

Patrick E. Mears and Eric Wang on

THE USE OF EQUITY JOINT VENTURES with CHINA'S AUTOMOTIVE INDUSTRY

2016 Emerging Issues 7465

[Click here for more Emerging Issues Analyses related to this Area of Law.](#)

I. INTRODUCTION

On May 5, 1983, the People's Republic of China ("PRC") and American Motors Corporation, a now-defunct United States auto assembler ("AMC"), ceremonially signed a series of historic agreements in the Great Hall of the People on Beijing's Tiananmen Square permitting AMC to manufacture and sell motor vehicles, namely the Cherokee Jeep, in China. This event marked the opening of China's automobile industry to foreign automakers. In the following year, China and Volkswagenwerk AG executed similar agreements granting VW permission to manufacture its Santana sedans in Shanghai.¹ In the decades following these initial developments, China dramatically opened its automotive market to more foreign competition; presently there are more than twenty global motor vehicle assemblers with operations in China. These operations are supported by a numerous foreign auto suppliers with operations located near these assembly plants spread throughout China. In 2009, in the midst of the Global Financial Crisis, China's annual domestic motor vehicle production surpassed that of the United States, thereby becoming the largest domestic automobile market in the world, a position that China still holds today. In 2015, sales of passenger cars in China amounted to 21,146,320 and sales during the first six months of 2016 are on a pace to exceed this annual total.

In order to establish manufacturing and sales operations in China, foreign motor vehicle assemblers are required by law to form joint ventures with Chinese companies. Although there are other organizational forms available to foreign assemblers, the "equity joint venture" under PRC law appears to be the entity of choice. In these joint ventures, foreign assemblers are limited to a maximum 50% equity interest and are required to own not less than a 25% interest in the limited liability company. The 50% maximum limit is inscribed in the 2015 edition of the Foreign Direct Investment Industries Guidance Catalogue published jointly by China's (i) National Development and Reform Commission and (ii) Ministry of Commerce ("MOFCOM"). This publication places the manufacture of complete automobiles in the "restricted" category of industries that may be invested in by non-Chinese entities, subject, however, to significant limitations. Foreign auto assemblers are also compelled to transfer their relevant manufacturing technologies to newly-created, equity joint ventures as part of the price for entry into the world's largest automobile market. These foreign assemblers, often referred to as "original equipment manufacturers" ("OEMs"), typically select as their equity partner a Chinese state-owned enterprise ("SOE") that manufactures and sells vehicles in China and perhaps elsewhere under its own nameplates. Foreign

¹ The sagas of AMC and VW embarking on their manufacturing adventures in post-Mao China are the topics of two books: Eric Mann, *Beijing Jeep: A Case Study of Western Business in China*, Westview Press, Boulder, Colorado (1997); Martin Posth, *1000 Days in Shanghai: The Volkswagen Story--The First Chinese-German Car Factory*, John Wiley & Sons, Inc., Hoboken, New Jersey (2008).

auto suppliers operating in China, however, are not subject to this joint venture mandate. Suppliers that fabricate components, assemblies and modules for ultimate delivery to automobile assemblers are not compelled by law to establish joint ventures with domestic companies, although many of these foreign companies voluntarily enter into joint ventures with a Chinese partner for increased market access. Foreign auto suppliers may also form “wholly foreign owned companies” (“WFOEs”) as separate vehicles for conducting business in China, which organizations do not require a Chinese partner. A number of foreign suppliers have formed both joint ventures and WFOEs in China, depending upon their particular needs and business strategies. Among foreign suppliers utilizing this dual approach are Robert Bosch GmbH, Delphi Group and Denso Group.

This article addresses and analyzes issues that arise for foreign OEMs and auto suppliers when they undertake to negotiate joint venture agreements with their Chinese counterparts in order to establish operations in China.

II. LAWS APPLICABLE TO CHINESE JOINT VENTURES

The concept of a “joint venture” under Chinese law is similar in many respects to the construct in American law that defines such an entity as “an association of persons formed to carry through a single piece of business, as opposed to a partnership, which implies continuity of business. Nevertheless, in the absence of a specific corporate form being employed, partnership principles apply to joint ventures.”² PRC law recognizes two different forms of joint ventures involving foreign entities: the “equity joint venture” (“EJV”)³ and the “cooperative joint venture.”⁴ Detailed Regulations have been adopted to supplement these two statutes, all of which must be consulted and applied when creating Sino-foreign joint ventures in China.

