-immediately.

80 *FAB Universal Responds to Allegations: Board Authorizes Third Party Investigation to Verify Its Findings*, BUSINESSWIRE (Dec. 10, 2013, 11:36 AM), http://www.businesswire.com/news/home/20131210006189/en/FAB-Universal-Responds-Allegations#.VhCVc7RViko.

81 FAB's stock was trading at $3.05 when the NYSE suspended trading—down from a 52-

pany,[82] but because of the VIE structure, it is virtually certain that U.S. shareholders will not be able to recover in China.[83]

3. *Alibaba*

Alibaba Group experienced what one China-watcher called "[t]he most serious case related to loss of the [RealCo] to the VIE shareholder."[84] Well before the company offered shares publicly in 2014, Alibaba established a VIE structure in order to pursue one particular foreign investor: Yahoo.[85] The gambit worked, and Yahoo took a forty-three percent stake in the company.[86] The partnership went smoothly for a few years, but then, much to Yahoo's surprise, Alibaba spun off its lucrative Alipay online payment processing service.[87] Alipay became independently owned by Alibaba's founder and majority shareholder, Jack Ma, and completely separated from the RealCo in which Yahoo was invested.[88] Although Yahoo made out well on its overall Alibaba investment (shortly after the IPO it was reported that Yahoo's remaining 15.4% stake in the company was worth nearly $40 billion[89]), it would never regain control of Alipay.[90] Shortly after Alibaba's IPO, Yahoo announced that it planned to divest completely from Alibaba.[91]

The Gigamedia, FAB Universal, and Alibaba incidents show a pattern of insider misappropriation of VIE company assets, followed

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week high of $11.48. *See FAB Universal Corp. (FU)*, YAHOO! FINANCE, https://finance.yahoo.com/q;_ylt=AriJ7NDCnUZC5cJvoJ9S9tep_8MF?uhb=uhb2&fr=uh3_finance_vert_gs&type=2button&s=FU (last visited Jan. 30, 2016). At the time of this writing, the stock is only trading on the grey market for $0.025 a share. *FAB Universal Corp.*, OTC MARKETS, http://www.otcmarkets.com/stock/FABU/quote (last visited Feb. 8, 2016).

82 Justine Coyne, *Hearing Set to Determine FAB Universal's Future on Stock Exchange*, PITTSBURGH BUS. TIMES (July 3, 2014, 2:47 PM), http://www.bizjournals.com/pittsburgh/news/2014/07/03/hearing-set-to-determine-fab-universals-future-on.html?page=all.

83 *See* Gillis, *supra* note 19.

84 GILLIS, *supra* note 6, at 8.

85 *See* Chang, *supra* note 16.

86 Schindelheim, *supra* note 25, at 214.

87 *Id.* at 214–15; *see also* Dinny McMahon & Paul Mozur, *Alibaba and VIEs: A Primer*, WALL ST. J.: MONEYBEAT (May 6, 2014, 6:26 PM), http://blogs.wsj.com/moneybeat/2014/05/06/alibaba-and-vies-a-primer.

88 *See* Chang, *supra* note 16.

89 Vindu Goel & Michael J. De La Merced, *Yahoo to Spin Off Its Stake in Alibaba*, N.Y. TIMES (Jan. 27, 2015), http://www.nytimes.com/2015/01/28/technology/yahoo-earnings-alibaba-spinoff.html?_r=0.

90 *See* Kathrin Hille & Joseph Menn, *Alibaba Settles Alipay Dispute with Yahoo*, FIN. TIMES (July 29, 2011, 4:39 PM), http://www.ft.com/cms/s/2/40a66dd2-b9ec-11e0-8171-00144feabdc0.html#axzz3nZLTsvQF.

