By **Lei Zhao**

Managing Sino-foreign joint ventures in China

Sino-foreign joint ventures are the best way to produce internationally branded goods for middle-class consumers in China. Although the relationship can be tricky to manage, some basic rules can make it harmonious and profitable for both partners

With the rise and rapid development of international economic integration, investment in overseas markets has grown significantly. To some degree, overseas markets are even more important than domestic markets for big multinational companies. At the same time, foreign investment is an important measure for many developing and middle-income countries and a key way for them to promote economic development.

As the largest emerging economy and the second-largest economy in the world, China has not only established its own legal system for foreign investment, but also taken steps to make its business and investment climate more attractive. Even confronted with economic crisis, China has maintained its momentum as an emerging economy and exhibits huge market potential. One important reason for this is the rise of its middle class. Research by the Asian Development Bank suggests that between 1990 and 2008, China's middle class grew from 2.5 billion to 3 billion, while consumer spending grew by an average of $1.825 billion a year.

Many Chinese companies without internationally influential brands are seeking to produce goods in conjunction with companies from Europe or the United States in order to satisfy a desire for Western foods and products among the Chinese middle class. Such joint ventures allow Western companies to exploit the Chinese enterprise's geographical advantage, legitimately reducing their financial expenditure and operational costs, while also enjoying preferential treatment as foreign investors. Thus, establishing a joint venture in China with a Chinese company is a comparatively good option for Western multinationals.

However, Sino-foreign joint ventures are quite different from wholly foreign-owned enterprises and merely license trade in China. Accordingly, there are several fundamental issues regarding partner selection, trademark protection and negotiating strategies that Western multinationals must resolve before they incorporate a Sino-foreign joint venture.

Case law

Wahaha v Danone

Wahaha is the largest food and beverage production enterprise in China and the fifth largest beverage production enterprise in the world. Danone, which has its headquarters in Paris, is the most famous food and beverage group in the world, a Fortune Global 500 company that operates in over 120 countries. The two companies entered into agreement in 1996 and incorporated a joint venture which was 51% owned by Danone (which had given $45 million plus a ￥50 million trademark transfer fee) and 49% owned by Wahaha.

There were two versions of the joint venture agreement. Wahaha signed a trademark assignment agreement with Danone in 1997 in order to transfer some of its marks to the joint venture. However, the Chinese Trademark Office did not approve this transfer based on the provision of joint venture capital contribution. Then the two parties signed a trademark licence contract in 1999 again. Danone gained over ￥3 billion from the joint venture, which allowed it to use trademarks owned by Wahaha for 10 years.

In 2006 the new president of the joint venture, appointed by Danone, discovered that Wahaha had also set up many other non-joint venture companies, which were generating large profits. Danone was of the opinion that these companies were taking away market share and profits from the joint venture. After Wahaha turned down Danone's offer to purchase a 51% share of its non-joint ventures at ￥4 billion, Danone initiated 29 lawsuits and arbitrations against Wahaha and its president, Qinghou Zong, in China and many other foreign jurisdictions, including arbitration at the Stockholm Chamber of Commerce Arbitration Institute and litigation in the United States.

As the essential nature of the licensing and the applicable law was Chinese, by May 2009 Danone had lost 23 of these lawsuits and arbitrations. In 2009 both parties agreed that Danone should sell its 51% share in the joint venture to Wahaha. This case is now cited as the most remarkable example of global commercial war after 30 years of reform and liberalisation (www.baike.baidu.com/view/3414132.htm).

Choosing the right partner

Sino-foreign joint ventures are quite different from wholly foreign-owned enterprises. In addition, the joint venture relationship between Western multinationals and local Chinese companies is not a pure licensing deal, making it susceptible to certain problems and risks in China. International trademark holders and investors should pay attention and consider the following measures to avoid or minimise any losses.