Cooperative joint ventures are not as widely employed as equity joint ventures; they have been most often used in certain economic sectors, such as real estate development and oil exploration. Unlike equity joint ventures, which require the parties to share profits and losses according to their proportionate share of equity in the entity, the cooperative form permits investors to make these distributions and assessments as agreed in the documents creating the joint venture. Other primary differences between these two forms of enterprise organization include the following: (i) governance and management of the entity is more complex in an equity venture compared to a cooperative venture; and (ii) whereas an equity venture must by law be a limited liability company, a cooperative venture may be organized as an entity with either limited or unlimited liability. This article discusses in detail only the organizational and operational issues of the Sino-foreign EJV and not those of the less utilized, cooperative joint venture. One important item to remember is that any matters not addressed by the two laws specifically governing these types of joint ventures and

2 “joint venture.” Collins Dictionary of Law. 2006. W.J. Stewart 25 Jun. 2016 <http://legal-dictionary.thefreedictionary.com/joint+venture>.

3 Law on Sino-Foreign Equity Joint Ventures. Adopted July 1, 1979 at the 2d Session of the Fifth National People’s Congress. Amended April 4, 1990, at the 3d Session of the 7th National People’s Congress in accordance with the Decision to Revise the Law of the People’s Republic of China on Sino-Foreign Equity Joint Ventures. Amended March 15, 2001 at the 4th Session of the 9th National People’s Congress in accordance with the Decision to Revise the Law of the People’s Republic of China on Sino-Foreign Equity Joint Ventures (hereinafter referred to as the “EJV Law.”)

4 Law on Sino-Foreign Cooperative Joint Ventures. Adopted April 13, 1988 at the 1st Session of the Seventh National People’s Congress. Amended October 31, 2000 at the 18th Meeting of the Standing Committee of the National People’s Congress by the Decision on the Revision of the Law of the People’s Republic of China on Sino-Foreign Co-operative Enterprises.

their corresponding regulations will be governed by applicable provisions of China's Company Law. Article 218 of the Company Law.

Finally, legal counsel for foreign OEMs and suppliers planning to establish EJVs in China should determine whether any local legal requirements for the proposed EJV, e.g., those enacted at the provincial or municipal level, modify national directives. Although the number of these local regulations has declined in recent years, they have not yet disappeared. Foreign counsel and their clients should also note that Chinese statutes, directives and regulations are typically drafted with few defined terms, which may generate disputes over the proper interpretation of these legal prescriptions.

III. BASIC ORGANIZATIONAL AND OTHER KEY DOCUMENTS

A. *Memorandum of Understanding.*

When negotiating the formation of an equity joint venture with a potential Chinese partner, foreign OEMs and auto suppliers will often be asked by their Chinese counterparts to enter into a "Memorandum of Understanding" ("MOU"), which document should be carefully negotiated and drafted as a non-binding document evidencing only the positions of the parties to be taken during the negotiations. Foreign parties who adopt this approach should realize that their Chinese counterparts will attach substantial importance to the MOU provisions and may argue that a later change in position by the foreign party during the negotiations constitutes a breach of trust, which may jeopardize the successful completion of the proposed transaction.

B. *Equity Joint Venture Contract.*

The Equity Joint Venture Contract ("EJVC") executed by the Legal Representatives of the parties at the successful conclusion of their negotiations is a binding contract under Chinese law setting forth the parties' rights and obligations *inter sese*. Standard provisions in EJVCs include the following:

1. The name and address of the EJV and its duration. Equity joint ventures in the automotive industry typically have a life of either twenty or thirty years, although their organizational life may be extended upon completion of the procedures outlined in Article 13 of the EJV Law.
2. The identification of the venture as a limited liability company, the purpose of the EJV and the scope of its business. Importantly, Chinese law requires that the business purpose and scope of the EJV be specifically described in the EJVC and the related Articles of Association, in contrast to similar laws of most American jurisdictions, which require only a general descriptions.