91 Goel & De La Merced, *supra* note 89.

by settlement with the perpetrator of the misappropriation—all at the expense of the VIE shareholders.[92] As Paul Gillis, a professor of accounting at Peking University and an often-cited commentator on VIE issues,[93] has described it:

> Investors in Chinese companies have been badly burned by CEOs who seem to forget that they have shareholders. Some CEOs have *sold assets out of the company* and kept the proceeds. Some have just cleaned out the bank accounts. Others have *taken the whole company*. The variable interest entity (VIE) structure, where companies are controlled with contracts[,] is a common enabler of these scams. *Shareholders have little, if any, legal protection when things go wrong with a VIE.*[94]

B. *Hostile State Action*

In addition to the risk of insider misappropriation, shareholders in VIE structure companies also face the threat of a Chinese government crackdown.[95] There is precedent: in 1998, the Chinese government declared a foreign investment scheme illegal after previously tolerating its existence without interference.[96] The corporate structure involved in the 1998 incident was slightly different in form, but almost identical in purpose, to the VIE structure.[97] It was called a "China-China-Foreign" ("CCF") structure, and it was first used by China United Network Communications Group ("China Unicom") to facilitate foreign investment in violation of MOFCOM Catalogue prohibitions—just as VIEs do today.[98] Like the VIEs of today, the CCF was technically illegal, but (at least initially) tacitly permitted by authorities.[99] Using the CCF structure, Unicom was able to raise more than $1.4 billion over three years.[100] A few other telecommunications com-

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92 *See, e.g.*, Linnane, *supra* note 69 (quoting Mark Mobius, who says that if "the founders . . . decide to take all the pay away, there's nothing [foreign shareholders] can do about it"); Wong, *supra* note 68 (observing that a "foreign party most likely has no legal recourse" when Chinese partners in VIEs "decide they don't want to follow the contracts any longer").

93 *Faculty Directory*, PEKING UNIV., http://www.gsm.pku.edu.cn/faculty/en/gillis.html (last visited Oct. 16, 2015).

94 Gillis, *supra* note 19 (third emphasis added).

95 GILLIS, *supra* note 6, at 6–7.

96 *See* Shi, *supra* note 23, at 1275–76.

97 *See id.* at 1275–77.

98 *See id.* at 1275.

99 *See* Lubman, *supra* note 1, at 50 (quoting James Kynge, *China Cuts Off Foreign Telecom Investors' Hopes*, FIN. TIMES, Sept. 23, 1998, at 4) (noting that top Chinese officials have openly endorsed the CCF structure).

100 Shi, *supra* note 23, at 1275.

panies followed suit.[101] Then, without warning, the Chinese government declared the CCF structure illegal.[102]

Though few companies had adopted the CCF before its prohibition, shareholders in those companies faced substantial losses and difficulty in pursuing relief.[103] The Chinese government did not fully explain why it cracked down on CCFs so suddenly, aside from calling the CCF "irregular" under state policies and regulations.[104] As the VIE is virtually identical in purpose to the CCF, there are grave concerns that it could suffer a similar fate, which would cause serious harm to VIE-based company shareholders.[105]

An additional cause for concern is the recent 2012 ruling handed down by the PRC Supreme People's Court in a case against Chinachem Financial Services.[106] In that case, contracts similar to those used in VIE structures were declared illegal.[107] This ruling did not create binding precedent, as China is a civil law jurisdiction, but it does signal to investors that a court or the government may someday soon declare a VIE structure illegal.[108]

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101 *See id.* at 1276 (noting that "CCF had been utilized by a few dozen telecom businesses for several years without official intervention").

102 *See id.* at 1275–76; *see also* Donald Clarke, *More on Gray Areas in Chinese Law*, Chinese L. Prof Blog (July 4, 2011), http://lawprofessors.typepad.com/china_law_prof_blog/2011/07/more-on-gray-areas-in-chinese-law.html (describing how the government of the PRC issued a notice requiring foreigners to divest their interests in CCF-structured companies).

103 *See* Shi, *supra* note 23, at 1276; Reily Gregson, *CCF Investors in China May Not Go Quietly*, RCR Wireless (Aug. 23, 1999), http://www.rcrwireless.com/19990823/archived-articles/ccf-investors-in-china-may-not-go-quietly (explaining how Unicom's investors threatened to sue in their countries, while the U.S. Chamber of Commerce stated that U.S. investors had not "come up with any suggestions as to what the U.S. government [wa]s to do" about the issue).

104 Leontine D. Chuang, Comment, *Investing in China's Telecommunications Market: Reflections on the Rule of Law and Foreign Investment in China*, 20 Nw. J. Int'l L. & Bus. 509, 520 (2000) (outlining how the Chinese government first told Unicom that contracts with foreign investors were "irregular" and later asked for an outright ban of CCFs).

