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VIEW POINT

Avoiding Mistakes in Chinese Joint Ventures

By Steve Dickinson

Before deciding to invest in a business in China, the foreign investor must first make a fundamental decision about what form the enterprise should take. The investor can go it alone and form a 100% foreign-owned entity (a wholly foreign-owned entity, or "WFOE"), or work together with an existing Chinese business and operate through some form of joint venture entity (an equity joint venture, or "EJV"). With the exception of some market sectors, China is remarkably open to foreign investment, and in the past several years WFOEs have become the most common vehicle for foreign investment, partly due to investor skittishness as stories about past problems with Chinese EJV partners made the rounds. Despite these sentiments, many foreign investors still choose to enter the market through a joint venture, and the particular risks involved with this type of arrangement require very careful planning.

One way to reduce your exposure to risk from an unscrupulous EJV partner who might be looking to undercut your cooperation is by thoroughly vetting them ahead of time. Taking the time to learn more about potential partners upfront will dramatically increase your likelihood of success. In addition, controlling the levers of power in an EJV is a critical factor that can help you succeed, or potentially doom you to failure.

A Chinese joint venture is formed as a limited liability corporation under PRC company law. The fundamental issue in forming such an entity revolves around which party has ultimate control over company operations. As most foreign investors wish to maintain control over the entity, this issue is paramount for them. Yet foreign investors frequently make a fundamental mistake that effectively leaves them without control—a mistake so critical that it accounts for most of the failed EJVs in China.

Foreign investors too often assume that a Chinese joint venture company is managed according to a common Western model, under which a board of directors has controlling power over the company. Since the board is elected by a majority vote of company owners, most foreign investors will strive to obtain a 51% ownership interest in the EJV. As majority owner, the investor then assumes he has the right to elect the entire board, and thus effectively control the company.

After winning the struggle for percentage ownership, as a concession the foreign investor will frequently allow the local side to appoint the representative director and the company general manager. Unintentionally, this concession cedes effective power. As a result, the investor's struggle for board control is rendered meaningless. Frequently the Chinese side intentionally angles to ensure this outcome. We know of cases where an EJV partner concedes on the percentage ownership issue in return for control over the two key management positions in the company.

In order to exercise effective control over a joint venture in China, investors must avoid this mistake. It is necessary to have control over the day-to-day management of the joint venture company. Such control comes from the following:

- *The power to appoint and remove the JV's representative.* The side that appoints the representative director will have significant control over operations. The usual practice of conceding the power to appoint a key officer or director to another investor is a mistake.

- *The power to appoint and remove the general manager of the joint venture company.* It must be made clear that the general manager is an employee of the joint venture company who is employed entirely at the discretion of the representative director. The common practice of appointing the same person as both representative director and general manager is a mistake.

- *Control over the company seal, or "chop."* The person who controls the registered company seal has the power to make binding contracts on behalf of the joint venture company and to deal with the company's banks and other key service providers. The power over that seal should be carefully guarded. Ceding control over it as a matter of convenience is a mistake. There is a long, documented history of this seemingly minor consideration dooming EJVs.

In most cases, the Chinese side to a joint venture will flatly refuse to agree to these three measures of control. The common argument is that it is more efficient to allow the Chinese side to control day-to-day management of the company. Under this rationale the experience with day-to-day management is a primary reason for operating as a joint venture.

In many cases, the local partners will argue that they cannot bring their political connections, or *guanxi*, into play unless their own people act as the representative director and general manger. This is often a bit of a red herring and the point should not be accepted at face value. When these arguments are made, the real issue is operational control over the company. Majority control is simply a smoke screen for the true levers of control in a company in China.

Once these three control mechanisms are entirely under the control of the partner, foreign investors will quickly discover that they have relinquished all power. When this happens, the investor should face the reality of the situation, and either reduce the investment to a minority share or abandon it altogether. Once power over operations is out of an investor's hands, it becomes very difficult to run a successful partnership in China.

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