Seven Steps to a Successful Chinese Joint Venture

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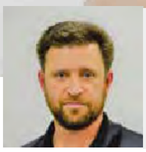

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Amidst volatile trade winds and political turmoil, Sino-foreign joint ventures are attracting fresh interest. Foreign investors surmise that a local partnership could mitigate the impact of negative domestic sentiment. Further, China's new foreign investment law, effective next year, will in theory reduce the likelihood of board deadlock that has so often ensnared joint ventures.

Nevertheless, numerous other variables contributed to past joint venture failures, so foreign investors would be wise to understand these and take steps to avoid the same mistakes. The following seven tips should increase the odds your Sino-foreign joint venture relationship will succeed.

1. Include non-traditional due diligence in the mix

Your Chinese partners' business has accumulated stakeholders that exert unique influence on their organization. Some such stakeholders will come as a surprise to Western partners, such as government-level patrons and even extended family members. Despite your partners' best intentions, they may not be immune to undesirable influence. Put another way, related-party business transactions are a normal part of your Chinese partners' dealings.

Start early by identifying your partners' extended circle of stakeholders and how they influence the business. Make the most of your China network, to the extent it exists, to probe widely, yet tactfully, and enquire about your partners' business and its stakeholders.

Some of these stakeholders have representatives working in your partners' business, and they may be assigned to your joint venture, bringing with them their agendas and loyalties. Identify who they are early and where their commitments lie, before accepting them into your venture. Consider the simple example of an expatriate colleague of mine who was informed frankly for the first time, after providing work instructions to a young assistant who curtly rejected them, that the assistant's father was a senior executive.

Other useful sources to empower your informal due diligence are public and private providers. A preliminary National Enterprise Credit Information Publicity System check will reveal basic, publicly available information about your partners' companies and any formal sanctions. Professional service providers frequently offer a basic "background check," which often contains a surprising amount of useful information, sometimes including corporate financials and even banking activity details and other operational facts (e.g., large vendors, large customers, etc.).

Non-traditional due diligence is available from well-known service providers to provide even more thorough, though more expensive, investigation. Come to your joint venture relationship building activities armed with the information obtained, ready to discuss the relevant Chinese industry and probe your partners' involvement.

A note of caution: Some information obtained from non-traditional due diligence service providers may have been acquired through informal relationships with staff at *government agencies. Be careful about acquiring such information. Consult local counsel beforehand to avoid running afoul of the law. Chinese authorities have an elastic definition of what is public and private and what may even be considered a "state secret."*

2. Negotiate directly with the entire joint venture team

Joint venture establishment negotiations culminate with the signing of a joint venture contract and articles of incorporation, although they should start with an MOU, the main business points of agreement. Even at this early stage, urge your Chinese partner to appoint an attorney or other third-party professional to represent him or her in the preparation of the MOU and joint venture documents. While likely to meet resistance, this team-based negotiating approach will improve the quality of the discussions and the final result.

Where your Chinese partner lacks experience with foreign partnerships or "international standards," an experienced professional can help to educate and moderate the expectations of your partner. And the same goes for you and your understanding of what's reasonable in China. On the other hand, beware of high-end legal teams that "paper" a transaction overnight, but do not fully engage and support partner-to-partner discussions.

Similarly, resist delegating negotiations, even though partner-to-partner language barriers may slow progress. Pursue open and frank discussion of the detailed terms of the agreements; you will need to have many more such conversations for a successful joint venture. It is better to discover any possible propensity early in the relationship, when you can still back out.

Finally, no matter how thorough your negotiation of the documents and how much the importance of its terms have been impressed upon the parties, your Chinese counterpart will still regard the legal agreements as just first steps in an ongoing business relationship. The negotiations have not ended; they have only just begun. However, to the extent you have discussed the terms in detail in a person-to-person dialogue and impressed their importance upon the participants, then the higher the likelihood the concepts will "stick."

3. Position yourself in the enterprise for the greatest possible influence

Under current Sino-foreign joint venture law (to be phased out over the next five years), the majority shareholder does not automatically control the enterprise. Rather, control rests in the board and in the contractual right to appoint the key leadership of the company, as set forth in the joint venture contract. If and when board deadlock occurs, as has happened innumerable times in Sino-foreign joint ventures, then the existing management appointees effectively determine the organization's fate.

The legal representative (often shortened to "legal rep") is arguably the most important appointment. Under Chinese law, the legal representative carries full authority to bind the company and direct its affairs, although, in practice, day-to-day management is usually delegated to a general manager and/or finance manager. Such expansive authority invested in one person has no parallel in U.S. law. Consider that only the legal representative can open or close bank accounts and only he can direct what becomes of those funds. Also remember that once the legal representative is appointed, she cannot be quickly or easily removed. Usually a period of months is required to make an official change; meanwhile, the existing "legal rep" continues to wield full authority over the organization. For these reasons, think twice before abruptly terminating a legal representative, thereby prematurely alienating him or her. Understand that if you acquire a new company in China, you do not actually control that entity until you have officially replaced the legal representative in the public records.

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4. Control the corporate seals

General manager and finance manager appointments are key for several reasons. One or both are likely to be in daily possession of the company's corporate seals, otherwise known as the "chops." Whoever controls the "chops" effectively controls the company on a day-to-day basis. This may strike "Western" ears as an exaggeration, but it is most certainly not. Understand that the corporate seals are the levers of day-to-day power in a Chinese corporation required for many daily tasks, including authorizing contracts. Whoever physically possesses these levers, whether it be the general manager or even his or her assistant, that person effectively controls the corporation.