3. The total amount invested in the EJV by the parties. All stated sums must be expressed in Renminbi. As will be discussed below, when forming an EJV with a Chinese partner, the foreign party should perform extensive and careful due diligence on the capital contribution to be made by the Chinese member, especially when that capital consists of property other than currency. In these circumstances, it is common for the parties to obtain expert appraisals of these non-cash assets and attach schedules to the EJVA listing the nature and value of each element of registered capital contributed by the parties.
4. The requirement that the parties assist the EJV in obtaining possession of real estate and produce proof of ownership and status of any relevant land-use rights to land that will be used by the EJV in its business operations.
5. The establishment of a Board of Directors for the EJV, a description of the Board's powers and duties, the specification of a quorum requirement for board meetings and other voting requirements. The Board of Directors is typically appointed as the Legal Representative of the EJV, who is authorized to bind the EJV to its decisions and actions.
6. Creation of management positions, including that of Supervisor, General Manager, Deputy General Manager, Chief Engineer, Chief Accountant and Auditor. Foreign OEMs and suppliers when negotiating the EJVC and Association Agreement should thoroughly understand the nature and extent of the powers inherent in these positions and determine which individuals will be appointed to serve in these capacities. For example, because the powers of a EJV General Manager in China often exceeds the powers of CEOs in the United States, the selection of a candidate for this position should be made with great care.
7. Identification of labor management duties of management and the listing of management's duties to pay taxes, obtain working capital, and prepare accounting statements for the EJV. Chinese laws impose numerous taxes on business entities including business, foreign enterprise income, withholding and value-added taxes.
8. Description of the obligations of each party during the term of the agreement. The negotiation and description of these obligations are important to foreign parties, especially when they involve the selection and termination of auto suppliers furnishing parts to the EJV. Foreign parties should also seek to include a "minority rights" clause in the EJVC, which should (i) identify major decisions to be made by the EJV; (ii) define key decision-making processes; (iii) provide protections against dilution of the foreign party's EJV equity interest; and (iv) protect the

right of the foreign party to obtain adequate access to information concerning the EJV.

9. Description of how and under what circumstances the foreign OEM or supplier may exit the EJV, either by means of sale of the foreign party's equity interest or by dissolution of the EJV. The grounds for dissolution of EJVs and the procedure to followed are set forth in the EJV Law and the accompanying MOFCOM Regulations. Contractual exit provisions should be negotiated and drafted with reference to this law and regulations. Events triggering an exit often include defined amounts of losses suffered by the EJV over a specified time, an insufficiency or absence of profits generated over a defined period, occurrence of *force majeure* events, etc.
10. Specification of required dispute resolution procedures (e.g., mediation and/or arbitration) in the event of a disagreement between the parties.
11. Identification of the applicability of the law of the PRC to the interpretation and construction of the EJVC.

C. *EJV Articles of Association*

The Articles of Association ("AA"), also signed by the parties' Legal Representatives, contain provisions similar to those in the EJVC. Typically, the AA provide more detail on the powers and duties of Board of Directors and, like corporate by-laws employed in the United States, contain specifics for convening and holding of Board of Directors' meetings. AAs also confirm that the EJV's employees are entitled to establish a trade union and to conduct activities in accordance with the PRC's Trade Union Law. AAs also routinely display detailed provisions concerning the Board of Directors' and the parties' rights to terminate the existence of the EJV prior to its stated expiration date and describe with particularity procedures upon a voluntary liquidation of the EJV's assets.

D. *Other Important Documents Accompanying EJV Formation*

1. *Technology Transfer/License Agreements.* In negotiating with a prospective Chinese partner for the establishment of an automotive EJV, a foreign party will normally provide the enterprise with the necessary technology to fabricate motor vehicles or, in the case of suppliers, auto components, assemblies and/or modules. Chinese law governing Sino-foreign EJVs specifically requires that "technology and equipment contributed as an investment by a foreign partner must genuinely be advanced technology and equipment appropriate to China's needs. If

losses occur due to deception resulting from the intentional supply of outdated technology or equipment, compensation shall be paid.”⁵

The issue facing the foreign OEM or supplier faced with this requirement is whether (i) to simply license the technology to the EJV with appropriate protections, including the right to terminate the license on the EJV's default on its obligations under the license agreement; or (ii) to transfer title to this intellectual property as a capital contribution to the EJV. If a license agreement instead of a capital contribution is utilized, the foreign entity should register the intellectual property in China on an immediate basis and then license the technology to the EJV in return for royalty payments.