105 *See* Clarke, *supra* note 102 (describing the CCF as an "early version" of the VIE structure); *see also* Gregory J. Millman, *Foreign Companies at Risk from Proposed Chinese Law*, Wall St. J. (Apr. 19, 2015, 12:01 AM), http://www.wsj.com/articles/foreign-companies-at-risk-from-proposed-chinese-law-1429474352 (explaining that proposed legislation in China would legalize VIE operations controlled by Chinese citizens and declare other VIEs illegal).

106 *See* Chang, *supra* note 16.

107 *Id.*

108 *See id.*

III. A Mutually Beneficial Solution: A Bilateral Investment Treaty with an International Arbitration Commission

Any solution to the VIE problem will require a delicate balancing of interests in order to satisfy both the U.S. and Chinese governments. The Chinese government's interests include facilitating further U.S. investment in certain sectors of the Chinese economy,[109] while also keeping some companies in other strategically important industries exclusively under Chinese control.[110] Similarly, the U.S. government is interested in promoting U.S. investment in China,[111] protecting U.S. investors, businesses, and markets,[112] and facilitating fair dispute resolution for U.S. investors.[113] All of these interests are currently undermined by the VIE investment system because (1) U.S. investment in China is suppressed due to the uncertainty surrounding the legality of the structure,[114] (2) U.S. investors may lose their capital if insiders misappropriate assets or the Chinese government decides to crackdown on VIE structures,[115] and (3) PRC restrictions on foreign ownership in strategically important industries are ignored.[116]

Fortunately, there is hope for a solution. The VIE problem can be solved through the enactment of a bilateral investment treaty ("BIT") between the United States and China that establishes an international arbitration commission for investment-related disputes. This approach will satisfy all of the interests of the U.S. and Chinese governments: while the U.S.-China BIT will facilitate greater U.S. investment in China and keep strategic PRC businesses under Chinese control, the international arbitration commission will work to protect investors and businesses in both countries through fair and binding

109 *See* U.S. Dep't of State, 2014 Investment Climate Statement: China 1 (2014), http://www.state.gov/documents/organization/228504.pdf (noting that in November 2013, CCP leadership "unveiled an ambitious reform agenda that directs the authorities to broaden foreign investment access").

110 Gillis, *supra* note 6, at 11 ("The original concern of Chinese regulators in restricting foreign investment in certain sectors was to make certain that Chinese, and not foreigners, were making the decisions that impact sensitive sectors.").

111 *See* U.S. Dep't of State, *supra* note 109, at 2.

112 *See id.*

113 *See id.* at 2–3.

114 *See id.* at 2 ("[F]oreign investors often temper their optimism regarding potential investment returns with uncertainty about China's willingness to offer a level playing field . . . . In addition, foreign investors report a range of challenges related to China's current investment climate.").

115 *See id.* at 3; *see also* Gillis, *supra* note 6, at 6–9.

116 *See* Öqvist, *supra* note 10.

resolution of disputes. This solution will ultimately create a regulated, predictable, and sustainable system for U.S. investment in China.

A. *Why a Bilateral Investment Treaty?*

Bilateral investment treaties are commonly used in international relations as a vehicle for setting standards regarding the treatment of foreign investors.[117] Unlike free trade agreements, which address a variety of economic interests between two or more countries, BITs are narrowly focused on investment issues.[118] In the United States, the Department of State and the Office of the U.S. Trade Representative negotiate all BITs.[119] Each individual BIT is based on the model U.S. BIT currently in use, with terms individually tailored to the unique circumstances of specific partner countries.[120]

U.S. BITs generally focus on securing six significant protections for U.S. investors abroad, including protection from government takings, freedom to transfer capital in and out of the host country, and guaranteed access to a fair method of dispute resolution.[121] The main concerns of the U.S. government, however, come down to *national treatment*, which requires a country to treat U.S. investors like domestic investors, and *most-favored nation treatment*, which requires a country to treat U.S. investors at least as well as foreign investors from other countries.[122] Taken together, the protections of a standard U.S. BIT are said to create "meaningful new market access opportunities, and a robust investor-state dispute settlement . . . mechanism," not only for U.S. investors putting capital to work in the partner country, but also for the partner country's investors when they choose to invest in the United States.[123]

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117 *See* PETERSON INST. FOR INT'L ECON., TOWARD A U.S.-CHINA INVESTMENT TREATY 3–4 (2015), http://www.iie.com/publications/briefings/piieb15-1.pdf.