Due diligence on prospective partners

Selecting the right partner is key to a joint venture's prosperity or decline. Therefore, it is necessary to investigate any potential partner thoroughly, especially with regard to credit status. This due diligence should look into the prospective partner's qualifications, credit, fame and reputation, in order to present a clear picture of its historical development and current state, including nature, size and credit record.

Some Western companies prefer to choose their Chinese partners by using an intermediary, and many place complete faith in the intermediary's introduction and the various favourable conditions promised by the prospective partner. However, picking your partner blindly risks leaving you open to future disputes. Examples of these, which might have been avoided with due diligence, include the following:

- The ownership of the place of operation provided by the Chinese partners is disputed by a third party;
- The workshop or equipment provided by the Chinese partners has been mortgaged for a loan;
- The Chinese partner's company does not actually exist;
- The Chinese partner's company consists merely of a desk, a telephone and a few employees; or
- The Chinese partner's company is registered, but it negotiates in the name of its parent company or head offices and then signs contracts in the name of a subsidiary or branch offices – in the event of any problems, liability and risks are transferred to subsidiaries and branch offices, which are easier to declare bankrupt.

Some Chinese companies do not always tell the truth and Western companies often fail to carry out the necessary further investigations into them. Due diligence is necessary and may be conducted by credit investigation organisations or law firms, using banks, local administrations of industry and commerce and any other related government offices. According to the results, Western companies can then select partners with favourable reports in order to help promote a healthy and smooth joint venture.

Common business philosophy

Both parties come from different countries and regions with different social, political and legal systems, as well as cultural backgrounds. It should come as no surprise that this might lead to big differences in management styles, decision making and enterprise operation, and mean that some conflicts may be inevitable.

Independent research conducted by McKinsey Inc and quoted by *BusinessWeek* pointed out that 70% of joint ventures do not meet the desired targets or are dissolved. The average lifespan of joint ventures is less than half of the agreement term. These statistics apply to Sino-foreign joint ventures in China, 70% of which cite 'marital disharmony' for one reason or another.

Therefore, Western companies should ensure that prospective partners have a common business philosophy and operational principles, in order to avoid or reduce the likelihood of conflicts. By communicating properly about such issues, Western companies can discover whether prospective partners are of a like mind – or are at least willing to recognise and adopt different approaches.

Essential provisions for trademarks

As stated earlier, joint ventures are quite different from both wholly owned enterprises and pure licensing deals in China. They enable the Western company's international brand to be used on products produced locally by the joint venture in order to be sold to local consumers. An agreement with a well-drafted and effective trademark clause could help to reduce some infringement risks and secure better protection for marks. The following recommendations should be followed when implementing a trademark strategy:

- No matter how long the term of contract, local joint ventures should be authorised to use the international brands owned by Western companies through a trademark licensing contract rather than a transfer.
- Marks owned by the prospective partners should not appear on products manufactured locally by joint ventures, unless the partners transfer these to the joint venture. At the same time, Western companies should be willing to use those marks, which must be evaluated based on subjective criteria.
- During the joint venture's operation, it is likely that any marks used will increase in value, due to advertising. In addition, new marks may be registered. Title to these valuable and/or new marks should remain with the Western company or the joint venture, and this should be set out in an explicit agreement.

Negotiating strategies

Generally, Western companies use negotiating strategies to increase pressure gradually on their prospective partners, exploring every opportunity to persuade them to accept their terms and expand the following rights and interests.

Control over equity ownership

Equity control in a joint venture plays a fundamental role in how it is controlled. The higher the proportion held by shareholders, the more power they have. So dominating a holding position and preventing the other party from assuming this by purchasing is crucial.

Control over corporate governance structure

In order to control the joint venture's daily operations, the following three aspects are key:

- Control over the joint venture's board of directors – the board is a joint venture's highest authority and decides all major matters concerning it. Controlling the board means that a Western company can control the joint venture's strategic direction and keep it consistent with the parent company's strategic intention.
- Control over the position of general manager – the general manager is responsible for the joint venture's operation and management; therefore, he or she plays an important role in controlling it.
- Control over lower-level managers and ordinary employees – good training for lower managers and ordinary employees can help them to understand the parent company's business philosophy and operational principles.