Additionally, MOFCOM regulations classify technologies imported into China and those exported from China into three categories: (i) freely importable, (ii) restricted, and (iii) prohibited. The EJV must comply with these legal requirements when intending to take these actions.

Finally, the parties in their documentation for the EJV's creation should define the ownership and usage rights of any derivative intellectual property that will be transferred or licensed by the foreign EJV member. These members should consider retaining engineering experts to assess potential intellectual property risks in order to define the proper level of precautionary terms in the documentation.

2. *Selection of Suppliers, Preparation and Negotiation of Supply Contracts and their Termination.* As discussed below, foreign parties may seek in negotiations to include in the EJVC provisions allocating to the foreign entity the sole power to select and terminate suppliers and to prescribe the terms of supply contracts up and down the value chain. By doing so, the foreign entity will maximize protections against liabilities resulting from warranty and products liability claims resulting from defective components manufactured by Chinese or foreign suppliers that are incorporated into assemblies and, ultimately, into the manufactured vehicles. In addition, reservation of the sole right to terminate a supply contract with a defaulting supplier should permit the EJV foreign partner to limit its losses by promptly resourcing the contract to another, more stable and/or expert supplier. This concern of the foreign party is heightened when either the manufactured vehicle or a component thereof is exported to other nations with strict warranty, products liability and consumer protection laws. In order to avoid future disputes, EJVCs often contain a list of suppliers that the EJV may contract with, which list has been prepared by the foreign party.

⁵ Law on Sino-Foreign Equity Joint Ventures, Article 5. See also Articles 25-27 of the MOCOM Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures.

E. Registration of EJV Documents

The paperwork required to establish an EJV in China is significantly more substantial and complex compared to that required to create a similar business entity in the United States. The more significant steps in this process are as follows:

1. Obtaining approval from the State Administration for Industry and Commerce (“SAIC”) of the proposed Chinese name of the EJV and the subsequent issuance of the approval certificate and business license. In order to clear this process, the foreign investor must submit large amounts of information concerning the EJV, which documents include (i) the business license of the foreign investor; (ii) a bank statement from the investor evidencing its creditworthiness; and (iii) copies of passports held by (x) the Legal Representative of the foreign investor and (y) the individual directors of the EJV. Other required submissions include the entity’s AA, a Feasibility Study Report, and an Environmental Impact Report describing the EJV’s proposed operations on the identified site and the EJV’s toxic waste disposal procedures and capacities.
2. The Certificate of Approval will be issued by the local office of MOFCOM. Within 30 days after the issuance of this document, the EJV must be registered with SAIC, which then will deliver a Business License to the EJV. At this point, the EJV formally comes into existence in China.
3. In addition to the foregoing, the newly-formed EJV must submit additional, post-registration paperwork with the Chinese authorities. These include (i) an Enterprise Code Registration; (ii) office inspection by the tax authorities; (iii) opening a capital account with a Chinese bank; (iv) registration with the customs authorities; and (v) application for general taxpayer status.

IV. DUE DILIGENCE AND NEGOTIATION ISSUES

A. Invested Capital of EJVs

As previously stated, a foreign OEM must have contributed at least 25% of the invested capital to the EJV but is prohibited from holding more than 50% of that capital. Although a prior version of China’s Company Law required a minimum registered capital for EJVs in the amount of RMB 30,000 and provided rules for the payment of this sum in a lump sum or installments, these requirements have been abolished. Nevertheless, counsel to foreign OEMs and auto suppliers planning to form a EJV should quickly determine whether these provisions have

been altered by more recent PRC statutes, administrative regulations or decisions of the PRC State Council.