118 *See id.* at 4.

119 *See Bilateral Investment Treaties*, OFFICE OF U.S. TRADE REP., https://ustr.gov/trade-agreements/bilateral-investment-treaties (last visited Feb. 9, 2016).

120 *See id.*; *see also* U.S. DEP'T OF STATE, *supra* note 109, at 1.

121 *See* Jeffrey J. Schott & Cathleen Cimino, *The China-Japan-Korea Trilateral Investment Agreement: Implications for U.S. Policy and the U.S.-China Bilateral Investment Treaty*, *in* PETERSON INST. FOR INT'L ECON., *supra* note 117, at 6, 9; *see also* U.S. DEP'T OF STATE, 2012 U.S. MODEL BILATERAL INVESTMENT TREATY 8–9, 26–28 (2012), http://www.state.gov/documents/organization/188371.pdf. Articles 3–10 of the BIT contain the substantive terms of the model treaty. *See id.* at 7–13.

122 Schott & Cimino, *supra* note 121, at 9.

123 PETERSON INST. FOR INT'L ECON., *supra* note 117, at 4.

In contrast, China's BITs historically have been less extensive than U.S. BITs and have provided fewer protections for investors.[124] Most significantly, U.S. BITs seek national treatment for investors at the pre-establishment stage of investment, meaning *before* they invest, while most Chinese BITs offer national treatment only post-establishment, allowing the Chinese government to legally discriminate against foreign investors prior to an investment being made.[125] This fuels the VIE problem because prohibiting a U.S. investor from investing in a particular industry (the problem that VIEs are designed to circumvent) is an example of pre-establishment discrimination against a foreign investor.[126] However, as China has entered more and more BITs, the sophistication of the agreements has evolved, and Chinese BITs are beginning to more closely resemble their U.S. counterparts.[127]

Although some negotiation will be required to reconcile the two countries' default BIT models, there are several reasons to believe a U.S.-China BIT is the best vehicle for reforming the VIE system at this moment in history. The first reason is that both the U.S. and Chinese governments seem to look favorably upon BITs as a policy tool.[128] The United States views BITs as successfully protecting investors' rights in countries that are not covered by a free trade agreement,[129] and it currently has forty-one BITs in force.[130] On the Chinese side, BITs are even more popular—the Chinese government had over 100 BITs in force by the end of 2014.[131] In addition, the Chinese government is likely very interested in pursuing a BIT with

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124 *See* Schott & Cimino, *supra* note 121, at 10 (explaining that the inclusion of national and most-favored nation treatment is usually conditioned on extensive exceptions).

125 *See id.* at 10 n.12, 11; *see also* PETERSON INST. FOR INT'L ECON., *supra* note 117, at 4 (discussing how a recent China-Korea foreign trade agreement promises to extend investment rights further into the pre-establishment stage).

126 *See* U.S. CHAMBER OF COMMERCE, *supra* note 36, at 8 (outlining MOFCOM's Foreign Investment Catalogue under the heading "Pre-Establishment Approval Process"); U.S. DEP'T OF STATE, *supra* note 109, at 1 (describing the concern foreign investors have regarding the Chinese government's discrimination against foreign investors in establishment phases of investment).

127 *See* U.S. DEPT. OF STATE, *supra* note 109, at 24 ("At the 2013 U.S.-China Strategic and Economic Dialogue, China agreed to conduct negotiations based on the concepts of 'pre-establishment' national treatment, which would expand market access for foreign investors . . . ."); Schott & Cimino, *supra* note 121, at 10 & n.12 (explaining that Chinese BIT provisions have improved as China has expanded its treaties with developed countries).

128 *See* Schott & Cimino, *supra* note 121, at 8.

129 *See id.* at 8–9 (noting that free trade agreements may be easier to pass since they only require a majority vote in each house of Congress, as opposed to the two-thirds vote in the Senate required to enter into a treaty).

130 *Id.* at 8.

