Establishment of a Joint Venture (JV) in China

A joint venture (JV) is a business arrangement in which the joint venture partners create a new business entity or official contractual relationship, and share the investment & operational costs, management responsibilities, and profits & losses.

During the roll out of China’s “Open Door” policy over two decades ago, JVs were the initial investment vehicle used by foreign investors, not by choice but by obligation. At this time, the Central Government used JVs as a vehicle to transfer advanced technology and management techniques from foreign companies to state owned enterprises. In return, foreign investors benefited from access to markets and suppliers, as well as lower investment and operational costs. Although liberalization of foreign investment has led to alternative investment vehicles, such as WFOEs and FICEs, some projects still require the involvement of Chinese partners, thus forbidding WFOEs and limiting foreign investors to establishing JVs.

There are two types of Joint Venture, the Equity Joint Venture (EJV) and Contractual Joint Venture (CJV). Both investment vehicles require the drafting and agreement of a joint venture contract between the foreign partner and the Chinese partner, specifying the responsibilities, rights and interests of each partner in detail. Whereas the EJV has this division in accordance with the ratio of equity interests, the division in a CJV is up to the partners to decide.

I. Equity Joint Venture (EJV)

The Equity Joint Venture (“EJV”) is probably the most common of the foreign investment vehicles in China.

EJVs are governed by the Law of the People’s Republic of China on EJVs Using Chinese and Foreign Investment. This was first promulgated in 1979, at which time it was the first law pertaining to foreign investment, and as such EJVs were the first investment vehicles used by foreign investors. EJVs must necessarily be established as limited liability companies, thus separate “legal persons” distinct from their investors, with the liability of the partners limited to the contributions made to the Registered Capital of the EJV.

The Registered Capital must be paid up by the investors in the proportion agreed between them and set out in the relevant EJV contract. The EJV Law requires that the foreign partner to the venture contribute at least 25 percent of the Registered Capital for the EJV to achieve FIE status and related tax benefits. There is usually no upper limit on the foreign partner’s contributions (no more than 99%) except where Chinese law requires the Chinese partner to have a maximum ownership (i.e. “restricted” industries). The Company Law limits the capital contribution of the Chinese partner to 50% of its own net asset value. Profit is distributed in the form of dividend to the parties in proportion to each party’s respective ownership interest.

Capital contributions to an EJV must be made in cash, patented and unpatented technology, materials and equipment and other property rights.

Parties may contribute their respective capital to the EJV in the form of cash, capital goods, industrial property rights, and other assets. Commonly, the Chinese partner will contribute cash, land development or clearance fees and land use rights while the foreign partner commonly contributes cash, construction materials, technology, equipment and machinery. All contributions must first be approved by the relevant Chinese authorities and later certified in a report from a Chinese-registered CPA firm.
EJVs have a two-tiered system of management:

- The Board of Directors, which must comprise at least three members, is the highest decision-making body of the EJV and has the authority to make all major decisions concerning the EJV. The EJV partners are responsible for appointing the board members, and representation must be in proportion to each party's respective ownership interest in the venture. Under the EJV Law, either party may elect the Chairman, who acts as the Legal Representative of the EJV.

- The General Manager is responsible for the daily management. The "Deputy General Manager System" means that, if one side appoints the post of General Manager, then the other side will have the right to appoint the Deputy General Manager, thereby acting as a check on the powers of the General Manager.

EJVs are formed through a similar process to that of WFOEs. Foreign investors can normally only recover their capital upon liquidation of the EJV, if the company is solvent, or if they sell their interest to the Chinese partner or a third party. Unilateral termination of the EJV is not possible.

II. Contractual Joint Venture (CJV)

CJVs are governed by the Law of the Peoples Republic of China on CJVs Using Chinese and Foreign Investment. A CJV is organized by means of a contract rather than equity interest. There are two types:

- In cases where a CJV is formed as a limited liability company, then the CJV owns all of the contributed assets, and the liabilities of the investors would be limited to contributions made to the Registered Capital of the CJV.

