In Defense of Joint Ventures

Since the 1980s the joint venture was the most common route for structuring foreign direct investment into China. Two decades later, are joint ventures still the right choice?

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When China began opening up its economy to foreign direct investment (FDI) in the 1980s, precautions were taken that compelled foreign investors to partner with Chinese, usually state-owned, counterparts. This structure was heralded as a win-win situation and there is logic behind the joint venture (JV). From a Chinese perspective, a JV allows for the acquisition of foreign technology, know-how, insight into international management practices and access to foreign markets. For the foreign partner, the JV promises benefits stemming from the resources of the Chinese party and its knowledge of the market, as well as familiarity with local culture and business practices.

Whether the JV structure was practical or not in the past, recent developments show they are becoming less common. Since China's accession to the World Trade Organization in 2001, legal restrictions on foreign investment have gradually been lifted. Partnering with a Chinese company has become an option rather than an obligation and as a result the landscape has shifted. Many existing JVs have been dismantled and new wholly foreign-owned enterprises (WFOEs) greatly outnumber new JVs. For example, in 2008 30% of all German-invested companies in China were JVs, while by 2011 this proportion had decreased to a mere 11%. It is apparent that investors need to consider when a JV is the right strategy for China investment and what steps can be taken for a foreign party to protect its interests in the JV.

The basic idea behind the Chinese-foreign JV structure is that two or more parties (including one foreign investor and a Chinese company) invest in and hold a third entity. Foreign investors sometimes assume that the JV represents a merger of two existing companies, but this perspective is misleading. The investing parties continue to exist independently from the JV and from each other. The investment structure is characterized by a mutual contribution of investment in cash and/or assets, a share of the benefits between the parties and shared risks that come with the investment. Rather than a merger, a JV is more like a marriage – with the ever-existing risk of divorce.

Two Types

Chinese law recognizes two different types of JVs: the equity JV; and the cooperative (or contractual) JV, with the former being the most straightforward and popular. The equity JV is a limited liability company and Chinese legal entity, to which the JV partners contribute capital in the form of cash and/or assets such as machinery, facilities, land-use rights and intellectual property. Profits made by the JV can be distributed to the investors as dividends, proportionally to the equity held by each party. Management are hired by and should be working for the JV (though senior managers are often nominated by one of the parties), but the highest decision-making authority of the JV is the board of directors. Directors to the board are appointed by the parties, and

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make decisions in accordance with the terms agreed in the JV contract and the company's articles of association.

Cooperative JVs allow for more flexibility than the strict framework of the equity JV. They may be established as limited liability companies or as a contractual cooperation between two or more separate legal entities that bear independent liabilities. Moreover, the capital contribution does not have to be of monetary value but can also consist of resources, services, special licenses, market-access rights and other contributions difficult to appraise. In contrast to equity JVs, there is no legal requirement to establish a binding system of voting rights, for example through a board of directors, and the plan for how parties wish to have their investments returned is negotiable rather than strictly linked to the size of a party's equity. This freedom makes cooperative JVs attractive for build, operate and transfer projects, in which one party withdraws from the JV after agreed-upon goals have been achieved. The contract should determine which party has the first right to an investment return and who will own the assets during and after the project.

Why Choose a Joint Venture?

Legal restrictions initially resulted in a dominance of the JV over other FDI structures in China. Since the gradual opening of industries to WFOEs from 2001, strict requirements for a JV structure remain only in a few industries considered sensitive, usually for reasons of economic interest or national security. These industries are listed in the restricted category of China's Foreign Investment Industrial Guidance Catalogue (外商投资产业指导目录) and include certain financial and insurance services, telecommunications, media publishing and certain mining activities. Foreign companies that want to invest in one of these sectors must do so through a JV.

China remains an unfamiliar environment for many foreign companies, both legally and culturally, and some may feel more comfortable with the support of a partner who is familiar with the culture and language. A China partner also has insight into local business practices and can share their knowledge of the market and its existing network of commercial relations. Chinese partners also manage relations with government authorities, a task which is thought to be particularly challenging.

The JV is also considered as a means to minimize costs, especially for enterprises of moderate size. Shared capital contribution may facilitate market entrance and Chinese partners are usually more apt at setting up cost-effective facilities under local conditions. In this regard, JVs are often more localized than WFOEs, a distinct advantage where cost is an important factor for profitability and business success.