131 U.S. DEP'T OF STATE, *supra* note 109, at 24.

the United States because Chinese private investment in the United States is increasing rapidly—for example, 2013 levels doubled from 2012 levels to reach $14 billion[132]—and a BIT will serve to protect these investments.[133]

The second reason a BIT is the ideal vehicle for fixing the VIE situation is that a U.S.-China BIT has already been proposed, though it has languished since it was tabled in the 1980s.[134] The prospect of a BIT was revived in 2013 with a "breakthrough" in bilateral economic talks.[135] Since then, both sides have actively negotiated a new treaty based on the 2012 U.S. Model BIT,[136] with the loose goal of completing the BIT by 2020.[137] While these talks have not yet addressed the VIE question, the topic will inevitably be dealt with, as it is central to the concept of U.S. investment in China.[138]

The third reason a U.S.-China BIT is a particularly appropriate solution right now is that China is working to overhaul its entire legal framework pertaining to foreign investment through a new Foreign Investment Law ("FIL").[139] The draft of the FIL and the associated explanation released by the Chinese government explain that the FIL will replace existing foreign investment law and "conform[ ] to . . . internationally recognized rules, and create a more stable, transparent and predictable environment for foreign investment."[140] Importantly,

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132 CONG.-EXEC. COMM'N ON CHINA, 113TH CONG., ANNUAL REPORT 155 (2014).

133 *See* U.S. DEP'T OF STATE, *supra* note 121, at 1.

134 *See* Timothy A. Steinert, *If the Bit Fits: The Proposed Bilateral Investment Treaty Between the United States and the People's Republic of China*, 2 J. CHINESE L. 405, 405 & n.5 (1988) (explaining that negotiations began in 1983). Talks regarding the U.S.-China BIT were revived again during the presidencies of George W. Bush and Hu Jintao, but put on hold after the 2008 election of President Barack Obama. PETERSON INST. FOR INT'L ECON., *supra* note 117, at 3.

135 Sean Miner & Gary Clyde Hufbauer, *State-Owned Enterprises and Competition Policy: The U.S. Perspective*, *in* PETERSON INST. FOR INT'L ECON., *supra* note 117, at 16.

136 *See generally* U.S. DEP'T OF STATE, *supra* note 121.

137 U.S. DEP'T OF STATE, *supra* note 109, at 1.

138 *See* Thomas Lee, *U.S. and China Need to Complete Foreign Investment Treaty*, S.F. CHRON., http://www.sfchronicle.com/business/article/U-S-and-China-need-to-complete-foreign-6171955.php (last updated Apr. 1, 2015, 4:02 PM) (noting that the treaty will include "negative list[s]," detailing industries off limits to outsiders—something central to the VIEs' existence).

139 JONES DAY LLP, FOREIGN INVESTMENT LAW OF THE PEOPLE'S REPUBLIC OF CHINA (DRAFT FOR COMMENTS) (2015), http://www.slideshare.net/USChinaBusiness/2015-draft-foreign-investment-law-of-the-peoples-republic-of-china-jones-day (translation of draft Chinese foreign investment law); *see also* THE HONORABLE MARIO MANCUSO & MICHAEL GERSHBERG, FRIED, FRANK, HARRIS, SHRIVER & JACOBSEN LLP, CHINA RELEASES DRAFT FOREIGN INVESTMENT LAW 1 (2015), http://www.friedfrank.com/siteFiles/Publications/Finalv2-%20020915%20-%20FF%20International%20Trade%20and%20Investment%20Alert%20-%20China%20Releases%20Draft%20Foreign%20Investment%20Law.pdf.

140 JONES DAY LLP, *supra* note 139, at 33.

the draft FIL proposes to replace the absolute restrictions and prohibitions on investment in certain industries with a new rule allowing foreigners to invest in such industries as long as businesses are majority-owned by Chinese citizens.[141] This critical proposal means that the VIE structure will no longer be needed for U.S. investors to invest in a company within a restricted or prohibited industry, as long as they do not take a controlling position in the company.[142]

B. *Elements the BIT Must Contain*

For a U.S.-China BIT to resolve the problems created by the VIE structure, the treaty must include three specific elements: (1) the BIT must be conditioned upon the enactment of the new Chinese FIL with its proposed changes to foreign investment rules in restricted and prohibited industries, (2) the BIT must address the grandfathering of existing VIEs—at least those listed on U.S. stock markets—into the new regulatory regime, and (3) the BIT must be conditioned upon the establishment of an international arbitration commission.