Technology control

Joint ventures are often based around the transfer of technology from the parent company to the joint venture. The party that can control this transfer can exercise significant control over the whole joint venture. The following are ways to control a joint venture's core technology:

- Blur the core technology – this restricts knowledge of the technology's design principle and the setting of key parameters to key personnel, so that users are aware only of the technology's function and cannot develop secondary technology based on it.
- Increase the transfer complexity of technology – with the rapid development of new technology, it is always important to strengthen education in security, promote security skills and improve security regulations.

Other lessons

This analysis shows what measures Western companies can take to select the right partner, prevent infringement and control the joint venture. To some extent, the stated measures and strategies could reduce investment risk and increase the success rate for Western companies. However, there are still some common mistakes made by Western companies in such negotiations. To solve these problems, we have the following suggestions.

First, we have handled cases where Western companies signed joint venture agreements with unqualified Chinese partners and the courts finally ruled the agreement invalid. Under the Sino-Foreign Joint Venture Law, the Chinese partner must be a for-profit enterprise or other economic organisation. Government departments, public institutions, social organisations and other organisations are not qualified to be the Chinese partner of a joint venture. Thus, prospective partners should be selected according to the law's requirements.

Second, we have also encountered many cases that were labelled as joint venture agreements, but were actually loan contract cases. Both parties formally entered into a joint venture agreement, but in the process of implementing the contract, it became apparent that the Western company did not plan to be involved directly in any operational or management capacity and would not be responsible for any losses or damages. Such an agreements is deemed to be fraud and therefore null and void. Western companies need to make sure that they get involved in the joint venture's management and take responsibility for implementing the contract.

Third, Western companies should choose the best applicable law and the jurisdiction of any future court or arbitration institution. In *Wahaha v Danone* the applicable law was Chinese, which meant that the transfer of trademarks was not approved by the Chinese Trademark Office and Danone lost many lawsuits concerning ownership of the marks.

In addition, the choice of jurisdiction is important. For example, the choice of arbitration institutions must be clearly spelled out. The usual choice is the China International Economic and Trade Arbitration Commission. If choices are not clearly articulated, the other party may initiate a lawsuit before the courts. However, under the New York Convention, to which China is a signatory, awards made by arbitration institutions are mutually recognised and enforced by most of the convention's 145 signatories. The disadvantage to this is that arbitration remains a time-consuming and energy-consuming process, and awards must be enforced by the courts.

If Western companies want awards to be enforced outside China, in countries that are signatories to the New York Convention, arbitration is an ideal choice. However, in order to ensure that awards are smoothly enforced in China, judicial proceedings in courts are comparatively convenient and rapid, and may be the better option.

Finally, all joint venture contracts are subject to ratification by the responsible government department. According to the Sino-Foreign Joint Venture Law, the agreement shall come into effect once it has been examined and approved by the aauthority.

Conclusion

As international brands belonging to Western companies continue to be used on locally produced goods which are then sold to local Chinese consumers, Sino-foreign joint ventures show no signs of going away. However, as both parties come from different countries and regions with different social, political and legal systems, different cultures and languages, and different management principles, conflicts are inevitable.

Western companies should treat joint ventures differently and adopt measures that suit them. Specifically, they should ensure that their Chinese partners have the right qualifications to cooperate by:

- conducting a thorough investigation;
- including essential trademark clauses in the joint venture agreement;
- adopting the right negotiating strategies to maximise their own interests in agreement; and
- paying attention to other important issues.

Only in this way will joint ventures be ready for the challenges and opportunities in the future. Although this can be challenging to manage, it is in the best interests of both parties.

As the joint venture grows bigger, more conflicts and problems will emerge and both parties are likely to experience instability after the honeymoon period. However, if they can get through this, they will better understand each other and be better able to cooperate. Joint ventures are still one of the best modes of operation for many enterprises, including multinational companies and Chinese enterprises. WTR

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