Proceedings of the 3rd International Conference on Global Politics and Socio-Humanities
DOI: 10.54254/2753-7048/2025.23093

The Practice and Enlightenment of Variable Interest Entity Structure in Luckin Coffee

Shuhan Zhang

Shanghai Yichuan High School, Shanghai, China
Kimmy071205@outlook.com

Abstract: This paper examines the Variable Interest Entity (VIE) structure through a case study of Luckin Coffee which analyzes its risks, regulatory challenges, and comparative advantages over franchising, joint ventures, and Red Chip structures. The VIE structure, initially developed by the Financial Accounting Standards Board during the event of Enron scandal, enables Chinese firms like Luckin Coffee to bypass foreign investment restrictions and access global capital markets via protocol control rather than holding equity right directly. However, the case reveals critical vulnerabilities, including legal uncertainties, cross-border supervision gaps, and data fraud risks, taking Luckin's 2020 delisting due to financial misconduct as an example. Despite these risks, the study highlights the VIE's flexibility, tax efficiency, and adaptability to sensitive industries like technology, education and media, arguing that its stability relies on corporate integrity and transparent governance. The analysis concludes that while the VIE structure remains a double-edged sword, its strategic benefits for globalization outweigh inherent risks if coupled with stronger regulatory frameworks and ethical cognition.

Keywords: Variable Interest Entity, financing structure, risk management

1. Introduction

The concept of Variable Interest Entity (VIE) was initially introduced by the Financial Accounting Standards Board (FASB) in the United States. The emergence of this concept is closely related to the Enron scandal, which shocked the world. Enron Corporation hid debts and losses by establishing Special Purpose Vehicles (SPVs), ultimately leading to the company's bankruptcy and the exposure of the accounting scandal. To regulate the financial reporting of listed companies and prevent the recurrence of similar events like the Enron scandal, FASB introduced the concept of VIE, as the VIE structure is clearer and more transparent.

With the growing trend of globalization, China has launched a lot of policies and concepts in order to keep pace with the global trend. In that, China has created a double development dynamic with the domestic economy as the mainstay and the domestic economy and international engagement providing mutual reinforcement. Thus, under this economic climate, the VIE structure dominates an important position in Chinese firm's financing structure, which can help Chinese companies to collaborate with foreign countries and improve both countries' economy as well.

Recently, during China's strategic transformation period, the country has constantly improved the capital market to further serve the real economic development in high quality with the government support [1]. So far, the VIE structure has been used in many giant firms, such as Alibaba Group, Didi,

DOI: 10.54254/2753-7048/2025.23093

Luckin coffee and iQiyi, which includes a host of industries such as Internet, services and social media. However, despite of the wide use of this structure, Chinese government is still approaching tighter and tighter supervision due to the concern about data security and other underlying risks [2].

Current literature demonstrated the pros and cons of the VIE structure and the government's attitude by analyzing cases like Didi and Alibaba group. First and foremost, the VIE structure helps the Chinese company to get rid of the regulation limitation and helps with raising their funds. Secondly, it realizes domestic companies' overseas financing and tax optimization. Thirdly, it provides a more flexible managing measures protecting the two cooperating companies' control rights. Last but not least, it helps fulfill companies' listing demand.

However, there still exists some disadvantages such as dispute of control and insufficient information disclosure, which lead to the concern and panic of the market, eventually causing the investigate and risk of reliance [3, 4]. In the 2023 periodical, it illustrated that most departments, including supervision department, the judiciary and the legislature, hold an open and neutral attitude. Moreover, some judgement of cases demonstrates that the legislature tried to maintain the stability of VIE structure [5].

While current findings all focus on its application of giant companies like Alibaba or Didi, this article first takes Luckin Coffee, a Chinese fast selling enterprise, as a case to study the current situation of VIE structure in a more objective way. Then, this article predicts the future trend of VIE structure in China by comparing the VIE structure with other kinds of financing structures.