- A CJV may also be established without forming a new “legal person” separate from its investors, and is then merely a contractual arrangement. In such cases, the contributions remain the property of the partners, the income generated becomes the joint property of the partners, and the partners are jointly and severally liable to the extent of their total assets.

In contrast to EJVs, the parties to both types of CJV have considerable freedom to negotiate in the CJV contract their respective rights, obligations, sharing of risks and liabilities, management and ownership of property at the time of termination of the CJV, etc. As such, although CJVs were initially designed as a legal framework for companies to work together in China on a contract-per-contact basis, CJVs have become attractive to foreign investors for other reasons. In particular, as profit sharing is NOT required to be proportionate to the contribution by each party:

- CJVs have become attractive to foreign investors who prefer their Chinese partners to receive fixed payments only. This has often be the case for many Hong Kong and Taiwanese investors whose Chinese partners are silent minority shareholders, basically “renting” their business licenses and assets to the foreign companies.

- CJVs have become attractive to foreign investors who desire a fast return on their investment but whose Chinese partners are reluctant to handover long-term control. In this arrangement, the foreign company would have a controlling interest in the CJV at its inception, and then gradually transfer control over to the Chinese partner as the CJV became profitable.

For a CJV operating as a limited liability company, the nature of the capital contributions is similar to those of an EJV. However, for a CJV operating without a separate “legal person” status, as the assets used by the CJV are not owned by the CJV but remain in the possession of the CJV partners themselves, certain taxes and fees can be avoided and present a third reason why CJVs have become popular to foreign investors. For example, this type of CJV doesn't have to pay taxes on the transfer of title to the
land from the Chinese partner to the CJV, or pay fees for the purchase by the Chinese partner of title to the land in cases where the Chinese partner’s title to the land is unclear.

CJVs operating as limited liability companies have a two-tiered system of management:

- The Board of Directors, which must comprise at least three members, is the highest decision making body of the CJV and has the authority to make all major decisions concerning the CJV. The CJV partners are responsible for appointing the board members, but unlike an EJV, representation on the Board of Directors is NOT required to be proportionate to the contribution by each party. The Chairman of the Board of Directors is the Legal Representative of the CJV.
- The General Manager is responsible for the daily management, and there is no “Deputy General Manager System” as in an EJV.

For a CJV operating without a separate “legal person” status, a Joint Management Committee is required instead of a Board of Directors. The Head of the Joint Management Committee is the Legal Representative of the CJV. It is advisable to supplement statutory regulations by agreeing the extent to which the Head of the Joint Management Committee may represent the investing parties.

For both types of CJV, the CJV is formed after negotiation of the CJV Contract terms between the foreign and Chinese investors, and the approval of the contract by the relevant authority. In contrast to EJVs, foreign companies can recover and repatriate their capital prior to the termination of a CJV, via preferential distribution of profits or products, for example. This is conditional upon the Chinese partner receiving all the assets of the CJV upon its termination and, in principle, the approvals of the financial and tax authorities are received. Unilateral termination of the CJV is possible upon breach of contract.

### III. The Advantages and Disadvantages of JVs

#### The Need for Chinese Partners

When considering investment vehicles, foreign investors need to take into account the advantages and disadvantages of having a Chinese partner. Having a Chinese partner can apply equally to establishing a JV with a Chinese company as well as acquiring a shareholding in a Chinese company.

The advantages of having a Chinese partner are based on the support they can provide to foreign companies unfamiliar with doing business in China. Such support may include obtaining government approvals, labor recruitment, sourcing raw materials, acquiring land & production facilities, and obtaining access to marketing & distribution channels. Whilst experienced Chinese staff in a WFOE may offer a similar range of support to a foreign investor as a Chinese partner in a JV, there are some aspects where established Chinese partners are able to provide greater levels of support than individuals themselves. The most important of these, which is pertinent when domestic sales are the main priority, is the provision of access to existing and established marketing & distributions channels. This greatly reduces upfront investment risks of the foreign investor, particularly in business-to-business transactions that are largely based on multiple personal relationships that take time to develop. However, it should be noted that some foreign investors have been greatly disappointed when the promises made by their joint venture partners turn out to have been exaggerations, and thus careful partner evaluation is recommended.