Therefore, monitor who is in possession of the "chops" and where they are being kept. Create a protocol for tracking their usage and storage. Consider that if you must unfortunately replace a senior leader of your China organization, you would be well advised to first locate and secure possession of the corporate seals or "chops," along with any other keys to physical and digital assets, before proceeding with the replacement. I have been involved in several recovery efforts that were required after the "chops" were retained by alienated staff (without authorization) as a bargaining chip in severance negotiations, whose absence left the company's operations temporarily paralyzed.

5. Establish financial oversight

There is a good chance your Chinese partner and his or her team are unaccustomed to "international" compliance standards. Depending upon your own standards and expectations, it will be important to set the right tone from the beginning of the joint venture. Secure the right to appoint the finance manager, along with the right to select the accounting service provider and auditor. Have your team take charge of building the financial management and reporting system from the very beginning. If you cannot secure such management, at least obtain rights to regular internal financial review (at company's expense) by a third-party service provider of your choice.

Besides securing the right to appoint the general manager and/or financial manager, consider creating additional reporting channels. You might consider embedding representatives of your own into the joint venture organization to both leaven the cultural milieu and to provide regular reports on company activities. You will need to select representatives with strong linguistic and cultural fluency who can operate effectively in the Chinese context.

6. Critically review proposed commitments and hold back whenever possible

Once the joint venture is officially registered, you are committed in accordance with its contract terms. One of the hard commitments is the "registered capital" commitment, the amount of capital you will be required to pay into the joint venture's special capital account in China, which cannot be easily withdrawn. Even though you might persuade your joint venture partner to reduce your capital commitment, you must also obtain official Chinese approval to do so, which will not be readily forthcoming.

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Hiring is another form of hard commitment in China. Downsizing involves a resource intensive process, typically involving the payout of severance in negotiated settlement with each employee. Move methodically when expanding China operations; it will not be easy to reverse course. I received a Sunday night call from a large U.S. real estate investor: "We're laying everyone off tomorrow; is there anything we should know?" I noted that there were a few things we should talk about first, and then asked that they delay the layoff. They did not take the advice and that same team abruptly left the country a week later, amidst a rapidly deteriorating situation over which they had lost control.

When you are creating your commitments in the joint venture contract, negotiate vigorously to limit your commitments and delay their implementation as long as possible. Draft the joint venture contract terms so that your contribution of capital and other assets can be made over an extended period of time, preferably upon reaching tangible milestones, and consider making them conditional on your partner's matching contributions. Your partner will resist, and these terms may not pass official review by Chinese authorities, but try your hardest.

Another hedging strategy to consider, where practical, is to divide and segregate your China operations. Limit your commitment to the joint venture to the absolute minimum, then establish and operate a parallel structure in the form of a wholly foreign-owned enterprise (WFOE) that supports the joint venture's activities through services contracts and/or licensing contracts. This way, you will have greater control over your China operations with the singular ownership of the WFOE that supports the joint venture. If and when you encounter trouble with your joint venture, or a Board deadlock occurs, you will retain unimpeded control over the other half of your China operations.

Another commitment that is hard to reverse once made is that of your intellectual property. Chinese partners are notorious for pressuring foreign investors to contribute intellectual property to joint ventures. Resist this pressure and, to the extent practical, extend only limited IP rights to the joint venture (e.g., licensing rights), then implement rigorous controls to avoid theft and leakage. Such hedging may be met with ferocious objections by your Chinese partners, but take this as a sign you're on the right track.

I participated in a joint venture negotiation where, at the very last minute before a major media event to announce the joint venture's establishment in a smaller Chinese city, the Chinese partner demanded that the foreign investor pass title to the key software to the joint venture and pushed for the code be placed in escrow in China.

Why is passing title to the joint venture such a concern? For reference purposes, here's the oft-cited worst-case scenario. You have contributed title to IP to a joint venture, then the joint venture board deadlocks or the joint venture becomes insolvent and its management becomes paralyzed. Meanwhile, the IP has leaked somehow and a competitor has launched a new business using your IP. Amidst the board deadlock or insolvency, the joint venture is impotent to enforce its rights.

7. Be excessively diligent in your follow-through

Your hard-won negotiating successes and thoroughly prepared agreements are a great start, but in China you must follow through on every point and make sure nothing slips through the cracks. Hire your own legal or advisory team in China, one that will very diligently follow through on every detail of your joint venture establishment. For example, make sure that the joint venture contract and articles that you have signed are the actual ones filed, specifically including the Chinese versions.

Your stubborn attention to detail and practical matters should continue from there. For bank accounts, make sure you know who has been registered to access and use the bank accounts and who has been given tokens for online access, etc. Check the actual bank records and don't just rely on what one advisor has told you. Have a diligent and tenacious team member at headquarters follow up with your local advisors in China to double-check everything.

Conclusion

Trade tensions and political turmoil have frightened investors of foreign companies expanding into China, yet the large and increasingly prosperous Chinese consumer base is very difficult to overlook. Joining forces with a local partner to navigate domestic consumer markets and manage government relationships seems a natural risk mitigation strategy. Yet to create a successful joint venture would involve considering and correcting for mistakes of the past.

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