The pros and cons of joint ventures

Joint ventures are becoming less visible in Chinese foreign investments. But David Boitout and Bastien Trelcat of Gide Loyrette Nouel say they still have their uses

When Deng Xiaoping opened the Chinese economy to foreign investors in the late seventies, he paved the way for regulations permitting ventures between Chinese and foreign companies. Those regulations however, did not go so far as to permit foreign players to engage in cross-border activities. Foreign companies were effectively locked out from making investments if they did not have a physical presence in China.

The next decade of economic liberalization resulted in big increases in the number of foreign invested enterprises (FIEs) being established. They took the form of equity joint ventures (EJV), cooperative joint ventures (CJV), or wholly foreign-owned enterprises (WFOE).

In the wake of these changes, regulations were adopted that set the stage for joint venture companies to be established through M&A transactions. A regulatory framework for these activities was created, where none existed before.

China's accession to the World Trade Organization in 2001 has helped enormously to level the playing field in China for foreign investors, by further opening previously closed sectors of industry to foreign investment.

By gradually lifting restrictions on foreign players, particularly in the service sector, and increasing the number of industries where WFOEs are now allowed, the Chinese government has well and truly let the foxes into the hen house. It has also altered the need for foreign investors to resort to using joint ventures companies involving a Chinese partner.

In this changing landscape have joint ventures suddenly become passé?

The Catalogue for foreign direct investment

To implement its WTO commitments, from time to time China promulgates an updated version of the *Catalogue for the Guidance of Foreign Investment*. The Catalogue classifies foreign direct investment projects into three categories: encouraged, restricted and prohibited. All foreign investments that are not included in the Catalogue are permitted. The level of approval for the project and the availability of tax holidays are both derived from this all-important classification.

The Catalogue, together with the applicable regulations in each sector, also nails down the permitted levels of foreign ownership and the corporate form for project companies. In limited liability companies (LLCs), which include EJVs, CJVs and WFOEs, registered capital is exchanged for equity interests. In contrast the registered capital of companies limited by shares (CLS) is divided into shares. However, investors' liabilities in both types of companies are capped at their contributions to the registered capital.

A CLS possesses a striking similarity to western stock companies. It is governed by a board of directors under the supervision of its shareholders assembly. In contrast to LLCs, no decisions in a CLS need the unanimous consent of its shareholders. Also, a CLS may be listed on a PRC stock exchange.

Depending on the provisions of the Catalogue, the exact form of an LLC (either an EJV or a CJV) may either be allocated or left to the investors' discretion. While the rules governing both entities are slightly similar, the regulations applicable to CJVs offer some additional benefits, including more flexibility for the investors in determining their relationships within the company.

For example, EJV regulations are firm on the point that both the number of directors and the division of profits should strictly reflect the investors' shareholdings. This requirement does not exist for CJVs, which allow investors to arrange voting rights and the dividend rights differently. CJVs are commonly recognized as useful tools for infrastructure or energy projects where investors wish to get together on terms that are not commonplace in China.

Investors might also elect to establish a CJV that has no separate legal identity to investors. In this situation, each investor is responsible for contributing to the venture, paying its own taxes on profits derived from the venture, and bearing its own liability for risks and losses. However, this category of CJV is rare.

Often, instead of being a business option, resorting to a joint venture is an obligation. The Catalogue frequently gives no other choice to foreign investors who wish to invest in a wide range of industries (life insurance, energy, construction of transportation facilities, higher education and healthcare).