B. Determination of Ownership and Valuation of Land and Buildings Contributed to the EJV

Article 5 of the EJV Law specifically provides that each party to an EJV may contribute as their respective investments in the enterprise “cash, capital goods, industrial property rights, etc.” The article continues by stating that a Chinese partner may also invest “site-use rights for an equity joint venture during its period of operations.” In the event that such rights “are not part of the Chinese partner’s investment contribution,” the EJV must pay site-use fees to the Chinese government. Finally, Article 5 requires that all items of investment described therein “shall be specified in the equity joint venture contract and articles of association.” The value of each item, excluding the site, must be determined by means of “joint assessment.”

It is not uncommon for a potential Chinese partner to propose to the foreign party that the Chinese entity contribute to the EJV factory buildings or other assembly facilities for use in the EJV’s manufacturing processes. The OEM or auto supplier, however, must determine through due diligence that the Chinese partner holds the right to occupy and use the land and buildings during the proposed term of the EJV. In these circumstances, the foreign party must verify whether the Chinese partner has legally cognizable “allocated rights” in the land for a period covering the proposed duration of the EJV. Allocated rights allow their holder to occupy and use the land for a period of years in the absence of legal “ownership” of that property. The risk involved with allocated rights is that improvements made on the land during the EJV’s possession will likely revert to the landowner upon expiration of these rights. In addition, if the Chinese partner proposes to enter into a use agreement with the EJV without a transfer of these rights to the EJV, then the EJV and the Chinese partner could be evicted upon the partner’s default under the terms of the agreement with the landlord.

Finally, because of the significant importance of contributing site-use rights to the EJV, the foreign OEM or supplier must review all Land Use Right Certificates concerning the subject property. In addition, the land and buildings subject to the site-use agreement should be appraised by an independent, certified appraiser for purposes of determining the value of the proposed capital contribution.

C. Repatriation of Profits to Foreign Countries

Article 8 of the EJV Law on specifically provides that, upon payment of all income tax liabilities, obligations due to employees and on their behalf, and other obligations, “the net profit of an equity joint venture shall be distributed

between the equity joint venture partners in proportion to their investment contribution to the enterprise's registered capital." If the foreign party reinvests its share of net profit within China's borders, that entity may "apply for a rebate on that portion of income tax already paid." Alternatively, Article 11 of this same law permits a foreign member of an EJV to remit this net profit abroad "in accordance with the exchange control regulations and in the currency specified in the equity joint venture contract" after paying certain specified obligations. Article 11 also encourages foreign parties who intend to remit these sums overseas to deposit them in the Bank of China.

In light of the foregoing, the foreign party should include in the EJVC a provision whereby the parties recognize these rights of remittance, specify the currency in which these remittances will be made and describe this process of remittance in detail.

D. Control Over Selection and Termination of Suppliers

In the global automotive industry, the assembly of a finished motor vehicle will normally occur at an assembly plant owned and operated by the vehicle assembler, such as General Motors Corporation or Volkswagenwerk AG. However, the components, assemblies and modules that are incorporated into the finished vehicle will be produced by other manufacturers in the automotive supply chain. These members of the chain are typically approved by the assembler, which is the end-user of their products, and operate on the basis of supply chain contracts that require "just-in-time" inventory systems. If one of these chain members becomes insolvent or otherwise unable to perform its manufacturing and delivery obligations on a timely basis, an extended lack of parts will often trigger production line shutdowns, resulting in actual, incidental and consequential damages in the millions of dollars. In addition, the selection of suppliers to provide these parts is of critical importance to the purchasing departments of other chain members that depend upon timely and uninterrupted deliveries of subject to express and implied warranties. In short, the selection of an incompetent or financially troubled supplier may cause significant damages up and down the chain.

For these reasons, it is critical for foreign OEMs and auto suppliers to control the process of selecting competent and financially stable suppliers of components, assemblies and modules that will be incorporated into their finished products. In addition, these foreign parties should solely determine the terms and conditions of the contracts to which the partners will be party to up and down the supply chain. This is of extreme importance, especially when substantial percentages of assemblies in present-day motor vehicles are extremely sophisticated and complex, electronic parts on which the proper functioning of these vehicles depend. Foreign parties should insist upon the inclusion of

provisions in the EJVC granting these protections and accomplishing these objectives.