The first necessary element of the BIT is that it must be conditioned on the enactment of the new FIL. First, the FIL will make the VIE structure superfluous by allowing foreign investment in restricted and prohibited industries as long as U.S. or other foreign investors do not take a controlling shareholder position in the company.[143] In doing so, the FIL will shift the focus of Chinese foreign investment regulation: instead of restricting or banning foreign ownership of businesses in strategically important industries, the Chinese government will simply look at whether the company is Chinese-controlled or foreign-controlled.[144] If the company is Chinese-controlled, it will be legal for that company to operate in a restricted or prohibited industry, even with foreign investment.[145] If the company is foreign-controlled, it will be illegal for the company to operate in a restricted or prohibited industry.[146] Therefore, for all U.S. investors who want to own equity in—but do not seek control of—Chinese companies in

141 Gillian Wong & Juro Osawa, *How China's New Foreign Investment Rules Might Play Out*, WALL ST. J.: DIGITS (Jan. 22, 2015, 7:16 AM), http://blogs.wsj.com/digits/2015/01/22/how-chinas-new-vie-rules-might-play-out.

142 THOMAS CHOU ET AL., MORRISON FOERSTER LLP, CHINA'S DRAFT FOREIGN INVESTMENT LAW: A PARADIGM SHIFT IN REGULATION OF FOREIGN INVESTMENT 1, 3 (2015), http://www.mofo.com/~/media/Files/ClientAlert/2015/02/150212ChinasDraftForeignInvestment.pdf.

143 *Id.* at 3–4.

144 Paul Gillis, *Chinese VIEs—Winners and Losers*, CHINA ACCT. BLOG (Jan. 21, 2015, 6:34 PM), http://www.chinaaccountingblog.com/weblog/chinese-vies—-winners-and.html.

145 *See id.*

146 *See id.*

restricted or prohibited industries, the FIL will permit such investment activity. This means the vast majority of U.S. investors will no longer need VIEs to accomplish their investing goals.

The second element that must be incorporated into the BIT is the grandfathering of existing VIEs into the new regulatory regime. While the current draft of the FIL is silent on the issue of grandfathering current VIE companies,[147] many of those that would be in violation of the FIL are large Chinese and multinational companies.[148] In the interest of not disrupting these significant businesses, the BIT should include a provision giving special permission for these companies to continue operating in their respective industries despite their foreign ownership. Such grandfathering will be a suboptimal solution for the Chinese government, but allowing a few companies in sensitive industries to persist under foreign control is the lesser of two evils when compared to the consequences of dismantling otherwise productive large companies.

Finally, the third element the BIT must address in order to solve the VIE dilemma is the creation of an international arbitration commission to resolve investment-related disputes. This condition is essential because none of the existing options for dispute resolution—foreign courts, foreign arbitration, Chinese courts, and Chinese arbitration—consistently provide U.S. investors with fair and predictable results.[149] Foreign courts, though often preferred by U.S. investors who distrust China's legal system, are not a viable option for dispute resolution, because foreign judgments are almost never—some scholars would say *absolutely* never—enforced by Chinese courts.[150] Chinese courts fail to provide an adequate alternative. U.S. investors seeking to adjudicate claims in Chinese courts have found that the court system is not independent from the government and the CCP,[151] the quality of judging is low and many judges lack legal education,[152] "corruption among judges remains a pervasive concern,"[153] and discrimination against foreign parties is a regular occurrence.[154]

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147 *See* CHOU ET AL., *supra* note 142, at 1, 5.

148 *See* Gillis, *supra* note 144; Wong & Osawa, *supra* note 141.

149 HERBERT SMITH FREEHILLS, *supra* note 30, at 11–20.

150 U.S. DEP'T OF STATE, *supra* note 109, at 16; *see also* Dan Harris, *China Arbitration. When, Why, Why Not, and Where.*, CHINA L. BLOG (Aug. 31, 2008), http://www.chinalawblog.com/2008/08/china_arbitration_to_be_or_not.html.

151 U.S. DEP'T OF STATE, *supra* note 109, at 15.

152 Lubman, *supra* note 1, at 29.

153 *Id.*

154 *See* TIM CLISSOLD, MR. CHINA 120–21 (2005) (describing instances where courts decided in favor of Chinese fraudsters seemingly only because the plaintiff was a foreign company).