Establishment rules

October 2004 was noteworthy for the *Interim Foreign Investment Project Ratification Administrative Procedures* promulgated by the National Development and Reform Commission (NDRC). The Procedures provide that foreign investment projects will be dealt with as follows, depending on their level of total investment (including increases in capital) and classification in the Catalogue:

- Projects with either: (i) a total investment of $100 million or more in the encouraged or permitted categories; or (ii) $50 million or more in the restricted category, must be reported to NDRC for ratification.
- Applications for projects that are either: (i) in the encouraged or permitted categories and have total investment amounting to $500 million or above; or (ii) are in the restricted category and have total investment amounting to $100 million or above, will be submitted to the State Council for final verification after initially being examined and verified by the NDRC.
- Encouraged or permitted category projects where the total investment is below $100 million and restricted category projects where the total investment is below $50 million must be ratified by the local NDRC. These restricted category projects must also be ratified by NDRC at the provincial level.

As far as the approval process is concerned, recent proposals have been made by several ministries aimed at boosting control and approval conditions for foreign investment in certain industries. They include shipbuilding, nuclear activities, and equipment for the petrochemical and steel industries.

To circumvent this hurdle, foreign investors often decide to select a Chinese ally to dissuade administrative bodies from raising difficulties or delaying the approval of the project. Chinese partners also frequently undertake to supply both the joint venture and the foreign investor with market knowledge, contacts and legal and political information that would ordinarily be out of reach to the foreign party. These types of obligations can greatly assist with approval processes and formalities as well the smooth operation of the company.

In particular, land use rights needed by the joint venture might already be owned or could be acquired faster by the Chinese partner than by a foreign company wishing to establish an FIE as a sole investor.

Lastly, to a certain extent the Chinese investor is in a better position to champion the rights of the joint venture than the joint

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venture itself, should difficulties arise in the course of operations.

Establishment by acquisition

Foreign investment in China has traditionally taken the form of greenfield joint ventures. Yet after 2003, the popularity of M&A transactions skyrocketed among foreign investors wishing to enter the Chinese market immediately or to control their supply chains in China.

Foreign investors have two options when purchasing equity: either investing in an FIE or in a Chinese company with no foreign investment. This Chinese company is then transformed into an FIE after the acquisition.

Any acquisitions require the approval from Ministry of Commerce (Mofcom) or its local branches. Additional approval from agencies in various sectors of the economy might also be required. For example, transactions in the banking sector must get a green light from the China Banking Regulatory Commission, while transactions in the insurance sector require the China Insurance Regulatory Commission's approval.

In this regard, in August this year Mofcom revised the regulations on M&A transactions (*Provisions on the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*). Those revised regulations will require new regulatory approvals for transactions involving offshore special purpose vehicles.

After an investment project is approved, the investors can proceed with registering the project company with the administration for industry and commerce. This agency will also issue a business licence to the joint venture, which is needed before the joint venture company can open for business.

Table 1: Investment-capital ratios

Category	Total investment (TI)	Minimum registered capital
1	Up to $3 million	At least 70% of the TI
2	From $3 million to $4.2 million	At least $2.1 million
3	$4.2 million to $10 million	At least 50% of the TI
4	$10 million to $12.5 million	At least $5 million
5	$12.5 million to $30 million	At least 40% of the TI
6	$30 million to $36 million	At least $12 million
7	More than $36 million	At least 33.33% of the TI

Means and amount of contributions

Joint ventures and WFOEs have a limited capacity to become indebted. As a result, their registered capital must never be less than a certain proportion of their total investment. In this context, total investment refers to the sum of the registered capital and the amount of the company's medium- and long-term debts (see Table 1).

Capital contributions can be made in cash, patented and unpatented technology, materials and equipment or other property rights. Investors to a CJV (usually Chinese investors with insufficient financial facilities) may also contribute *cooperative conditions* in exchange for an agreed share of the profits. These could consist of access to or use of certain assets or rights that are not formally transferred to the CJV, including market access rights or undertakings to supply certain services that will drum up business for the CJV.