At the same time there may be disadvantages, discovered by many foreign investors through hard found experience, with most stories abounding from JVs due to their greater number and longer history. The disadvantages are often down to the difference in business cultures between the foreign investor and Chinese partner, and the consequent divergence in objectives and expectations for their project. Foreign partners generally seek a toehold in the China market, and are willing to forego profits to build market share or reinvest profits into the venture. Chinese partners are usually looking for quick cash to finance
their own expansion or pay off debts, as well as an outlet to dump excess workers. This inevitably results in project failure when placed in the context of normal operational and managerial difficulties in China, including bridging the communication gap between the Chinese and foreign parties. Even where interests coincide, battles over strategy and management control are frequent.

Should it be deemed preferable to have a Chinese partner, then the foreign investor must search for a suitable Chinese partner. The scale, diversity and dynamism of the Chinese market can either offer an overwhelming number of potentials, or make the right partner extremely difficult to be found. Unless the partners are a “perfect match”, the balance between the advantages and disadvantages for the foreign investor is often dependent on the level of control.

**Necessity & Difficulty of Due Diligence**

Should a Chinese partner be deemed desirable, and a potential Chinese partner found, then foreign investors should not underestimate the importance of conducting serious due diligence investigations on this potential Chinese partner. This equally applicable to establishing a JV with a Chinese company as well as acquiring any level of shareholding in a Chinese company. Classic problem areas include the under reporting of tax, complicated debt and security arrangements (sometimes involving a tangled web of connections with affiliated companies), the under-funding of employee social welfare obligations, and incomplete evidence of title to land and buildings. In some cases, this will have an impact on the valuation, and can be used as leverage during the price negotiations. In other cases, the issues identified will prove to be deal-breakers, and thereby save the foreign investor from making an expensive mistake.

The most common problems encountered during due diligence investigations are poor transparency and inadequate documentation. It is thus very important to closely coordinate the various due diligence teams to ensure that any suspicious discoveries are properly followed up. Moreover, a much more hands-on approach to due diligence is necessary in China to get effective results, including a focus on commercial aspects in addition to financial and legal aspects. As such, detailed discussions with the potential Chinese partner’s management are recommended to understand their business philosophies, expectations and practices. Furthermore, interviews with their suppliers, customers and even competitors should be conducted to learn about the potential Chinese partner’s trustworthiness, reliability and reputation. It is only in this way that the foreign investor can determine whether this is a partner with whom they can do business, a “perfect match” as such, and thereby avoid the many problems faced by foreign investors over the years.

Because China’s corporate governance standards are far from perfect, any foreign investor has to accept a certain level of risk or uncertainty to proceed with a JV. Clearly establishing a WFOE avoids this necessity for due diligence and any risk exposure of this kind.

**The Level of Control**

The foreign investor’s level of control is not a simple matter. It is frequently the case that the Chinese partner will effectively exercise management control over the JV, regardless of equity share or contractual arrangement. This is because the JV staff, transferred from the JV partner, retain their original objectives, practices and loyalties. Some foreign investors have dealt with this problem through patient and continual communication, but it is far better to structure the JV properly in the first place.

If the foreign investor has a majority stake, then it can assume a high level of control. In an EJV, with a >50% shareholding, the foreign investor can appoint the majority of the members of the board. Under PRC Law, only a few decisions require unanimous board approval, and thus majority control of the board can give the investor effective control over the target. Moreover, the foreign investor also has a
persuasive argument for ensuring that its nominees fill the important management posts, and thereby avoid the situation where the Chinese partner is a minority shareholder yet still effectively exercises management control, as discussed above.

