

## Baidu.com's Corporate Structure

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The leading Chinese language Internet search provider, Baidu.com, Inc. listed 4,040,402 its ADRs (American Depositary Receipts) on NASDAQ on August 5, 2005. In addition to Chinese language Internet search service, Baidu.com provides auction-based pay-for-performance (“p4p”)<sup>2</sup> and online advertising services in China. This article considers how Baidu.com, as a company incorporated in the Cayman Islands, can provide Internet advertising service and Internet content provider (“ICP”) service, which are value-added telecommunication (“VAT”) services in China. Chinese laws restrict foreign ownership of VAT business to be no more than 50%.<sup>3</sup>

Similar to most Chinese Internet companies listed in the US, Baidu.com designed its corporate structure using a series of contractual arrangements to maintain substantial control of the VAT businesses operated by Baidu Netcom, a Chinese domestic company, without owning shares in that company. Under this structure, there is no foreign equity interest in Baidu Netcom to trigger the historic VAT restrictions, yet Baidu.com can consolidate Baidu Netcom's historical financial results into its own financial statements as a variable interest entity under US GAAP. Although this structure has been effective in permitting Baidu.com to indirectly operate a VAT business in China, a new regulation<sup>4</sup> which took effect in China last July raises the question whether Baidu.com and its peers can continue using the structure without alteration to operate Baidu Netcom's business without running afoul of the law in the future.

Let's take a closer look at Baidu's current operating structure first.

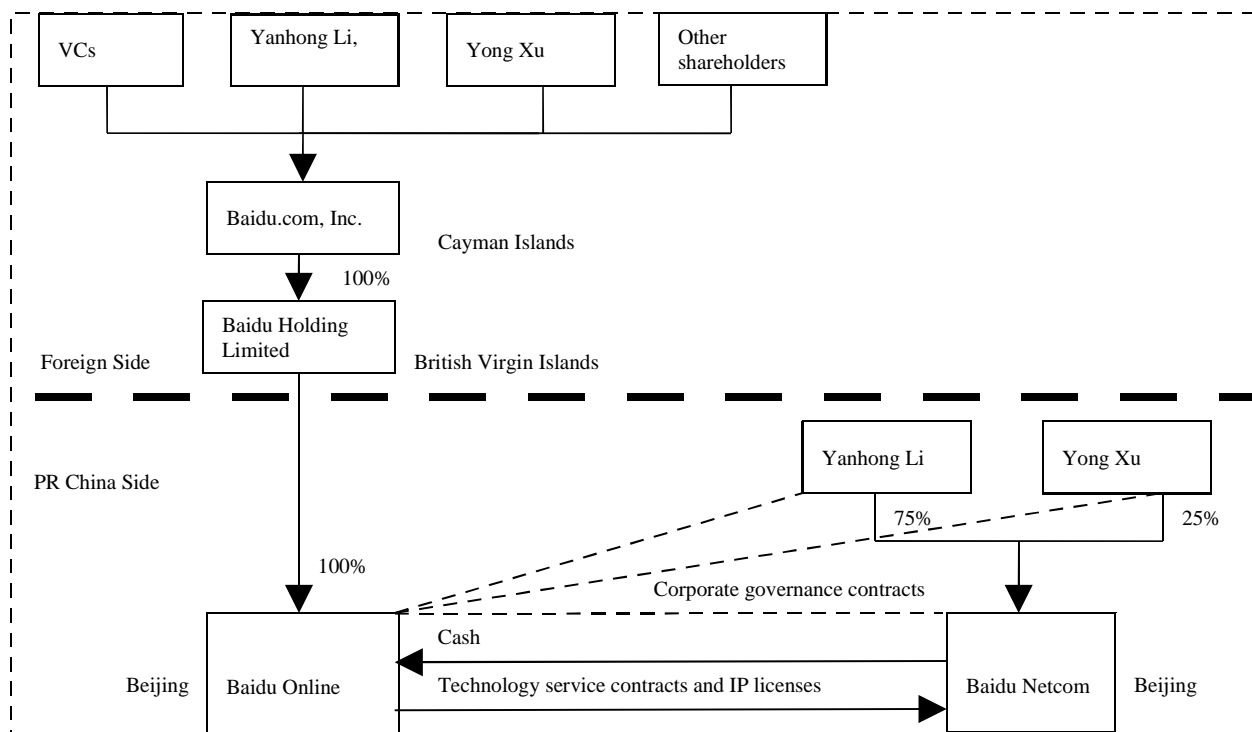
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<sup>2</sup> P4p service: A service that enables customers to bid for priority placement of their links in keyword search results.

