Joint Ventures in China - Getting Started

November 2018

Joint ventures in China offer huge opportunities for overseas companies. In certain industries, foreign ownership restrictions mean that a JV is the only way for an overseas player to access the China market (e.g. agriculture and value-added telecommunications services). In areas where there is not a legal requirement to do so, it may still be commercially advantageous for overseas companies to team up with a local partner. For example, as a result of the Chinese indigenous innovation policy in the hi-tech sector, a China JV may have better access to parts of the Chinese market than a wholly foreign owned business.

China is in the process of relaxing foreign ownership restrictions in certain industries, most recently in June 2018 when it was announced that foreign ownership restrictions would be relaxed or lifted in 22 areas. For example, the limit on foreign investment in certain financial services companies was relaxed to 51%, and is due to be removed entirely by 2021. Overseas companies should check the status of any relevant foreign ownership restrictions at an early stage, as this may affect the optimal timing for their JV project.

Joint ventures in China also carry a series of risks and complexities that need to be factored into clients' assessment of the opportunity. The aim of this briefing is to set out what we think are the main early stage points for overseas companies to think about.

Early stage commercial decisions

At the outset of any JV project, companies face a number of fundamental business decisions: determining the scope of the JV and its product/service proposition; choosing the right partner or partners; and determining where the JV should be located.

The choice of partner is key for a China JV. The overseas partner will want to find a local partner that can accelerate the growth of the new venture, and will also be focussed on the local partner's reputation, anti-bribery and corruption record and history of regulatory compliance. Local partners in cross-border JVs will often look for overseas partners that can offer them strategic advantages, including by providing know how and/or technology. This may create risks for the overseas partner where the local partner is an existing or potential competitor or a state-owned enterprise.

The location of the JV may be driven by the location of the Chinese partner. However, in many cases, international companies will target the Free Trade Zones, which are subject to a different and less extensive set of foreign ownership restrictions and may offer various other advantages such as tax benefits and more flexible foreign exchange arrangements.

Early stage legal considerations

Overseas companies should also address the following key initial legal and structuring considerations as early as possible with their legal adviser.

1. Structure

If the JVCo is incorporated in Mainland China, this is referred to as an "onshore" JV (or "Sino-foreign joint venture"). The contractual arrangements between shareholders for an onshore JV will need to be governed by PRC law.

A contract governed by PRC law can accommodate the customary terms of a JV agreement, including reserved matters, restrictions on transfer, rights of first refusal, drag and tag along rights, put and call options and non-compete provisions. However, PRC law is less flexible than the alternatives and certain provisions may not be possible to achieve "onshore" (e.g. differing shareholder returns or complex exit mechanics). Practical enforcement of the terms of a PRC law-governed JV agreement will also need to be considered. For example, if the partners agree to make certain share transfers on termination or breach, in practice, these transfers will be subject to approvals by local PRC authorities. The PRC authorities may require, as part of their approval process, documents issued by the JVCo to be signed by all incumbent directors or shareholders, which would effectively grant an additional veto right to the local partner if it withholds the signatures of itself or its representatives. An experienced lawyer should review the proposed JV terms to identify red flags and possible roadblocks for enforcement.

Unless there is an imperative for the JV to be onshore (e.g. regulatory requirements or eligibility for government grants), the parties may favour an "offshore" structure. Here the JVCo is set up in a jurisdiction other than Mainland China, and it in turn incorporates a "wholly foreign owned enterprise" or "WFOE" in Mainland China to be the operating company of the venture.

Offshore structures have generally been preferred in the past in large part due to the contractual flexibility and certainty of contract other jurisdictions such as Hong Kong can offer. An offshore structure may also offer tax benefits for the partners. In particular, China imposes withholding tax (**WHT**) on dividends at 10%, unless reduced under an applicable tax treaty. There is a treaty with Hong Kong that reduces WHT on dividends to 5%. As such, taxes may be lower where profits are distributed via an offshore JVCo, rather than directly to the overseas investor.