This is not possible when the foreign investor has a minority stake. In such cases, the investor may consider establishing a CJV operated as a limited liability company, as in theory it is possible for a minority investor to have majority control of the Board of Directors. A more common strategy, though, is for the investor to use an EJV but negotiate so that the list of matters requiring unanimous board approval in the EJV contract is expanded to include certain important business decisions. The investor may also try to negotiate with the Chinese partner so that important management posts are rotated, or managers recruited from the open market with unanimous board approval, and thereby reduce the level of control of the Chinese partner.

For some foreign investors, majority control over the board is not enough. They dislike the fact that the minority shareholders can still use their appointed Directors to veto decisions that require unanimous board approval, including merger, division, dissolution or amendment of the constitutional documents. This can be important when it comes to responding to changes in market conditions, including consolidation of multiple JVs in which a foreign investor has an equity interest in order to rationalize and achieve economies of scale. There are several solutions:

- One option is to structure the JV so that it is converted into a wholly owned subsidiary of an offshore vehicle with the foreign investor and minority Chinese investor holding shares in the offshore vehicle. Although this would allow a structuring so that the foreign investor is in full control, both of the offshore vehicle and consequently the JV, this is uncommon due to the difficulties Chinese investors face investing in offshore vehicles.

- Another option, which is pertinent to foreign investors with a >67% shareholding in the JV, is to convert the FIE into a Foreign Invested Company Limited by Shares (FICLS). FICLS have a different corporate governance structure, and with a >67% shareholding the foreign investor can acquire effective control of the FICLS highest governing body, the Shareholder's General Meeting. As such, it can pass resolutions even on important decisions such as merger, division, dissolution or amendment of the FIE's constitutional documents. The drawback of a FICLS is that the conversion process requires central MOFCOM approval and thus takes longer to complete.

In practice, control is always compromised whenever a Chinese partner is involved. The ultimate level of control is only achieved when a foreign investor avoids having a Chinese partner and “goes it alone” with a WFOE.

**Risk Exposure to IPR Infringement**

China’s IPR legislation is fairly well developed, including the Copyright Law, Trademark Law, Unfair Competition Law, Product Quality Law, Patent Law (Patents, Utility Models, Designs) and Custom IPR Regulations. However, IPR infringement is common place in China, and the real issue has not been the IPR legislation itself but the enforcement of that IPR legislation. In particular, there has been a lack of support for IPR enforcement at the local level, partly due to widespread local protectionism and partly due to endemic corruption. As a result, IPR offenders are relatively unhindered in their activities, and infringement thus commonplace.

Many foreign investors have discovered through hard found experience that one of the greatest exposures to the risk of IPR infringement is by having a Chinese partner. There are a multitude of methods that Chinese partners have deployed over the years, including competing directly with the JV themselves or transferring IP from the foreign partner to external parties, and methods will continue to be invented and deployed. The consequences are dead copies, look alike products, misuse of trademarks, patent infringements and copyright infringements. As foreign investors typically have high
quality products, valuable brands and registered copyrights and patents, IPR infringement is extremely damaging to foreign investors.

Establishing a WFOE removes this level of risk exposure. Whilst a certain level of risk exposure will always remain, as staff within the JV can still leave to establish their own companies or transfer IP to external parties, this risk is much more manageable.
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<th>Advantages</th>
<th>Disadvantages</th>
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<td>JV over WFOE</td>
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Fewer restrictions on project approval than for a WFOE, thereby possible in “restricted” industries where WFOEs not allowed.

Upfront investment required from the foreign investor likely to be lower for an JV than a WFOE as shared with the JV partner.

Assistance from partner in such areas as obtaining government approvals, labor recruitment, sourcing raw materials, acquiring land & production facilities, obtaining access to marketing & distribution channels etc.