<sup>3</sup> Order No. 333 of the State Council of People's Republic of China, *Article 6 in Provisions on the Administration of For. Inv. Telecomm. Enter.* (Jan. 1, 2002)

<sup>4</sup> Ministry of Commerce of People's Republic of China, *The Notice on Strengthening Management of Foreign Investment in Operation Value-added Telecommunications Business* <http://www.mofcom.gov.cn/aartic:e/b/g/200608/20060802960777.html> (announced Aug. 2006)



Baidu.com created a wholly foreign-owned company in Beijing, Baidu Online Network Technology (“Baidu Online”). Baidu Online operates p4p service and enterprise search software business in China. Baidu.com also formed an intermediate holding company in the British Virgin Islands, Baidu Holding Limited, to hold the 100% ownership of Baidu Online.

Baidu.com’s two founding shareholders, Robin Yanhong Li and Yong Xu, who are Chinese citizens, established a Chinese domestic company, Beijing Baidu Netcom Science and Technology Co., Ltd. (“Baidu Netcom”). Since there is no foreign ownership interest in the company, Baidu Netcom obtained an Internet advertising license which allows it to engage in VAT business, providing online advertising services in China. Baidu Netcom operates the well-known Chinese Internet search website, www. baidu.com, and other websites.

Interesting enough, neither Baidu.com nor Baidu Holding owns any assets or conduct any operations in Baidu Online or Baidu Netcom, except the equity interest in Baidu Online. In addition, Baidu Online has no ownership interest in Baidu Netcom. However, it owns the “Baidu Chinese Search Engine” and “Baidu Internet p4p System” software, domain names, trademarks, and web layout used by Baidu Netcom for the www.baidu.com website (the “intellectual properties”). Moreover, Baidu Online seconded employees to Baidu Netcom, the real VAT operating company, to operate the online advertising business.

How does Baidu.com ensure that it has the necessary assets, revenue and operational history to qualify for listing with NASDAQ? It does so by using the following contractual arrangement.

The contractual arrangement has two parts. The first part ensures Baidu Online gets long term, stable revenue from Baidu Netcom's operation. That is governed by a series of technology service contracts or business operation agreements between Baidu Online and Baidu Netcom. Under these contracts, Baidu Online (1) has the exclusive right to provide to Baidu Netcom technology consulting services related to maintenance servers, software development and design of advertisement; (2) grants Baidu Netcom a right to use its intellectual properties; and (3) sends employees to Baidu Netcom to operate the latter's business. Baidu Netcom pays Baidu Online monthly fees for the services and license annually and bears the costs and expenses of Baidu Online's employees.

The second part ensures Baidu Online substantial control over Baidu Netcom's daily operation and its corporate governance through a series of contracts between Baidu Online, Baidu Netcom and Baidu Netcom's shareholders. Under these contracts, (1) Baidu Online has the right to provide guidance and instructions on Baidu Netcom's day-to-day operations and financial affairs; (2) shareholders of Baidu Netcom must designate the candidates recommended by Baidu Online as the shareholders' representatives on Baidu Netcom's board of directors; (3) Baidu Online has the power to appoint senior executives of Baidu Netcom; (4) Baidu Netcom agrees to pledge its accounts receivable and all of its assets to Baidu Online; and (5) shareholders of Baidu Netcom agree to entrust all the rights to exercise their voting power to persons appointed by Baidu Online. Shareholders have pledged all of their interests in Baidu Netcom to Baidu Online to guarantee their obligations under certain loan agreements with Baidu Online, as well as Baidu Netcom's performance of its obligations under a technology consulting agreement.

