Danone v. Wahaha: Lessons for Joint Ventures in China

Steven M. Dickinson
Harris Moure PLLC
www.harrismoure.com

Danone Group and its partner, Wahaha Group Company, are shareholders in a joint venture company that is the largest beverage company in China. A recent dispute between the partners now threatens to wreck the joint venture. What lessons can be learned from this dispute for investors considering new joint ventures in China? Disputes such as this are not inevitable in China. They can be avoided by following certain basic rules. Many of the most important rules were violated in this case. As a result, the problems that have arisen were almost certain to occur.

I. The Facts

A. Formation of the Joint Venture Company

The Wahaha Joint Venture ("JV") was formed in February, 1996. At the start, there were three participants in the JV. (1) Hangzhou Wahaha Food Group Co. Ltd. ("Wahaha Group"), led by its chairman Mr. Zong Qinghou. (2) Danone Group, a French corporation ("Danone"). (3) Bai Fu Qin Ltd., a Hong Kong corporation ("Baifu"). Danone and Baifu did not invest directly in the JV. Instead, Danone and Baifu formed Jin Jia Investment Co. Ltd., a Singapore corporation ("Jinjia"). Upon the formation of the JV, Wahaha Group owned 49% of the shares of the JV and Jinjia owned 51% of the shares of the JV.

This structure led to immediate misunderstandings between the participants. From the Wahaha Group's point of view, the division of ownership was 49% Wahaha Group, 25.5% Danone and 25.5 % Baifu. From this point of view, Wahaha Group was the majority shareholder in the JV. Since Wahaha Group felt it controlled the JV, it was relatively unconcerned when it transferred its trademark to the JV. Wahaha was further comforted that the other party to the JV was a Hong Kong company, feeling that the Chinese participants in the JV thoroughly outnumbered the foreign side.

In 1998, Danone bought out the interest of Baifu in Jinjia. Through this buyout, Danone became the 100% owner of Jinjia and effectively the 51% owner of the JV. As 51% owner, Danone exercised legal control over the JV because of its right to elect the board of directors. This change came as shock to Wahaha Group. For the first time, the Wahaha Group and Mr. Zong realized two things:

1. They had given complete control over their trademark to the JV because 51% ownership in the hands of Jinjia meant 100% control by Jinjia/Danone.

2. As a result of the above, a foreign company was now in control of the JV.

From a legal standpoint, this result was implied by the structure of the JV from the very beginning. However, it is clear from public statements that the Wahaha Group (and Mr. Zong) did not understand the implications when they entered into the venture. The Danone "takeover" in 1998 therefore produced significant resentment on the part of Wahaha Group and Mr. Zong. Rightly or not, they feel Danone had misled them from the very beginning.

B. Transformation of Wahaha Group into a private company.

At the time of the formation of the JV, Wahaha Group was a state owned enterprise owned by the Hangzhou city government. After formation of the JV, Wahaha was converted into a private corporation. Approximately 40% of the shares were retained by the Hangzhou government with the remainder distributed to Mr. Zong, other senior managers and to a workers committee. The conversion of the Wahaha Group into a private company effectively controlled by Mr. Zong set the stage for he Wahaha Group's decision to act to take back control of the trademark they felt had been unfairly transferred to Danone. It was no longer a question of the loss of an asset of a company for which they merely worked; they now viewed the transferred trademark as their personal property. The feeling of injustice at the terms of the transfer became personal.

C. Failed transfer of the Wahaha trademark to the JV.

At the time of formation of the JV, the Wahaha Group obtained an appraisal of its trademark valuing it at 100,000,000 RMB. The Wahaha Group contributed nothing to the JV other than the ownership of this trademark. Jinjia contributed 500,000,000 RMB in cash as its contribution to the JV. The Wahaha Group contributed no cash to the JV, but was given a 49% interest in the JV in exchange for its contribution of the trademark. The Wahaha Group also entered into a JV Agreement which provided it would not use the trademark for any independent business activity, it would not transfer the trademark to any other entity, and it would not allow any other entity to make use of the trademark.