2. Case study on Luckin Coffee

2.1. Background description

Luckin Coffee is a famous Chinese coffee brand, which was established in 2017 by Zhiya Qian in Xiamen, China. Its main business is the retail and operation of coffee and ready-made beverages. This kind of industry is very competitive in China, as coffee and beverages are always popular among the young, and there has already been a lot of similar enterprises in this field in China. Additionally, it also registered its overseas listed entity 'Luckin Coffee Inc.' in Cayman Island and listed on the market in National Association of Securities Deal Automated Quotations (NASDAQ), using the VIE structure, at the same time. During 2017 to 2019, it expanded rapidly via the method of online application plus offline stores (O2O method). However, from 2020 to 2021, it was forced to delist due to financial fraud. Since then, the company conducted an internal rectification, shut down the loss-making stores and filed for bankruptcy protection and restructuring debt in 2021. Eventually, from 2022 till now, Luckin Coffee has expanded again through products innovations, brand reshaping and supply chain optimization.

Figure 1: Number of stores in 2024 (data from: Luckin Coffee 4th quarter 2024 presentation)

DOI: 10.54254/2753-7048/2025.23093

By 2024, it had opened 22,340 stores throughout the world, becoming first coffee chained company which has over 10 thousand stores in China. Figure 1 shows the number of self-operated stores and partnership stores (including overseas stores) of each quarter of 2024, which rose steadily each quarter, from 12,199 to 14,519, and 6,319 to 7,749, respectively. Luckin Coffee is expanding in recent years and has a relatively good developing prospect.

When it comes to its current financial situation, Luckin Coffee performs well. From 2023 to 2024, Luckin Coffee's operating profit increased by over three times, from 213 million yuan to 995 million yuan.

2.2. Financing and listing via VIE structure

Luckin Coffee set up operating company in China, which was responsible for daily businesses. At the same time, it registered 'Luckin Coffee Inc.' in Cayman Island as listing entity. In that period, the overseas company signed a series of contracts such as exclusive service and pledge of stock right, which realized the protocol control of the domestic entity, instead of holding the share directly. Thus, in this way, Luckin Coffee attracted international investment like private equity and pledge of stock right, and it was listed on NASDAQ in 2019, raising funds to expand its business. During operation, overseas company can combine the domestic company's financial data with its own financial statement, with the help of protocol control, which fulfilled the listing demands.

However, on 1st February 2020, Muddy Water Research published a report charging Luckin Coffee with financial fraud and pointed out that Luckin Coffee had been exaggerating its achievements and advertising expenditure. Moreover, Luckin Coffee was also accused that it had hidden the connected transaction by sending coffee machines to related companies and made those into fake sales. At last, Luckin coffee was forced to delist due to financial fraud [6]. Since then, the company conducted an internal rectification, shut down the loss-making stores and applied for bankruptcy protection. Fortunately, Luckin Coffee signed compromising contract with overseas shareholders in 2021, paid fines to the Securities and Exchange Commission (SEC), and finished debt restructuring in 2022. Since then, Luckin Coffee successfully solved the problem and went back on track again [7].

2.3. Risk analysis

The scandal of Luckin Coffee demonstrated the risk of the VIE structure. The first problem is the legal uncertainty and information insufficiency. Since VIE structure is established on the protocol control by signing a series of contracts rather than holding the share directly, it exists legal uncertainty because the contracts' legal efficacy can probably be challenged, just like the Luckin Coffee's overseas company could not enforce the domestic company to operate the contracts through legal means when its domestic company hid information or broke the contracts deliberately. Additionally, Chinese laws have not clearly admitted or banned the VIE structure; it is still in a gray area, which may not be beneficial for Chinese company, and the Chinese company may face the risk of being charged with breaking the laws if Chinese government changes the attitude towards the use of VIE structure. This shows VIE structure's vulnerability.