Thus, potential for reduction in upfront investment risks compared to a WFOE due to transfer of existing customers and sales contracts from the partner to the JV.

And also the potential for JVs to be up and running more quickly than WFOEs.

Could be first step to acquiring the JV partner.

Need to do proper due diligence on, then negotiate the JV contract with, a Chinese partner in China

Risk of inadvertently inheriting the baggage of the JV partner, including excess workers, poor reputation with past customers etc.

No unilateral control of operations, and thus significant risk exposure to partner disputes and losing control of the JV. Moreover, in the case of an EJV, the partner has power of veto over the major decisions that require unanimous board approval, possibly inhibiting the EJV’s ability to respond to changes in market conditions.

As a JV will effectively be a going concern, allows less control over corporate culture than with a WFOE.

In contrast to a WFOE, a JV presents a higher risk exposure to IPR infringement and even “arming” a future competitor with know how, trade secrets etc.

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<td>CJV over EJV</td>
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In contrast to an EJV, CJV partners may operate as either a limited liability company or without a “legal person” status, thereby allowing the avoidance of taxes and fees related to the contribution of land to the CJV.

In contrast to an EJV, there is much more flexibility regarding the division of control between the partners of a CJV, as well as change during different stages of operation, proving attractive to foreign companies seeking to avoid partner disputes.

In contrast to an EJV, the profit distribution ratio of a CJV may differ from the shareholding ratio, as well as change during different stages of operation, again proving attractive to foreign companies for various reasons.

In contrast to an EJV, and subject to approval, the Registered Capital of a CJV may be recovered and repatriated prior to the termination of the CJV.

Unilateral termination of a CJV is possible upon breach of contract, in contrast to EJVs where unilateral termination is not possible.
IV. JV Establishment Process

Target Selection

The first phase to establish an JV is the partner selection. The Foreign Investor looks for a target company that meets his criteria. Here below we outline some common parameters that are usually considered during the preliminary Target Selection process.

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<th>Target Search Common Criteria</th>
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<td>Others</td>
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Approval & registration for incorporation of an JV

Once the target enterprise is selected, the Approval and Registration process takes place together with the Trademark registration.
The JV establishment process should commence with the reservation of the company name with the State Administration for Industry and Commerce (SAIC). Trademark registration is an independent process, undertaken over 6 to 12 month period (at least), and thus should actually be initiated as soon as a foreign investor has business interests in China.

The JV partners should first negotiate and conclude a Letter of Intent (LOI). Once this has been done, then they can prepare a project proposal and have that approved by MOFCOM or the relevant approval authority.

Once the project proposal has been approved, then the JV partners can prepare the Feasibility Study and have that approved by MOFCOM or the relevant approval authority.

Prior to making the investment application, the JV partners need to first search and locate suitable land and buildings for the JV. If the Chinese partner is to contribute the land and buildings, this needs to be negotiated, and the Chinese partner provide the land use rights certificate and a board resolution allowing the use of the land and buildings as contributions to the JV. In addition, the JV partners also have to negotiate and conclude the Joint Venture Contract.

At this point, the JV partners can make the investment application to MOFCOM or the relevant approval authority. This includes submitting the Joint Venture Contract, Articles of Association, Feasibility Study and other documents. The Environmental Impact Assessment should be submitted to the Environmental Protection Bureau.

Once MOFCOM or the relevant approval authority has made their decision and issued an approval certificate, the JV partners should apply for the business license from the SAIC. Upon receipt of the business license, the EJV becomes a legal person in China.

At this point, the JV partners can then make the company seals for the JV (allowing the JV to sign contracts), apply for an organization code certificate, open bank accounts (in USD and RMB), and register with the relevant authorities (State Administration for Foreign Exchange, State Administration for Taxation, Customs Office, Statistics Bureau etc).

The total application and registration process will take one to three months once the relevant documents/information have been prepared. Normally, the bigger the city, the longer the application process.