In accordance with its obligation, the Wahaha Group formally entered into a transfer agreement for the trademark with the JV. Such transfers must be registered with the PRC Trademark Office. The Trademark Office, however, rejected the request for transfer on the grounds that the trademark was a well-known mark. As the well-known mark of a state owned enterprise, the Trademark Office took the position that the trademark belonged to the state and Wahaha Group therefore did not have the right to transfer the mark to a private company. Technically, this refusal to allow for the transfer of the mark was not consistent with the provisions of the Trademark Law. However, the decision was consistent with Chinese policy on the disposition of state owned assets.

Rather than terminate the JV, the shareholders (now Danone and Wahaha Group) decided to work around the approval issue by entering into an exclusive license agreement for the trademark. This license was entered into in May of 1999. Chinese law requires all trademark licenses be registered with the Trademark Office. Since the parties had written the license agreement to be the functional equivalent of a sale of the trademark, the parties were concerned the Trademark Office would refuse to register the license. For this reason, the parties did not register the license with the Trademark Office. Instead, the parties registered an abbreviated license with the Trademark Office. This abbreviated license omitted provisions likely to raise concern with the Trademark Office. The Trademark Office accepted the abbreviated license for registration. The full license was never seen by the trademark office.

As a result, Wahaha Group never transferred ownership of the Wahaha trademark to the JV. The only thing contributed by Wahaha Group to the JV was the exclusive license. Thus, Wahaha Group never complied with its basic obligation for capitalization of the JV. It does not appear that any of the JV documents were revised to deal with this new and changed situation.

D. Management of the JV and the creation of a competing non-joint venture companies by the Wahaha Group and Mr. Zong.

Though Danone was the majority shareholder and maintained a majority interest on the board of directors, day-to-day management of the JV was delegated entirely to Mr. Zong , the chairman of the Wahaha Group. Mr. Zong ran the JV basically as his personal company, filling management positions with his family members (his daughter and his wife) and persons from the Wahaha Group who were directly responsible to Mr. Zong. Under Mr. Zong's management, the JV became very successful, ultimately becoming the largest Chinese bottled water/beverage company, occupying about 15% of the very large Chinese market.

Beginning in 2000, Mr. Zong and the Wahaha Group began to create a series of companies that competed directly with the JV, selling the same products as the JV and using the Wahaha trademark. The ownership of the non-joint venture companies is not clear. They seem to have been owned in part by the Wahaha Group and in part by an offshore BVI company under the ownership and control of Mr. Zong's daughter and wife. To the extent the non-joint venture companies are owned by Mr. Zong's family, neither Danone nor the Wahaha group receive any benefits from the profits of such companies. According to press reports in China, product from the non-joint venture companies and the JV were sold by the same sales staff working for the same sales company, all ultimately managed by Mr. Zong. Profits were divided between the JV and the non-joint venture companies at the direction of Mr. Zong.

The creation of the non-joint venture companies violated both the trademark license and the JV Agreement. Danone apparently learned of the creation of the non-joint venture companies in 2005. To remedy the violation of the existing contracts, Danone insisted it

be given a 51% ownership interest in the non-joint venture companies. Danone agreed to purchase this ownership interest from the Wahaha Group and from Mr. Zong, who by this time was one of the richest men in China. Ultimately, the Wahaha Group and Mr. Zong refused to make the transfer.

E. Arbitration and Lawsuits

As the result of the breakdown in negotiations, both parties to the dispute over the non-joint venture companies resorted to arbitration and litigation. The proceedings to date are as follows:

On May 9, 2007, Danone filed for arbitration in Stockholm. The defendants in the arbitration are Wahaha Group, several of the non-joint venture companies and Mr. Zong himself. The arbitration was filed in Stockholm as required under the terms of the original JV agreement. The arbitration seeks to enjoin the non-joint venture companies and Mr. Zong from acting in violation of the terms of the trademark license and the JV Agreement.

