Joint Ventures in China

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Introduction

Today more than ever the hot industry in Chinese joint ventures is the automotive industry. This is because the Chinese Government has decided it is necessary to encourage domestic automotive production from a wider range of companies.1 At least in China there is an additional reason for a foreign business to work within the joint venture framework that does not rely on the traditional breaking into the foreign market formula.

[1] See Examples of Joint Ventures *infra*.

One of traditional reasons a foreign company might decide to create a joint venture with a local company is that the foreign company has no contacts within the local company's state. As the foreign company will be relying on the local company's contacts to do business the relationship between the two joint venture partners is essential. With the Chinese government's guidance that further automotive joint ventures are necessary for foreign automakers to do increased business in China, the relationship will be based on mutual interests. Mutual interest and market focus is an essential element in a successful joint venture; without this confluence of interest the joint venture is ripe for short and long term bickering and potential dissolution, which can be a very bad thing in China.

However, once the decision has been made to create a joint venture the counsel for the partners have little choice but to form that joint venture, or find alternative work. The following is meant to assist counsel in forming a joint venture in China; however this paper is only a short practice guide, designed to give counsel a general understanding of joint ventures in China. This guide should not be used alone, without any further resources; some good ones are to be found in the following footnotes.

Joint Venture Requirements

There are two types of Chinese joint ventures: equity and cooperative. An equity joint venture is simply the customary joint venture in which each partner contributes assets (tangible assets, land use rights, intellectual property, other intangible assets, or cash) in exchange for equity in the joint venture.[2] The joint venture then becomes the entity that develops (unless the strategic partner(s) performs research and development activities and licenses the intellectual property to the joint venture via a technical assistance/licensing agreement), manufactures, and sells whatever products(s) are within the scope or purpose for which the joint venture was created.[3] The second type of joint venture is a cooperative joint venture which can take one of two forms a "pure" cooperative joint venture in which both partners work towards a common goal without a separate legal entity or a "hybrid" cooperative joint venture which has a separate corporate form.[4] Most businesses would likely prefer the hybrid version of a cooperative joint venture as the corporate form of the joint venture protects the partners' direct liability.

Establishment of a Joint Venture

The establishment procedure of a joint venture is almost identical for an equity joint venture and a cooperative joint venture therefore this guide will deal with both together. The setup of such an entity is a time consuming and complicated process, which will vary depending on the ownership structure of the Chinese party and its location.[5] If the Chinese partner is a state-owned entity it must secure preliminary approval, which requires the creation of preliminary feasibility study, of the joint venture before moving forward.[6] Then the partners must prepare a joint feasibility study, negotiate and draft the joint venture contract and the articles of association.[7] These documents will have to be submitted to the appropriate authorities

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[2] BAKER & MCKENZIE, DOING BUSINESS IN CHINA 2011, 2 (Baker and McKenzie 2011) *available at* http://www.bakermckenzie.com/files/Uploads/Documents/China%20Update%202011/bk_china_dbi2010.pdf (last accessed Sept. 9, 2011) (hereinafter Doing Business in China).

[3] *Id.*

[4] *Id.*, at 8.

[5] *Id.*, at 3.

[6] *Id.*

[7] *Id.*

normally the Chinese Ministry of Commerce, where the authority will review the documents and decide whether to approve the joint venture.[8] Once approved the Equity joint venture must register with the local bureau of the State Administration for Industry and Commerce, which will then issue a business license.[9]

The simplicity of the preceding paragraph should not make anyone believe that these steps are *pro forma* or that approval is available solely because a request is made. Rather it is essential that time and effort is put into every element of the joint venture creation process. As it will become obvious later a simple mistake could cost one of the partners millions of dollars or more.

Taxation

The Chinese Tax system, like many tax systems, is a complex web of specifically tailored laws. Determining where a joint venture fits into this law will help predict its tax restrictions, benefits, and rates. The key variables for this determination are the type of joint venture, the type of business of the joint venture, and the location of the joint venture.

Chinese Law makes a specific distinction between two types of foreign joint venture, equity joint ventures and contractual joint ventures. Each of these types has its own law.[10] These two laws create different rules and requirements for the two types of joint ventures.

The two different laws have some common ground. One area that appears in both laws is that joint ventures may enjoy some tax benefits, depending on how the joint venture fits into the

[8] Doing Business in China, 3.
[9] *Id.*, at 4.
[10] Chinese-Foreign Equity Joint Ventures Law (P.R.C) (Mar. 15, 2001); Chinese-Foreign Contractual Joint Ventures Law (P.R.C.) (Oct. 21, 2000) (hereinafter JV Law).

tax code.[11] This variable depends on the type of business of the joint venture. Foreign investment is divided into four different categories: encouraged, permitted, restricted, or prohibited.[12] The Chinese tax code has different rates and incentives for businesses depending on how the business fits into these categories.[13]

The third variable, the location of the Joint Venture, is not specific to tax issues but is worth mentioning. The interpretation and enforcement of laws in China varies considerably depending on location. The structure of the Chinese tax system creates two parallel systems of agencies that businesses have to deal with, the national tax authority and local tax authorities. While the national tax authority is a very sophisticated and consistent entity, there is significant variation among the local authorities. Effective tax due diligence requires an understanding of the local tax authority and the way it interprets and enforces the relevant taxes.