Even where the JV is "offshore", an enforcement strategy should be considered, including an appropriate forum for disputes, bearing in mind that any judgment or award obtained against a Chinese company in the JV structure, or the Chinese partner itself, would likely still need to be enforced in China. Arbitration in Hong Kong is a good option.

2. Verifying viability

In a China JV, it is more important than usual to take advice at the term sheet stage given the complexities involved. The term sheet, even if non-binding, should be a fact-based document that confronts directly any legal, structural and regulatory challenges. A failure to tackle the key issues early can lead to wasted time and costs, which could have been avoided by pushing harder and asking the difficult questions first.

For offshore JVs, the partners will need to address early how the Chinese partner will hold its shares in JVCo, given the constraints on overseas investment by Chinese companies. If the Chinese partner will require an approval to invest in JVCo, then the prospects of obtaining that approval should be assessed realistically, or its ability to invest from overseas should be explored.

Chinese companies are subject to restrictions on making payments overseas. Overseas partners need to get advice on whether any restrictions could prevent the Chinese partner from fulfilling any of its payment obligations, including any initial consideration and any milestone and/or termination payments. Practically speaking, it may be helpful to provide for an upfront payment from the Chinese partner (e.g. a licence fee). A plan for extracting cash from the JV structure should be worked up in light of any PRC approvals that are needed for payments as well as the tax advice. Overseas partners should consider how best to manage the risks of not obtaining any of the required PRC approvals.

3. IP protection

IP law is less developed, and enforcement is much more difficult, in China, which in turn means that the attitudes of the JV partners towards IP infringement may be quite different.

The best means of protecting IP will always be fact-dependent, but tends to be a mixture of the practical and the legal. In practice, once an IP infringement has occurred within China, the situation may be difficult to retrieve and the chance of a satisfactory remedy are low. Therefore, the overseas partner should be focussed on its upfront protection, and cautious about sharing any sensitive information (such as designs or processes) before all aspects of the IP protection framework have been established.

On the practical side, it is often helpful for overseas partners to have their own employees involved in the operation of the JV from the outset, particularly in technical roles or other functions where they can oversee the JV's use of IP. Overseas partners can consider providing technology or other IP on a staged basis, so the JV's success and practical ability to protect IP is well understood before the most sensitive information is shared.

On the legal side, the JV arrangements will need to include strong protections on confidentiality and IP misuse; a tightly drafted regime to govern the ownership of background and foreground IP; appropriate non-compete provisions; and appropriate licence termination provisions in favour of the licensor. Even if the JV agreement is not governed by PRC law, there are likely to be a number of PRC requirements to navigate, e.g. the rules regarding technology import contracts.

Contacts

Chris McGaffin, Partner

Chris's experience in 2018 includes advising Arm Limited on the establishment of a joint venture for Arm's semiconductor technology in China; SoftBank Vision Fund on two minority investments in Chinese tech ventures; Amyris Inc on certain biotech ventures; and various other clients on their life insurance and fund management ventures in China.

T +852 2901 7230
E chris.mcgaffin@slaughterandmay.com

Clara Choi, Partner

Clara's experience in 2018 includes advising the Pan Asia Pacific Aviation Services on the joint venture investment from Hong Kong Airlines; SoftBank Vision Fund on two minority investments in Chinese tech ventures; and Alibaba on its joint venture with Auchan Retail in relation to Sun Art Retail, a company listed on The Stock Exchange of Hong Kong Limited.

T +852 2901 7217
E clara.choi@slaughterandmay.com

Oliver Broomfield, Associate

Oliver's experience in 2018 includes advising Amyris Inc on certain biotech ventures and various other clients on their life insurance ventures in China.

T +852 2901 7251
E oliver.broomfield@slaughterandmay.com

Justin Chan, Associate

Justin's experience includes advising the Ascendas-Singbridge (a joint venture between Temasek and JTC) on its formation of a Chinese real estate joint venture with China Merchants Land, a company listed on The Stock Exchange of Hong Kong Limited.

T +852 2901 7208
E justin.chan@slaughterandmay.com

© Slaughter and May 2018
This material is for general information only and is not intended to provide legal advice. For further information, please speak to your usual Slaughter and May contact.