On June 4, 2007, Danone filed suit in California state court. The primary defendants are Ever Maple Trading Ltd., a BVI corporation with offices in California and Ms. Kelly Zong, the Mr. Zong's daughter and the apparent owner of Ever Maple. Also named as defendants are Mr. Zong's wife, also a resident of California, and several of the Chinese non-joint venture companies alleged to be under the ownership and control of the Zong family. Danone requests in the suit that the court order these companies to terminate the use of the Wahaha trademark in China and cease selling Wahaha branded product in competition with the JV and in violation of the exclusive trademark license. After learning of the filing of this lawsuit, Mr. Zong resigned as chairman of the JV.

On June 13, 2007, Wahaha Group applied for arbitration before the Hangzhou Arbitration Commission. The arbitration seeks to have both trademark license agreements declared void. The basis for this claim is that the license was illegal at the time it was granted because it was intended to avoid the requirements of Chinese law.

On July 2, 2007, Wahaha Group threatened to bring a derivative action on behalf of the JV against the three Danone appointed directors of the JV. The claim is that the directors have violated the requirements of the Chinese Company Law by serving on the board of directors of companies that are competitive with the JV. Wahaha also threatened to bring a countersuit directly against Danone for violations of the JV agreement. It has not indicated in which forum it would bring such a countersuit.

II. Lessons to be learned.

The above legal proceedings have been accompanied by bitter verbal attacks, especially from the Wahaha side of the venture. Mr. Zong and the Wahaha Group have openly stated they do not believe it possible to continue to operate in a joint venture with Danone

as a partner. The dispute therefore threatens to destroy what was until recently a very successful joint venture company in China. What can potential foreign investors learn from this dispute? How can such problems be avoided?

Though joint ventures in China can be quite difficult, with proper planning and management, they can be successful. In the case of the Wahaha/Danone JV, many basic rules of joint venture operations in China were violated. By violating these rules, the parties virtually guaranteed success would end up destroying the JV. The primary rules violated in this JV are as follows.

A. Don't use technical legal techniques to assert or gain control in a joint venture.

Danone gained 51% control of the JV through a technical legal maneuver. Though this works in Europe and the United States, it seldom is successful in China. Explicit control gained through open contractual negotiations is one thing, but control through legal maneuvers is quite another. Even though Danone acted within the strict requirements of the law, Wahaha (and Mr. Zong) did not see it this way. This set the venture off on a bad basis from the start. Mr. Zong and Wahaha Group Company very quickly viewed Danone as "the enemy," with predictable results.

It is critical in China to make the ownership and control of a joint venture explicit and clear from the very start. Most managers of Chinese companies see the company as their own property. They are not sensitive to issues of control that arise from percentage ownership interests. It is important to insist that the Chinese side recognize and formally agree to any structure that will result in the foreign partner to a joint venture exercising control over the venture, particularly in the area of control of day-to-day operations of the venture. The foreign party should never assume the Chinese side to a venture understands the implications of a joint venture arrangement that flow entirely from purely technical legal rules. If the Chinese side feels it has been tricked or duped into signing away its rights, the Chinese side will take action to correct the situation, as is the case in the Wahaha JV.

B. Do not expect a 51% ownership interest in a joint venture to provide effective control.

51/49 joint ventures are generally a mistake in China. The Chinese see a 51/49 joint venture as fundamentally no different than a 50/50 joint venture. The absolute legal control afforded by 51% ownership is viewed as unfair. As a result, in ventures between Chinese participants where one side clearly intends to exercise control over the venture, a 60/40 or a 70/30 ownership structure is used. 51/49 ventures are almost never found in China. Any foreign investor using a 51/49 structure must understand it is operating against a strong cultural bias against such structures.

