

# How to protect foreign investors in Sino-foreign equity joint ventures?

## Description

Over time, foreign investors have come more and more inclined to “go alone”, i.e. setting up a WFOE (wholly foreign owned enterprise), when making green field investment in China. The reason behind is that Chinese partners may prove to be unreliable and may and can mess up things altogether. Look at the battle between Wahaha and Donone. Wherever it is possible to set a WFOE for investments in China, WFOE will always triumph over joint ventures with Chinese investors. However, some of the most profitable sectors in China’s economy are still restricted to foreign investment. Foreign investors who want to take a share of these cakes will have to partner with a Chinese company. Among those sectors is the outbound travel business in Chinese tourism industry. As more and more affluent Chinese people are extending their horizon beyond the borders of the country, outbound travel from within China has been on steady rise over the past. However, under current regulatory regimes, only selected Sino-foreign equity joint venture travel agencies are allowed to conduct outbound travel business according to the Interim Measures on Supervision over Pilot Projects for Sino-foreign Equity Joint Venture Travel Agencies Conducting Outbound Travel Business (the “Interim Measures”) jointly promulgated by National Tourism Administration and Ministry of Commerce. In other words, foreign investors shall have to partner with Chinese investors to set up equity joint venture travel agency in order to be selected as qualified travel agency under the Interim Measures.

Now when having to partner with (a) Chinese investor(s), foreign investors shall have to think over and over strategies and tactics that may be utilized to safeguard its interests in the joint venture company (the “JV Company”). We hereby introduce the following often-used tactics in protecting rights and interests of the foreign party. Such tactics shall be fully considered before entering into the partnership with Chinese parties and shall be clearly manifested in the joint venture contract, articles of association of the JV Company and other related documents.

### 1. Board and Management of the JV Company

Board of directors and management of JV Company mean the command and control of the JV Company and its operation. Foreign investors shall based on its equity ratio in the JV Company ensure that their interests are properly represented in the board of directors by securing a right to appoint certain number of directors on the board. Even as a minority shareholder, a foreign party shall make sure it is duly represented in the board. It may be possible for a minority foreign party to bargain for a veto right in deciding on certain corporate matters that will affect its interests most.

It is of particular importance to ensure due representation in the case of Sino-foreign equity joint venture whose board of directors is viewed as the highest power organ pursuant to relevant laws, which means most significant corporate decisions will be made by this board instead of shareholder meetings.

Due regard shall be given to the rules that govern the holding and conducting of board meetings. For instance, the quorum for a board meeting shall have to include the director appointed by a minority foreign party.

To guarantee the right to information especially in regard of corporate financial health, a foreign party may want to have a say in selecting the CFO for the JV Company and in selecting the accounting firm

that offers auditing service for the JV Company.

Since the Interim Measures do not impose restriction on shareholding of a foreign party in a joint venture travel agency, as a general principle, foreign investors will be better off to secure a majority shareholder status.

## 2. Non-competition by Chinese party

This will be paramount and vital clause you cannot afford to leave out in your joint venture contract with your Chinese partner. One of the biggest risks associated with partnering with Chinese investors is that your Chinese partner after learning your knowhow or expertise regarding operation, will start a similar business competing with JV Company that may cause fundamental detriment to the JV Company.

Therefore, a well-drafted non-competition clause is a must. In practice, Chinese partner together with their affiliates (generally including subsidiaries, family member, friends and the like) shall be subjected to such non-competition obligation, barring them from carrying out any competitive activities or otherwise being interested therein, alone or jointly with any other person, through themselves or on behalf of any other person. An ensuing clause providing for liquidated damages for breach of this obligation shall be put in place as a real deterrent to the Chinese partners.

A non-competition clause shall also be included in the employment contracts with key managerial personnel, making sure employees will not secretly take away business opportunities from the JV Company.

## 3. Non-self-dealing

Self-dealing often means conflict of interests. Without the approval of the board of the JV Company, Chinese partners shall not be permitted to conduct transactions with the JV Company which are often designed to siphon corporate interests. Foreign partner shall, regardless of its equity holding in the JV Company, secure a right to veto a self-dealing transaction to be made between the JV Company and the Chinese partner.

Also, non-self-dealing obligation shall bind other top management staff through stipulation thereof in the employment contracts.

## 4. Confidentiality

Chinese partners and top managerial staff shall be obligated to keep all designated confidential information in confidence. This is an indispensable clause in transactions where a foreign party will disclose any technical and other commercial knowhow to the Chinese party and key personnel.

## 5. Put/Call options

Those points discussed above are related to formation and operation of the JV Company. Very often joint ventures will not work out for both parties. Foreign investors shall at the very outset think about its exit strategy to avoid being strapped or hijacked in the course of running the JV Company.

A put option gives the option-holder the right to sell all or part of his stake in the JV Company to the other party at a price preset or calculated in an agreed formula or method. A call option on the other hand gives the option-holder the right to purchase all or part of the stake of the other party in the JV Company at a price preset or calculated in an agreed formula or method. Either way, the foreign investors may have a chance to end difficult, or deadlock situation.

Specifically for foreign invested travel agencies, it is possible that some years later during the operation of the joint venture that China further lifts its restriction on foreign investors from conducting outbound travel business, and therefore it will be in the interests of foreign investors to add a call option in the joint venture contract so as to buy the Chinese party out of the JV Company in case China laws change.

## 6. Drag/Tag along right

These two rights are purported to make sure that upon one party selling his stake in the JV Company

to a third party, a co-sale mechanism can be triggered so that the selling party may drag the other party along to sell the remaining stake in the JV Company or the non-selling party may tag along to sell his part of stake with the selling party to the same buyer.

A drag-along right is often requested by the majority shareholder in the JV Company to ensure that once the buyer intends to purchase more stake than his holding he will have the right to ask other shareholders in the JV Company to sell all or all of his interests to the buyer.

A tag-along right is often requested by the minority shareholder in the JV Company to ensure that in case he finds that the price at which the other shareholder(s) sells their stake is appealing to him, he may ask to sell all or part of his interests together with selling parties to the same buyer.

These clauses are mostly used ones to protect the interests of a foreign party in a Sino-foreign joint venture. However this is not an exhaustive list of protection instruments for foreign investors. Foreign investors shall diligently work together with your attorneys to ensure that sufficient protection is accorded in light of the real conditions of your deals.

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