Corporate Governance

Without effective corporate governance a company is unable to produce any products and as such is unable to create wealth for its partners. In todays age of harsh regulations and unforgiving government regulators another issue looms: destruction of the company through the levy of fines or other damaging measures taken because the company failed to follow the byzantine corporate governance requirements of any country that can claim jurisdiction. This is not a feature solely of Chinese Law, Sarbanes-Oxley is a very good example in the United States and the recent United Kingdom Bribery Act is a good one from the United Kingdom. Therefore,

[11] The Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures Art. 20; The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures Art. 8.
[12] PRICE WATERHOUSE COOPERS, THE PEOPLE'S REPUBLIC OF CHINA TAX FACTS AND FIGURES – 2010, 6 (2010).
[13] *Id.* 6-10.

what follows can only be a general overview of potential pitfalls, but this overview is not complete and must not be wholly relied upon.

Chinese Requirements

Perhaps the simplest command of the JV Law is that any joint venture must follow the laws of China. However, this becomes a problem when a foreign company is attempting to determine whether they are violating the secrecy and state interest laws of China. While there has been recent revision of the Chinese patent law, it does require that all inventions invented in China must complete a security review before being patented overseas.[14] If the security review step is not completed the inventor may lose its patent rights.[15]

Any joint venture must set up a foreign exchange account, upon issuance of a business license, with a State authorized financial institution.[16] This requirement in the JV Law is because the Renminbi is not a freely convertible currency.[17] Therefore, the Chinese government decided that instead of requiring the government to examine the foreign exchange documents it would delegate that job to specially authorized financial institutions.[18] However, should the joint venture wish to use foreign exchange for capital account transactions the Chinese government must still approve the transaction?[19]

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[14] Doing Business in China, 40.
[15] *Id.*
[16] JV Law, Art. 16.
[17] Doing Business in China, 6.
[18] *Id.*
[19] *Id.*, at 7.

A joint venture must use an accounting system based on a dual-entry, accrual system.[20] A registered Chinese accountant must review and audit all books, which are to be kept in Chinese and submitted to the local government financial and tax units, for the record.[21] Every a plan must be prepared to distribute the profits of the JV between the partners in proportion to their respective contributions to the joint venture.[22] Further, a joint venture must place a certain percentage of after tax income to a reserve fund, an enterprise expansion fund, and incentive and welfare plan for staff and workers.[23]

The Chinese JV Law allows a joint venture to import materials and export products produced in the course of the joint venture's operations.[24] However, the JV law requires that foreign purchases of raw materials must be based on the "principles of fairness and rationality."[25] The Law of the People's Republic of China on Foreign Trade (the "Foreign Trade Law") provides additional legal requirements that must be met before a joint venture can purchase products from the world market.[26] However, even though an entity has the right to import a good, as long as they are not state traded, this does not mean it has the right to sell those goods without a distribution license as well.[27] The Chinese import duty rates are separated by the originating location of the import into standard and preferential rates.[28] These preferential rates are based specific free trade agreements and as such very specific rules may be applicable, be

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[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] Doing Business in China, 7.
[24] JV Law, Art. 19.
[25] *Id.*
[26] Doing Business in China, 20.
[27] *Id.*
[28] *Id.*, at 22.

careful and review the agreements.[29] As often happens in today's multinational economy a product may be produced in multiple countries, if so the Chinese standard to determine country of origin is the "last country in which there has been substantial transformation to the product.[30]

The length of operations of a joint venture in China must be explicitly stated, and fixed terms may be extended if the partners agree to extend the joint venture and apply to original licensing agency 180 days prior to the expiration of the term with a response from the agency required within thirty days.[31] Typically the partners do not attempt to get permission to create an infinite term of operation; rather the average range of terms is fifteen to fifty years.[32] The term of operations is very dependent on the scope of the joint venture's operations, as a fifteen year term is unlikely to return anything useful on a multi-billion dollar investment. As American lawyers we are used to the infinite term of operations of a legal entity, "unless otherwise stated." Therefore, it is essential to keep in mind infinite duration is unusual and requires special approval if it is available at all as certain industries must be limited in term.[33]

Once the term of operations of a joint venture expires the joint venture must be dissolved.[34] After the debts of the joint venture are paid the property of the joint venture will be distributed to the partners based on their original capital contributions, absent earlier agreement.[35] Further the scope of the business is limited by the approved business scope.[36] This