As a result of these contractual arrangements, Baidu.com can control Baidu Netcom through Baidu Online, and consolidate Baidu Netcom's financial statements into its own by treating Baidu Netcom as a variable interest entity. Although Baidu Online is essentially the primary beneficiary of Baidu Netcom's operations and has effective control of Baidu Netcom, since they are two independent legal entities, Baidu Online is not arguably exposed to Baidu Netcom's liabilities to third parties.

The advantages of this structure are obvious. However, Baidu.com's current challenge is to address the legality of the structure, and, if necessary, adapt it in light of the new regulation which became effective on July 26, 2006.

The Ministry of Information Industry issued The Notice on Strengthening Management of Foreign Investment in Operation Value-added Telecommunications Business (the "Notice") in July 2006. The major purpose of the Notice is to prohibit unlicensed foreign invested enterprises from engaging in the VAT business through Chinese companies. The Notice requires that Internet domain name(s) and trademark(s) used by a company in the VAT business must be actually owned by that company or its shareholder.

The existing Baidu.com arrangement may not meet the Notice's requirements pertaining to ownership of Internet domain names and trademarks. Furthermore, Baidu Netcom may be viewed as assisting Baidu Online, a wholly foreign owned company that does not have a license, to engage in the value-added telecommunications business. Baidu.com can solve this problem by transferring

the domain names and trademarks to Baidu Netcom. However, that will mean that Baidu.com must revise its contractual arrangements to assure it doesn't lose its current income from the license fee.

There appear to be at least three ways to achieve this goal. The first method would be to transfer the domain names and trademarks to Baidu Netcom's shareholders. The transfer agreement and a new license agreement would provide that: (1) Baidu Online shall immediately transfer ownership of all domain names and trademarks (the Property) licensed to Baidu Netcom to the shareholders and complete all registration procedures relating to the transfer; (2) the shareholders shall make installment payments annually for the Property, which parallel or even exceed current payment provisions; and (3) the shareholders shall pledge the Property to Baidu Online until the shareholders pay all installments, and grant Baidu Online a first refusal right upon any proposed transfer of the Property.

The shareholders can then grant Baidu Netcom an exclusive right to use the Property. This new license agreement would provide that : (1) Baidu Netcom can use the Property at a fixed (or nominal) price, or even free of charge, which means the shareholders arguably might not receive any income by granting the usage of the Property and the shareholder may not realize his individual income tax for the transaction; and (2) Baidu Netcom agrees to bear the responsibility to pay the installments to Baidu Online on behalf of the shareholders, upon Baidu Online's approval.

The second method would be to transfer the Property directly to Baidu Netcom in return for contractual payments. In that case, a transfer agreement which has arrangements similar to those above will work. The difference between these two methods is: (1) Chinese law restrictions imposed on an entity are more harsh than those imposed on an individual in most situations; and (2) the first solution will not change Baidu Netcom's current asset situation and structure. However, if taking the second method, an intangible asset will be added to the balance sheet of Baidu Netcom, and Baidu Netcom will need to adjust its balance sheet for the change.

The third method would be to transfer the Property to Baidu Netcom in return for ownership interests, so Baidu Online will be a shareholder of Baidu Netcom. Since Chinese laws restrict foreign ownership of VAT business, Baidu Online would need to hold less than 50% of Baidu Netcom. Under this method, Baidu Online could get annual dividend distributions upon board approval. Of course, Baidu Netcom's asset situation and balance sheet would be adjusted accordingly, and Baidu Netcom's current shareholders' interest would be diluted accordingly.

According to the Notice, any company that has a VAT business license must perform an internal investigation, supervised by a local information industry department. If there is any activity not meeting the requirements of the Notice, the company will be ordered to correct the non-compliance. In the event that the company does not comply on a timely basis, the license will be suspended. All internal investigation results were required to be reported to the Ministry by November 20, 2006. However Baidu.com restructures its relationship with Baidu Netcom to comply with the Notice may set an important precedent and might also impact its business and financial results.