Disadvantages

Partnering up with a Chinese investor does not mean that the foreign party has an ally that will unconditionally support it to attain its goals. The Chinese JV partner has its own intentions and objectives, and it could even become a rival. This is one important reason why JVs have a high rate of failure, especially where the foreign party has little knowledge of what the Chinese side perceives the JV to be. The goals and expectations for the future direction of the jointly owned company are not the only common subjects of disagreement. Disputes also frequently arise from culturally affected differences in business and management practices. This is particularly threatening when both partners are or want to be actively involved in daily management.

Another important issue relates to confidential information and other intellectual property. Bringing IP into the JV exposes the foreign investor to a potential competitor. Withholding IP from the JV though could make it less competitive, a source of friction between the parties that could well lead to the failure of the cooperation.

One other risk that cannot be ignored is the Chinese party's ability to manipulate the JV to serve its own ends. While not unique to China or to the Chinese partner of a JV, there are too many examples of cases where the Chinese party has applied deception to unlawfully benefit from the JV. A visitor to China may be stunned at the broad availability of counterfeits for all kinds of products, but it is even more surprising that that these counterfeits may have been

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secretly produced by relatives of the Chinese JV partner. The relatives are supplied with the necessary intellectual property, blueprints and know-how for production. Other examples of common practices are diverting sales to related companies at a loss to shift profits, the partner's use of facilities to produce its own or competitive products during secret night shifts, and the JV paying for land, machinery and personnel that is shared at no cost to the Chinese company's other operations.

Minimizing Risks, Maximizing Opportunity

The failure rate of JVs is high and when disputes arise, a solution that is acceptable to both sides is not easy to find, especially if the foreign company has failed to take precautionary measures. Minimizing the risk of failure centers on performing proper due diligence before the deal is done.

Partner Strategies

Feasibility studies may conclude that a JV is the preferred investment structure, but finding the right partner has the greatest impact on the lifespan of a JV. The most obvious partner is not always the best match. Establishing a smooth and successful cooperation depends on the available resources of the partners, but most important is a clear understanding of the respective goals and intentions. Partners that understand each other's roles and have mutual expectations and aspirations aligned are much more likely to develop the JV into a mutually beneficial endeavor. Therefore, proper due diligence is mandatory for every set-up. Unpleasant surprises can be avoided by conducting research on the potential partner's legal situation and finances, internal management structure, decision makers and public reputation.

In order to avoid power struggles, which hamper effective decision making, it is important to understand that just because an investor holds a larger stake, does not guarantee them influence and control. A majority stake means little when key personnel, such as the general manager are on the side of the Chinese partner and the board of directors are paralyzed due to a minority veto.

Even some large foreign multinationals have made the mistake of relying on a majority share of equity rather than securing key positions in active management and/or voting arrangements that allow the majority shareholder to push through decisions at board level. It is key to remember that, irrespective of equity stakes, the most optimal arrangement for directing the JV is that one party takes the lead, leaving the other party to benefit from the rewards.

Exit Strategy

Under realistic circumstances and from an optimistic point of view, it is better to anticipate in advance the day the JV will end and prepare accordingly. As part of the exit strategy, the JV contract should include rules for fair evaluation and sale of equity share can facilitate negotiations in case one partner considers taking over the share of the other party. Closing a JV is relatively complicated, especially without the support of all involved parties, but a good exit clause can contribute to making the process less painful.

Exits typically occur during disputes, a clause determining how disputes between the partners should be handled, through arbitration or litigation, solves conflicts efficiently. When it comes to trade secrets and other intellectual property, the parties should agree in advance on the rules of IP ownership and licensing. Rather than placing blind trust in the other side, the parties should conclude confidentiality and anti-competitive agreements to avoid exploitation of each other's IP, trade secrets and other sensitive information. Moreover, use of IP such as trademarks, during and after the JV, should be agreed upon in advance.

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Joint Venture or Wholly Foreign Owned Enterprise?

JVs are complex vehicles that demand careful preparation. Experience has shown that foreign investors are often confronted with problems and dangers that are less prevalent in WFOEs. With fewer legal obligations to partner up with a Chinese company, the main argument in support of the JV has already lost much of its significance. A WFOE is more straightforward to set up and liquidated, leaves control over management and daily operations in the hands of the foreign investor and makes the protection of confidential information and intellectual property an internal issue.

Nonetheless, the JV is still regarded the ideal fit for many business models, especially where the resources of the Chinese partner or his ability to manage costs are crucial to business success. In such a situation, the foreign investor must be careful to choose the right partner, to be open and transparent about business objectives and demand the same from his potential partner. They must also reach clear agreements on how the JV will be operated.

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