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[29] *Id.*, at 23.
[30] *Id.*, at 22.
[31] JV Law, Art. 24.
[32] Doing Business in China, 5.
[33] *Id.*, at 5-6.
[34] JV Law, Art. 23.
[35] Doing Business in China, 6.

limitation on the scope of business is not limited to foreign companies but applies to all business entities in China.[37] As this scope of business clause can sink a joint venture's ability to even operate the clause must be drafted carefully and can often be subject to negotiations between the partners and the Chinese government.[38]

Home Nation Requirements

The difficulty here is determining the home country of the foreign investor. In most cases lawyers in Michigan are going to be dealing with American companies and those companies' home nation will be the United States. Most American lawyers specializing in international business are familiar with the American requirements as they related to foreign investment and doing business aboard. Therefore, this guide's limited scope is not best suited to exploring these issues; however the United States Department of Commerce is a good place to begin.[39]

The issues that must be considered include United States import and export issues depending on what the purpose of the joint venture. It is also important to discuss with tax counsel how the payments from the foreign entity will be characterized because both pass through and corporate taxation carry their rewards and detriments. Keep in mind that the joint venture's partner's employees may have to travel for long terms or immigrate to Russia, and be prepared to work with the American Federal Agencies which will have to be involved. Finally, be prepared to report about the joint ventures activities if the American partner of the joint venture is regulated under Sarbanes-Oxley.

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[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] The United States Department of Commerce website is available at http://www.commerce.gov/.

Examples of Joint Ventures in China

The Chinese government has "requested" that American automakers partner with indigenous automakers to increase the Domestic Chinese automotive industry.[40] Therefore, General Motors and Chinese partners have established the Baojun automotive line, the Chinese government's reasoning for a request that further joint ventures be consummated in the automotive market is to build an indigenous low cost automotive industry.[41] The reason foreign companies are even listening to this "request" is that if they do not decide to work with Chinese partners in joint ventures; their applications for expansion of their existent facilities are premised on the development of a low cost local automotive brand.[42] Therefore, this "request" is more of an unannounced government policy than a simple request.

There have been a recent number of joint ventures established in the financial sector as well. Morgan Stanley and Huaxin Securities have recently concluded and received approval for a joint venture between them, called Morgan Stanley Huaxin Securities.[43] J.P. Morgan and First Capital Securities have also formed a joint venture which was approved around the same time as the Morgan Stanley-Huaxin joint venture.[44] While all of the companies involved in these joint ventures are known for trading will still have to wait five years until they are able to begin acting

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[40] Christine Tierney, *GM and Its China Partners Launch Baojun Car*, The Detroit News (Aug. 8, 2011) http://detnews.com/article/20110808/AUTO01/108080322/1148/rss25 (last accessed Sept. 9, 2011).
[41] *Id.*
[42] John Reed & Patti Waldmeir, *Foreign Groups Told to Make Chinese Cars*, Financial Times (Mar. 20, 2011) http://www.ft.com/intl/cms/s/4a5c8d82-5328-11e0-86e6-00144feab49a,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F4a5c8d82-5328-11e0-86e6-00144feab49a.html%3Fftcamp%3Drss&_i_referer=http%3A%2F%2Fchinabizgov.blogspot.com%2F2011%2F03%2Fcreating-chinese-brands-now-part-of.html&ftcamp=rss#axzz1HFgN2UCz (last accessed Sept, 9, 2011).
[43] Michael Flaherty & Denny Thomas, *China OKs J.P. Morgan, Morgan Stanley Joint Ventures*, Reuters (Jan. 7, 2011) http://www.reuters.com/article/2011/01/07/us-jpmorgan-china-idUSTRE7060DG20110107 (last accessed Sept. 9, 2011).
[44] *Id.*

as brokerage houses.[45] The approval for brokerage houses must be sought from the China Securities and Regulatory Commission and perhaps the biggest requirement for these sorts of trading houses is that the maximum foreign investment is thirty three percent.[46] Foreign companies are still flocking to China to set up banking and investment joint ventures however, simply because the market is huge notwithstanding the investment risk of a bare thirty three percent of the capital contribution.[47]

Perhaps not surprising the automotive parts industry is expanding further into the Chinese market as well. HHI, LLC and Zhejiang 8+1 Precision Machinery Company and C & U Americas, LLC concluded an agreement in May for form a joint venture called Mapleland Precision Forge Company Limited.[48] Mapleland's purpose will be to supply the anticipated large requirements for automotive parts as the domestic Chinese automotive market's demand has increased.[49] Most interestingly, HHI was solicited by a number of Chinese automotive parts manufacturing companies to form a joint venture but chose 8+1 because of 8+1's "extensive technical forging and machining expertise, knowledge of local markets, and substantial customer base.[50]