Arbitration in China currently proves the best of several bad options. The China International Economic and Trade Arbitration Commission ("CIETAC") is the primary forum for foreign investment dispute resolution in China today.[155] CIETAC has historically enjoyed a reputation for fairness and for not having a bias against foreign parties.[156] A few factors, however, indicate that CIETAC needs to be replaced by a new BIT-specific arbitration body. The first of these factors is that some foreign parties have recently criticized CIETAC's procedures and effectiveness.[157] The second is that CIETAC's reputation has suffered since it underwent an acrimonious division in 2012.[158] Today, instead of one CIETAC, there are three, and there is uncertainty about how decisions by the breakaway CIETAC branches will be enforced.[159] Finally, CIETAC may not be willing or able to stand up to the Chinese government—in disputes between foreign investors and the PRC government, China has never lost before CIETAC.[160]

As a result of the inadequacy of existing methods for investment-related dispute resolution, it is necessary for the U.S.-China BIT to be conditioned upon the establishment of a new international arbitration commission, which will handle disputes fairly for all parties. China has previously agreed to similar dispute resolution mechanisms, such as when it joined the World Trade Organization ("WTO") in 2001.[161] Building on the best aspects of the WTO arbitration model and CIETAC, a new international arbitration commission—narrowly focused on addressing only U.S.-China investment-related disputes—could provide the U.S. and Chinese governments, investors, and businesses with a fair, predictable, and enforceable method of dispute resolution.

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155 Randall Peerenboom & Xin He, *Dispute Resolution in China: Patterns, Causes and Prognosis*, 4 E. ASIA L. REV. 1, 28 (2009).

156 *Id.* at 29.

157 *See id.* at 29 ("[F]oreign lawyers . . . are not allowed to interpret PRC law but must rather rely on PRC co-counsel. In addition, the pay for arbitrators is low by international standards, thus limiting the number of foreigners willing to serve in the crucial post of chief arbitrator." (footnotes omitted)); *see also* U.S. DEP'T OF STATE, *supra* note 109, at 14; Lubman, *supra* note 1, at 32.

158 U.S. DEP'T OF STATE, *supra* note 109, at 14; *see also* LEAR LIU & CLARISSE VON WUNSCHHEIM, WUNSCHARB, JUDICIAL SIDE EFFECTS OF THE CIETAC SPLIT—A CONFUSING MAZE WITH HAPPY END? 5 (2014).

159 LIU & VON WUNSCHHEIM, *supra* note 158, at 3–4.

160 *See* U.S. DEP'T OF STATE, *supra* note 109, at 14.

161 *Id.* at 17; *see also Understanding the WTO: Settling Disputes*, WORLD TRADE ORG., https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm (last visited Jan. 30, 2016).

Conclusion

The VIE scheme was created as a clever way to circumvent restrictions on foreign ownership of businesses in certain strategically important industries in China.[162] The use of this structure by major U.S.-listed Chinese companies, coupled with the Chinese government's ambiguous response to this rampant disregard for the law, has put billions of U.S. investors' dollars at risk.[163] Insiders have misappropriated corporate assets at Chinese VIE companies[164] and the threat of an abrupt state crackdown on VIE-structured companies looms over the U.S. and Chinese economies.[165]

The problems posed by the Chinese VIE system can be solved through the implementation of a robust U.S.-China BIT. Such a BIT will satisfy the interests of all parties involved—the U.S. and Chinese governments, investors, and businesses—if it is conditioned upon passage of the new Chinese FIL, inclusion of grandfathering provisions for existing VIEs, and establishment of an international arbitration commission to resolve investment-related disputes. This reform of the system will eliminate the threats and uncertainty posed by current VIE structures. As a result, U.S. investment in China will thrive, the Chinese government will be able to effectively regulate its sensitive industries, and U.S. investors will be protected by a fair and predictable dispute resolution process.

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162 *See* Gillis, *supra* note 6, at 2–3.

163 *See id.* at 6–8.

164 *See supra* Part II.A; *see also* Clarke, *supra* note 15; McMahon & Mozur, *supra* note 87.

165 *See supra* Part II.B; *see also* Chang, *supra* note 16.