Secondly, the VIE structure exists supervision loophole. From the Luckin Coffee event, it can reveal the difficulty of cross border supervision due to the difference between Chinese supervision and the American one. The Muddy Water Research investigated Luckin Coffee by itself instead of Chinese supervising organization and charged Luckin Coffee, revealing the complexity of cross border supervision that it is hard for Chinese supervision organization to manage. This shows the VIE structure's difficulty in management.

DOI: 10.54254/2753-7048/2025.23093

Nevertheless, the problems above can be solved if the company holds its integrity. Thus, the VIE structure's stability and benefits would totally depend on the credibility of the enterprises on both sides of the agreement.

Therefore, it is essential to establish enterprise credit system to improve professional ethics cognition and perfect companies' internal management and communication. If companies can achieve these standards, the VIE structure can be an ideal method to inspire international cooperation and government's attitude will probably be more positive.

3. Comparison of different financing structures

This section compares the VIE structure and other financial structures like franchising, joint venture, and Red Chip structure, in order to reveal the comparative advantage of the VIE structure.

3.1. VIE versus franchising

Franchising is a business expansion strategy that has been used for a long time to help companies develop. In this strategy, franchisor empowers the franchisee to sell products or service in the name of the brand or operation system (or both) via signing legal agreement, and the franchisee should pay a lump sum payment and annual royalty fee to the franchisor [8].

Through this strategy, brands can expand very quickly, but it is also the risk of this model. If the franchisor empowers the franchisee too much, it will be hard to supervise, and when one of the franchisees makes mistakes such as selling expired food, it will destroy the whole image of the brand. However, in the VIE structure, the domestic company can establish individual Office Automatization (OA) system to isolate direct data connections with overseas company, so that when one of the company face troubles, the other can effectively avoid the risk of being judged as the direct controlling company, and thus evading involvement risk. Another limitation is that franchising only fits traditional service industry like catering industry. When it comes to sensitive industries like education, social media and Internet, it can be difficult to practice because of the government regulation while the VIE structure can help avoid restrictions on the access of foreign investment.

In these extends the VIE structure can better cater the globalization trend and improve the development of education and social media industries.

3.2. VIE versus joint venture

Joint venture model means two or more independent enterprises which always come from different countries or background carry out specific business by sharing the holdings, making joint contribution and setting a new organization [9].

Through this strategy, risks can be shared by joint companies, but it limits flexibility. While joint venture is restricted by the ratio of foreign investment shareholding, for example, the car industry used to be limited to 50 percent, the VIE structure can avoid foreign investment access restriction, which improves the cooperation with foreign and domestic country. Joint venture model divides control rights according to the proportion of equity holdings, while the VIE structure manages control rights through protocol control to achieve 100% practical control without holding the share directly, which avoids losing the profit and core technology of the company and is more flexible. In addition, due to the strict supervision of government, joint venture model is limited to traditional manufacturing industry. On the contrary, the VIE structure can be applied in education, Internet, technology and some relatively sensitive fields. Last but not least, in the joint venture model, the change of the equity right needs government's examination and approval, but in the VIE structure, the terms of agreement can be adjusted at any time, if both companies agree to them, thanks to the protocol control.

Thus, the VIE structure is more flexible and better protects a company's core technology and profit.

3.3. VIE versus Red Chip

The Red Chip structure is a series of control and means that Chinese companies use to transfer the domestic property and equity right to the companies registered overseas and achieve the goal to list in the overseas market.

This structure has a lot in common with the VIE structure, but it has some limitations. First of all, the Red Chip structure requires the direct control of an overseas company of the equity right, which holds less initiative right than the VIE structure. Secondly, in the VIE structure, overseas listed company directly bound with the domestic operating company, while the Red Chip structure requires the recombination of domestic property and cross-border transfer. Thirdly, most companies care a lot about the cost of tax. In the Red Chip structure, dividend distribution is subject to income tax, but in the VIE structure, it transfers the profit from service fee and perfects the tax debt [3, 10]. Last, if a company wants to terminate the structure, the Red Chip model usually takes 6 to 12 months for the overseas entity to return the equity right to the domestic investor, while the VIE structure only takes 3 to 6 months to cancel the protocol control and thoroughly relieve the cooperation [11].