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[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] HHI Group Holdings, LLC, *HHI Group Holdings to Form Joint Venture with 8+1*, PR Newswire (May 2, 2011) http://www.prnewswire.com/news-releases/hhi-group-holdings-to-form-chinese-joint-venture-with-81-121090354.html (last accessed Sept. 9, 2011).
[49] *Id.*
[50] *Id.*

Dissolution of the Joint Venture

No one, except perhaps the attorneys, every wants to talk about the dissolution of a joint venture during the formation negotiations, however it is essential that certain decisions and clauses are part of the initial joint venture negotiations. Without such clauses disputes could go to the Chinese Court systems which may or may not be enforceable outside of China and without specific provisions he default JV Law rules will apply during dissolution. Stress to your clients that a joint venture in China is truly more of a matter of when and not if it will dissolve because most are only slated to operate for a fixed period of time.

Court Versus Mediation and Arbitration

The JV Law states that if a dispute arises between the partners of a joint venture the dispute will be referred to mediation or arbitration, however if there is no agreement in the joint venture contract and the parties do not subsequently agree to alternative dispute resolution the dispute must go to the court system.[51] As always it is a very good idea to avoid local court systems for the simple reason that a local judgment is not as easily enforceable as an arbitral decision. China is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) which all but ensures the enforcement of a foreign arbitral award.[52]

The Chinese JV Law envisions a system of escalating dispute resolution mechanisms even where the parties have agreed to specific dispute resolution elements. All disputes between

[51] JV Law, Art. 25.
[52] *Id.*

Chinese and foreign partners must be submitted to consultation or mediation in the beginning.[53] Apparently the mediators in China have won a bigger victory than they have in the United States in selling the effectiveness of mediation to at least the government. Second, should the dispute have not been resolved through mediation and consultation or the partners are unwilling to go through mediation or consultation the partners may submit it to an arbitration tribunal.[54] The partners are able to refer their case to a Chinese arbitration agency, like the China International Economic and Trade Arbitration Commission or CIETAC, or any other arbitration agency agreed upon in the arbitration clause.[55] The basic enforceability requirements for a foreign arbitral award to be recognized in China are the same requirements most countries have for enforcing foreign arbitral awards.

The grounds to set aside a foreign arbitral award are in Article V of the New York Convention. Firstly, if the moving party can demonstrate that the award was granted during the incapacity of the party against whom enforcement is sought; the party against whom the arbitration clause was invoked was not given proper notice of the proceedings; the arbitral award deals with an issue not contemplated by the drafters of the dispute resolution clause; the arbitral tribunal itself was improperly constituted; or the award has yet to become binding.[56] A court can also refuse the recognition and enforcement of a foreign arbitral tribunal if competent authority in the country where enforcement is sought finds the subject matter is not legally arbitral under

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[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Article V, New York (Jun. 10, 1958).

the county's laws or the recognition and enforcement would violate public policy.[57] Therefore, the average arbitral award as long as it was fairly received should not be too difficult to enforce.

Splitting the Assets

China's JV Law requires that upon the termination of a joint venture's period of operations, "all of the fixed assets of the contractual joint venture, as agreed upon by the Chinese and foreign parties in the contractual joint venture, are to belong to the Chinese party."[58] This is a pretty scary provision of the Chinese JV Law as it places a considerable straining on the set up costs of any joint venture as all physical assets are lost to the Chinese party upon dissolution. Importantly, the Chinese JV Law allows for one avenue to recover these fixed assets, namely a transfer prior to the end of the joint venture operations period as long as the transfer is provided for in the original joint venture agreement.[59]

A Chinese joint venture can dissolve by operation of the expiration date in the original joint venture agreement or by operation of law. Much like any other corporate form the judicial or arbitral systems may order the dissolution of the joint venture and accordingly split the assets between the parties. The split of assets under those circumstances will however depend upon a case by case analysis, but in general most agreements call for the reversion of all of the assets of the joint venture to revert to the Chinese partner.[60] As previously stated the fixed assets by default return to the Chinese partner and without the careful wording and negotiation of the reversion clause the foreign partner may quickly have a much greater loss on its hands as they expected.

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[57] *Id.*
[58] JV Law, Art. 21.
[59] *Id.*
[60] Doing Business in China, 10.

Conclusion

The joint venture will likely be a popular vehicle for foreign investment well into the future in China. The joint venture model allows partners to spread risk and share experience and the Chinese government is encouraging the development of further joint ventures in the automotive sector to grow its domestic brands. Arbitration is a good idea for all commercial disputes because it allows for the widest ability to enforce the judgment and protects from the vagaries of a national court system. Therefore, while certain dangers exist in the forming of and carrying out the business of joint venture in China, the current environment appears to require the expansion of foreign joint ventures in China.