For foreign investors that decide to go forward with a 51/49 joint venture structure, it is important not to rely on control of the board of directors as a means to exercise control over the joint venture company. In Chinese corporations, the board actually exerts very little control over the operations of the company. The managing director/representative director and the general manager of the company have the actual power to dictate the operations of the company and can act, and usually do act, with little or no supervision from the board of directors. Accordingly, for any joint venture company where the foreign party intends to exercise actual control, it is essential that the foreign party has the power to control and appoint both the managing director and the general manager of the joint venture company. These persons must be directly responsible to the foreign partner and not to the Chinese partner. If it is not possible to exercise direct control over these positions, then control over the board of directors is of little or no benefit to the foreign partner. Control over the board of directors is just a dangerous illusion.

This principle is illustrated in the case of the Wahaha JV. In the Wahaha JV, Mr. Zong served as the managing director of the JV. Mr. Zong was solely responsible for selection and supervision of the general manager and other staff of the JV. As a result, Danone’s control of the board of directors proved to be meaningless in terms of the exercise of effective control over the joint venture company.

C. Do not proceed with a joint venture formed on a weak or uncertain legal basis.

The whole basis for the Wahaha JV was the transfer of Wahaha's existing trademark to the JV. However, this transfer was rejected by the Trademark Office. Rather than terminate the venture or restructure, the parties to the JV elected to enter into a license agreement. The conduct of the parties suggests they themselves were uncertain of the legality of this under Chinese law. However, they were unwilling to test the legality of the license by registering the full license with the Trademark Office. In this way, the JV was never on a sound legal basis from the start.

It is very common to find business arrangements in China that are of questionable legality under Chinese law. Going forward with a joint venture in the face of such potential illegality means the foreign party cannot enforce its rights in the joint venture because the terms of an illegal joint venture will never be enforced by a Chinese court. Because of this, it is a standard strategy for the Chinese side to convince the foreign side to go forward with such questionable ventures. For the Chinese side, there is little or no risk. If the venture fails, the Chinese side has the advantage of having received funds from the foreign venture. If the venture succeeds, the Chinese side simply takes over.

The Wahaha Group and Mr. Zong are openly taking advantage of the potential illegality of the trademark license in their dispute with Danone. Though their claim that the trademark license is void appears to be weak, it is providing them with excellent leverage against Danone. This kind of situation must be avoided at all costs in China.

D. The foreign party must actively supervise or participate in the day-to-day management of the joint venture.

Danone did not actively participate in the management of the JV. They left management to their JV partner and to its chairman Mr. Zong. This produced two bad results which were inevitable. First, the Chinese side felt they were doing all the work with the reward going to absentee owners. This produced resentment and the desire to take action to restore the "fairness" of the arrangement. Second, the Chinese side of a JV, when not actively supervised, will frequently manipulate the JV for their own benefit. The creation of a non-joint venture factory or company manufacturing the same product is one of the most common ways this is done. Active participation in the management of the joint venture and effective supervision of senior management will prevent such issues from arising. Failure to do these things almost always leads to problems in China.

It may be possible to control the management of a joint venture company simply through active supervision of senior management by the board of directors. However, this is seldom successful or worth the effort. Active day-to-day participation in the management of the joint venture company by at least one senior manager appointed and controlled by the foreign partner is usually required. If this is not done, the Chinese side of the joint venture will view the foreign partner as an outsider and as a mere exploiter of the labor of the Chinese side to the venture with predictable results.

This is clearly the case in the Wahaha JV. Danone seems to have made no attempt to integrate itself within the JV. The JV personnel see themselves as working for Mr. Zong, and they see the Danone side as foreigners and strangers. Mr. Zong has expertly used this feeling of resentment towards the outsider to his benefit, even when the positions he takes are clearly not to the benefit of anyone except him and his family. This situation is entirely avoidable, but it takes time and effort on the part of the foreign partner to make it work. Foreign investors who are not willing to take the effort to actively participate in a Chinese joint venture should expect that problems similar to those afflicting the Wahaha JV will arise if the joint venture is ultimately successful.

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