Therefore, despite many common features, the VIE structure still has its own advantages that it is faster, more effective and easier to establish and terminate.

4. Conclusion

With growing trend of globalization, more and more Chinese companies are looking forwards to cooperate with foreign companies and expand cross-border development. The VIE structure is a useful and effective way to satisfy this kind of demand. Therefore, the research on the VIE structure has a strong practical value. Taking Luckin Coffee as an example, this article analyzes the background, recent numbers of stores and operating profit of Luckin Coffee to manifest the risk of the VIE structure and its current situation. Moreover, this study compares the VIE structures with franchising, joint venture and red chip structure to illustrate its specific advantages. The findings show that, the VIE structure is a double-edged sword for Chinese firms seeking global capital. In terms of risk, the VIE structure is difficult to supervise and is still facing the problem of Chinese governments' uncertain attitude, but these problems can be solved if enterprises maintain integrity and openness. The VIE structure is not the problem itself, while it is the dishonesty which causes the problem. The structure only lifts the possibility of data fraud, that the root of the problem is still the operators' irresponsible behaviour. In terms of advantages, the VIE structure has a broader application scope than other models, protects companies' core technologies, has higher level of efficiency and freedom, has lower cost and standard for the companies who want to be listed in foreign market, and is easier to establish and terminate. To sum up, this structure has a good developing prospect.

Nonetheless, this article has some limitations, that it mainly focuses on single case analysis of Luckin Coffee, but lacks quantitative examination. Thus, future research can incorporate data from multiple VIE firms. Due to limited access to legal documents, the analysis of China's VIE regulations relies on secondary sources such as news reports rather than original policy files, so future studies can examine on the original texts for the purpose of accuracy.

References

[1] *Ma, Y. (2024) Research on tax risks of VIE-structured enterprises returning. Shanxi University of Finance & Economics, Master's thesis.*

[2] *Li, Q. (2024) Financial risks and prevention of Alibaba Group under VIE mode, Hebei University of Economics and Business, Master's thesis.*

[3] *Wu, J. (2016). Analyzing the uncertainty of variable interest entities: A case study of Alibaba. In Proceedings of the 4th Century Star Innovation Education Forum. Century Star Magazine Press, 571-575.*

[4] *Wang, C. and Han, J. (2021) Motivations, problems, and countermeasures of VIE structure adjustment. Financial Management Research, 9, 112-115.*
[5] *VIE Research Group of Central University of Finance and Economics. (2021) Feasibility study and policy recommendations for Chinese legal persons holding securities companies under VIE structure. In Innovation and development: China securities industry 2020 proceedings. China Financial & Economic Publishing House, 645-653.*
[6] *Li, Q., Zhong, M. and Zhou, F. (2024) Luckin Coffee's financial fraud and accounting integrity system construction: Lessons and improvements. International Business Accounting, 9, 82-87.*
[7] *Li, Y. (2024) Analysis of Luckin Coffee's delisting and restructuring from the perspective of enterprise management strategy. Management and Technology of SME, 15, 115-117.*
[8] *International Franchise Association. (2021). The value of franchising. Retrieved from https://www.franchise.org*
[9] *Tan, B. (2013) Legal countermeasures for deadlocks in multinational joint ventures. East China University of Political Science and Law, Doctoral dissertation.*
[10] *Bao, D. (2023) Substantive consolidation and restructuring of red-chip structure groups: Principles and approaches. Foreign Investment in China, 7, 68-71.*
[11] *Chen, Y. (2023) Research on the selection and tax implications of red-chip structure dismantling schemes. Central University of Finance and Economics, Master's thesis.*