E. Selection of Dispute Resolution Procedures

In the event of a dispute between or among the partners concerning the construction, interpretation and/or application of the EJVC, the AA or other relevant documents, the parties should agree upon an appropriate means of alternative dispute resolution and memorialize that agreement in the EJVC. Article 15 of the EJV Law provides guidance in these circumstances. This article prescribes a general rule of dispute resolution when the EJV's Board of Directors is unable to settle a dispute by consulting with the involved parties. In these circumstances, the dispute may be resolved through "consultation or arbitration by a Chinese arbitral body agreed on by all parties of an equity joint venture." EJVCs involving foreign partners often prescribe arbitration under the auspices of the China International Economic and Trade Arbitration Commission ("CIETAC") in Beijing, which organization has been widely recognized for its professionalism and expertise. Providing for arbitration by other, similar organizations in countries other than China should also be considered by the foreign party in negotiations over the terms of the EJVC and AA. If the EJV or the AA lacks an arbitration clause or the parties fail to reach a written agreement providing for arbitration after a dispute arises, then they may commence litigation in a PRC people's court. However, this method of dispute resolution may involve prolonged and expensive court proceedings and produce unpredictable results.

V. ENTERPRISE REORGANIZATION OR BANKRUPTCY LIQUIDATION OF A DISTRESSED EJV

There may be circumstances where the members of an EJV conclude that its business is not succeeding in the marketplace and that they desire to liquidate the EJV's assets, pay its liabilities, recover all or a portion of their capital contributions and deregister the business entity. Liquidation in these circumstances may be accomplished by dissolution accompanied by a voluntary winding-up procedure directed by a liquidation committee and that proposes an asset distribution plan for approval by the equity members and creditors of the financially troubled entity. Alternatively, the EJV members may conclude that the entity's core business can become profitable again notwithstanding recent, serious losses, provided that the EJV is able to reorganize under the protection of the PRC's Enterprise Bankruptcy Law. Although this law has been in force since June 1, 2007, it has not been utilized to any great degree to restructure financially troubled businesses until recently. This law operates similarly to Chapter 11 of the United States Bankruptcy Code by facilitating the rehabilitation of financially troubled businesses through the means of a reorganization plan that is submitted to creditors of the debtor for a vote in favor or against the plan and then is subject to approval by a people's court. Finally, in hopeless cases insolvent EJVs may also be liquidated by an administrator appointed under China's Enterprise Bankruptcy Law.⁶

⁶ See, e.g., China's Enterprise Bankruptcy Act of 2007, see Rebecca Parry, et. al, *China's New Enterprise Bankruptcy Law: Content, Interpretation and Application*, Ashgate Publishing Ltd., Farnham England (2010).

VI. CONCLUSION

The foregoing discussion and analysis is intended to give readers a broad overview of important issues to be addressed and resolved if and when foreign OEMs and auto suppliers investigate the possibilities of establishing motor vehicle manufacturing and assembly operations in the People's Republic of China via Sino-foreign equity joint ventures regulated by PRC law. In considering the issues raised and discussed herein (along with many others that will intrude during the process), the authors urge their readers to retain competent counsel located within China to advise them on these complex issues when deciding whether to establish manufacturing facilities in Mainland China.

[Click here for more Emerging Issues Analyses related to this Area of Law.](#)

About the Authors. **Patrick E. Mears** is an Adjunct Professor of Law at the University of Mannheim, where he has taught a course in International Trade Law since 2015. Previously, he was an equity partner in various United States commercial law firms, admitted to practice in the States of New York, Michigan and Illinois. While in private practice, he specialized in the areas of corporate insolvency, commercial transactions and distressed real estate. His clients included automotive suppliers, commercial banks and other financial institutions.

Eric Wang is a Managing Director of Alvarez & Marsal Asia and resident in Beijing, China. He is also the head of the firm's China Transformation Practice.

The authors would like to thank Craig Meurlin, Esq. of the Michigan-based law firm of Warner, Norcross & Judd LLP and Huan Gao of Alvarez and Marsal Asia's Beijing Office for their expert reviews of and comments on this article.

Emerging Issues Analysis is the title of this LexisNexis® publication. All information provided in this publication is provided for educational purposes. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.