China Joint Venture: 7 Considerations to Reach a Successful JV Agreement

Since the outbreak of the COVID-19 pandemic, we have observed a new trend in China's foreign direct investment (FDI) area: more foreign investors have shown intention to choose the joint venture (JV) structure to enter the China market than compared to past practices.

Generally, most foreign investors have been cautious in choosing the JV mode as their market-entry approach of choice due to prospective managerial complexity, different cultures and business approaches between the partners, and high risk of technology leakage.

However, in the volatile, uncertain, complex, and ambiguous (VUCA) world of today, the JV structure has become popular for start-ups and large multinational companies.

For the foreign stakeholder, opting for a JV is a way to reduce their upfront investment, share costs, and minimize risks by working with a local partner who is familiar with the local market, local culture, local knowledge, and local policies and practices.

Meanwhile, travel restrictions due to the pandemic may be another reason for the growing trend towards the JV as foreign investors have begun to rely on their local partners' access to the local market much more than in the past.

Common reasons for the failure of a China joint venture

While taking advantage of the joint venture mode, as mentioned above, it is also necessary to examine past experiences to understand why JV companies in China were unsuccessful or short-lived.

The most common reasons for the failure of JVs are summarized as below:

- The joint venture partners do not communicate clearly about their respective goals and objectives when establishing the JV.
- The JV partners contribute different levels of investment, input, and assets (including tangible assets and intangible assets) or resources to the JV, which are contrary to the original agreement.
- Different cultures, management styles, and business approaches result in poor understanding, cooperation, management, and integration in the real business operation.

- The JV partners fail to discuss the future capital increase or fund-raising approaches for business development as this may impact the partners' shareholding percentage in the JV.
- The JV partners fail to design the deadlock, exit, and termination mechanism for cases where expectations are not met.

These reasons indicate that most cases of JV failures are related to defects in the JV agreement on key matters.

Therefore, before being able to take advantage of the JV mode, it is essential for the two parties to design and reach a clear, well-thought, and prospective JV agreement so as to conclude a business relationship professionally, effectively, and avoid or at least minimize future disputes between the JV partners.

In this article, **Dezan Shira & Associates** experts share their experiences in reaching China joint venture agreements.

Things to pay attention to in the MOU stage

Before preparing for a formal JV agreement, there are some key points to be discussed and agreed in the Memorandum of Understanding (MOU) stage as provided below:

1. Set out the parties' intentions
2. Recognize each partner's contribution
3. Identify the expected achievements of the JV as well as the performance measurement approaches
4. Discuss what actions can be taken if expectations are not met
5. Anticipate likely risks and future events and set out how they are to be managed

Consensus on these points lay the basis for the conclusion of the formal JV agreement.

7 things to consider when reaching a formal JV agreement

Apart from the above commercial considerations, the JV partners are suggested to pay special attention to and make proper arrangements for the below key legal clauses in the formal JV agreement so as to protect the interest of their own.

1. Shareholding ratio and capital contribution

Shareholding ratio determines how much weight each shareholder owns to pass resolutions and make decisions on significant matters.

According to *PRC Company Law*, the shareholding ratio of a limited liability company is normally subject to the capital subscribed by each shareholder. Therefore, the shareholder of a limited liability company shall cautiously consider the percentage of the total registered capital subscribed by itself and the shareholding structure of the JV.

For a start-up company, the core shareholder may seek for direct and absolute control over the JV for efficient decision-making. To achieve this goal, such shareholder shall at least own 66.7 percent for passing significant resolutions at its own discretion.

As to capital contribution, it should be clearly and comprehensively discussed in the JV agreement – the total subscribed amount, method, and timeline of capital contribution determines whether the JV can operate as anticipated. *PRC Company Law* allows the shareholders to freely decide on the total amount and the timeline, and the contribution method can be in cash or in kind if the non-cash properties can be valuated and transferred.

2. Commitments and inputs of each JV partner

Each shareholder may have different obligations to the JV. For example, the foreign investor may provide brand, technology, machinery, advanced management experiences, and develop the overseas market, while the Chinese investor assists in exploring the domestic market, sourcing for the materials, and running the operation locally. Under such a scenario, the JV agreement shall specifically arrange certain clauses to put the oral agreements on record, and schedule corresponding default clauses in case either party does not fulfill its promises.

3. Profit distribution

The ultimate goal of investment is to obtain profits. The profit distribution method is thus of close interest to the parties of the JV.

Article 34 of *PRC Company Law* sets forth the general principle of profit distribution as to sharing profit in accordance with the ratio of paid-in capital contribution.