Corporate governance and exits

Two separate regulatory systems exist for FIEs and purely domestic Chinese companies. FIEs fall under several regulations that govern the incorporation and operation of FIEs. However, the new Company Law (the New Law) issued by the People's Congress became effective in January 2006. The New Law governs domestic companies but also supplements the laws and regulations applying to FIEs. If there is a conflict between the provisions in the regulations on foreign investment and the New Law, the regulations prevail. Consequently, the New Law only applies to joint ventures in areas where the existing regulations on FIEs are silent.

For example, the New Law makes a general provision broadening the range of methods by which investors can contribute to registered capital in companies. Contributions of "non-cash assets which have a monetary value and are legally transferable" can now account for up to 70% of the new company's total registered capital. However, the New Law does not specify whether *non-cash assets* include shares. Unfortunately, as a result, this new rule will not benefit foreign investors establishing joint ventures until changes are made to the current FIE regulations. However it will immediately benefit foreign investors establishing CLS, as regulations for this type of company do not address contribution methods.

From a business perspective, the management structure EJVs and CJVs is similar. Both function with a board of directors (or a joint management committee for a CJV) and a general management department that is supervised and directed by the board of directors. However, these entities also share many characteristics of a partnership in that the parties appoint

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directors roughly in proportion to the investors' respective shares. There is no concept of a shareholders meeting where the power is concentrated at board level.

In practice *legal-person* CJVs typically adopt the board of directors model. The CJV law also permits management of a CJV to be delegated to a third party with government approval. This arrangement has been the standard mode of operation for the hotel industry. It has the potential to be used in other industries as well, although it is not common.

Associations with a Chinese partner can become tricky when unanimous decisions by the board required for the following are not obtained:

- amendments to the articles of association;
- termination and dissolution;
- increases or reductions of the registered capital; and
- mergers or divisions;

Negotiating an exit from a joint venture company could be problematic as transfers of equity interests require: (i) partners' consent; (ii) waivers of pre-emptive rights; and (iii) approval from Mofcom or local agencies.

Lastly, it is true that the parties generally negotiate the events that will trigger the termination of a joint venture. However, as a practical matter, termination usually requires action by consensus embodied in a unanimous board resolution. Even where parties are obliged to make sure their appointed directors approve a resolution in agreed circumstances, they could still instruct their directors to breach these obligations and drag their feet on the exit process.

Tax aspects

From a taxation perspective, the selection of a joint venture or a WFOE is neutral. FIEs and other foreign enterprises that are present in China and engaged in production activities are subject to foreign enterprise income tax (FEIT) at the rate of 33%. Reforms to the FEIT system are under discussion and FEIT is expected to be reduced to 24% or 25%. No particular timetable for this change has been announced, but it will probably not come into effect before 2007.

FIEs are able to take advantage of systems of national and local tax incentives depending on their locality and activities. The most common incentives include, for FIEs engaging in manufacturing activities, a two-year exemption followed by a three-year 50% FEIT reduction starting from the first profit-making year.

Tax relief may be also obtained for investments in certain industries, localities or zones, such as in western China. However, these tax incentives are expected to evaporate in line with the FEIT reforms. The good news for FIEs established under the current FEIT regime is that they are expected to be able to keep their current tax benefits after the reforms are completed.

Foreign investors who are not present in China, might have FEIT of around 10% withheld from certain income streams including interest from loans, rental income and royalties from trademarks or copyrights.

Joint ventures still of use

It is widely acknowledged that there are some significant pitfalls associated with joint ventures, namely irregular tax treatment and possible snags in unanimous decision-making.

Another element that foreign investors should take into account is how the costs and economic risks linked to the investment project can be shared. Foreign investors whose financial capacity and expertise of the Chinese market are satisfactory can afford to set up a WFOE on their own when a joint venture is not mandatory under the Catalogue.

However, all these things might also influence the foreign investor's decision to team up with a Chinese partner who can contribute assets and put precious knowledge and market shares in the basket of the foreign investor, which would otherwise be unreachable. From this perspective, the establishment of a joint venture in association with a valuable Chinese partner will always have some practical benefits compared with WFOEs.