On the other hand, Article 34 also allows the shareholders to break through above general principle by mutual agreement. That is to say, the shareholders are entitled to set out a principle on profit distribution based on their free will, such as sharing profits in accordance to certain percentage other than subscribed capital, and such principle should be included in the JV agreement.

To be noted, although the shareholders are entitled to agree on the ratio of sharing profits based on their discretion, the shareholders and the JV still need to follow the bottom line of profit repatriation, meaning that the profits can only be distributed to the shareholders after making good on losses, contributing to the statutory surplus reserve, and paying taxes.

Some foreign investors may seek for return of investment in a more time-flexible and tax-efficient way. As such, JV partners may consider discussing about other income repatriation methods, such as paying agreed service fee, royalty fee, and loan interest to the shareholders, and indicate the methods in certain terms of the JV agreement or sign separate agreements, such as service agreement, license agreement, and loan agreement to consolidate such arrangements.

4. Voting rights

The voting rights exercisable by shareholders are the basic and fundamental channel for the shareholders to participate in the supervision and management of the company.

Exercising voting rights is normally based on the ratio of capital contribution, unless otherwise provided in the articles of association of the company.

Based on actual needs, shareholders may consider reaching a consensus in the JV agreement and state in the articles of association that either party has the veto right on certain very important matters to prevent the interest of one shareholder being jeopardized by other shareholders. On the other hand, however, the veto right should be designed and used wisely, otherwise it will likely impact the management efficiency and decision speed.

5. Equity transfer and prospective capital increase / fund raising

The parties to the JV may transfer the equity, increase the capital, or raise fund during the operation of the business.

For a limited liability company, *PRC Company Law* protects the integrity of shareholder's partnership, encourages that the equity interest should be transferred among the shareholders under the optimum conditions, and allows articles of association to lay down special rules regarding the equity transfer to the external third parties. This leaves room for the arrangement of tag-along, drag-along, and other clauses. (The tag-along clause refers to a clause in an agreement that enables the minority shareholder to join the transaction and sell their minority stake in the company if a majority shareholder sells their stake. Drag-along clause refers to a clause in an agreement that enables a majority shareholder to force a minority shareholder to join in the sale of a company.)

Apart from the internal and external equity transfer, capital increase and equity expansion in varying proportions among the existing shareholders will also trigger the change of shareholding percentage, when shareholders intend to expand business or raise funding. Therefore, shareholders should also think about these possibilities and agree on the solutions in written in advance.

6. Non-competition clauses

To prevent shareholders from commencing similar business activities as the China joint venture and jeopardizing the interest of the JV and other shareholders, non-competition clauses shall be considered and included into the JV agreement.

Non-competition clauses may define the scope of the subject who are subject to the non-competition obligations, the restricted industry or business activities, and the certain territory and duration of time limit. Under certain circumstances, the subject undertaking the non-compete obligations can expand to the natural person who ultimately controls the corporate shareholder as well as his/her direct relatives.

7. Deadlock and exit mechanism

Ideally, the partners should manage the existence and closure of the JV through close cooperation to the greatest extent. However, it may not always be the case in practice. It’s not rare to see the relationship turn ugly among JV partners and the JV entering a dead end when a consensus cannot be reached.

To prevent potential deadlock or dispute, parties to the JV should take preemptive measures – that is, insert clear measures into the JV agreement. This is especially important given the current trend of the global economy.

Measures can include a well-organized corporate constitution and voting mechanism, a list of behaviors that can seriously damage the foundation of the cooperation, a list of right to exit and triggering events, etc. The combination of several measures in the JV agreement will grant flexibility to the shareholders when a worst scenario occurs and protect the shareholder’s interest.

Key takeaways

For all prospective JVs, a well thought out JV agreement will be key to their success in China. When reaching a joint venture agreement, investors are suggested to pay attention to certain important matters, including shareholder ratio, capital contribution, commitments to the JV, profit distribution method, voting rights, equity transfer, capital increase, non-competition clauses, and deadlock and exit mechanism, among others.

Dezan Shira & Associates is happy and able to provide advisory and relevant support when needed, and we welcome investors who intend to adopt the JV structure for their China business to come to us for further discussion or email us at **vivian.mao@dezshira.com.**

This article was first published by China Briefing, which is produced by Dezan Shira & Associates. The firm assists foreign investors throughout Asia from offices across the world, including in China, Hong Kong, Vietnam, Singapore, India, and Russia. Readers may write to info@dezshira.com for more support.