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Danone v. Wahaha

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September 2007

Steven M. Dickinson on the lessons to be learned from the tensions within China's largest beverage joint venture

Editor's note 10/8/2007
: Also see Danone's response to this article

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Danone Group and its partner, Wahaha Group Company, are shareholders in a joint venture (JV) company that is the largest beverage company in China. A recent dispute between the partners now threatens to wreck it. 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.

The Facts

• Formation of the joint venture

The Wahaha joint venture (JV) was formed in February, 1996. At the start, there were three participants in the JV: Hangzhou Wahaha Food Group (Wahaha Group), led by its chairman Zong Qinghou; Danone Group, a French corporation (Danone); and Bai Fu Qin, a Hong Kong corporation (Baifu). Danone and Baifu did not invest directly in the JV. Instead, Danone and Baifu formed Jin Jia Investment, 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 Wahaha Group's point of view - with the division of ownership at 49% Wahaha Group, 25.5% Danone and 25.5 % Baifu - it 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.

In 1998, Danone bought out the interest of Baifu in Jinjia, becoming 100% owner of Jinjia and effectively the 51% owner of the JV. This gave it legal control over the JV because of its right to elect the board of directors. For the first time, the Wahaha Group and Zong realized two things: 1) They had given complete control over their trademark to the JV; 2) 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 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 Zong. Rightly or not, they feel that Danone misled them from the very beginning.

• Wahaha Group becomes a private company

When the JV was formed, Wahaha Group was a state-owned enterprise owned by the Hangzhou city government. After formation of the JV, it was converted into a private corporation, effectively controlled by Zong. This set the stage for 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.

• Failed transfer of the Wahaha trademark

When the JV was formed, Wahaha Group obtained an appraisal of its trademark valuing it at RMB100 million (US$13.2 million). The trademark was its sole contribution to the JV, while Jinjia contributed RMB500 million (US$66.1 million) in cash. Wahaha Group also agreed not to use the trademark for any independent business activity or allow it to be used by any other entity.

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However, the trademark transfer was rejected by China's Trademark Office. It took the position that, as the well-known mark of a state-owned enterprise, the trademark belonged to the state and Wahaha Group did not have the right to transfer it to a private company.

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 1999. Since the license agreement was intended to be the functional equivalent of a sale of the trademark, they were concerned the Trademark Office would refuse to register the license. Therefore, they only registered an abbreviated license. This was accepted by the Trademark Office, which never saw the full license.

As a result, Wahaha Group never transferred ownership of the Wahaha trademark to the JV, just 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 changed situation.

• Management of the JV and the creation of competing non-JV companies
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 Zong. He ran it basically as his personal company, filling management positions with his family members and people from Wahaha Group. Under Zong's management, the JV became the largest Chinese bottled water and beverage company, with a 15% market share.

Beginning in 2000, Zong and Wahaha Group began to create a series of companies that sold the same products as the JV and used the Wahaha trademark. The non-JV companies appear to have been owned in part by Wahaha Group and in part by an offshore British Virgin Islands company controlled by Zong's daughter and wife. Neither Danone nor Wahaha group receives any benefits from the profits of these non-JV companies.

According to press reports in China, products from the non-JV companies and the JV were sold by the same sales staff working for the same sales company, all ultimately managed by Zong. He divided the profits between the JV and the non-JV companies.

The creation of the non-JV companies violated both the trademark license and the JV agreement. Danone apparently learned about it in 2005 and insisted it be given a 51% ownership interest in the non-JV companies. Wahaha Group and Zong, who by this time was one of the richest men in China, refused.

• Arbitration and Lawsuits
As the result of the breakdown in negotiations, both parties resorted to arbitration and litigation. The proceedings to date are as follows:

May 9, 2007

: Danone filed for arbitration in Stockholm, as required in the original JV agreement. The defendants in the arbitration are Wahaha Group, several of the non-JV companies and Zong himself. The arbitration seeks to enjoin the non-JV companies and Zong from acting in violation of the terms of the trademark license and the JV agreement.

June 4, 2007

: Danone filed suit in California state court. The primary defendants are Ever Maple Trading, a BVI corporation with offices in California and Kelly Zong, Zong's daughter and the apparent owner of Ever Maple. Also named as defendants are Zong's wife, also a resident of California, and several of the Chinese non-JV companies alleged to be controlled by 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 products in competition with the JV and in violation of the exclusive trademark license. After learning of this lawsuit, Zong resigned as chairman of the JV.

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.

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 Chinese Company Law by serving on the board of companies that are competitive with the JV. Wahaha also threatened to bring a countersuit directly against Danone for violations of the JV agreement.

Lessons to be learned

The legal proceedings have been accompanied by bitter verbal attacks, especially from the Wahaha side of the venture. Zong and Wahaha Group have openly stated they do not believe it possible to continue to operate in a JV with Danone as a partner. The dispute therefore threatens to destroy what was until recently a very successful JV. What can potential foreign investors learn from this dispute?
Though JVs 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 JV operations in China were violated, virtually

guaranteeing the JV's destruction. The primary rules violated are as follows:

• Don't use technical legal techniques to assert or gain control in a JV
Danone gained 51% control of the JV through a technical legal maneuver. Though this works in Europe and the US, it seldom is successful in China. Even though Danone acted within the strict requirements of the law, Wahaha (and Zong) did not see it this way. This set the venture off on a bad basis from the start.

Most managers of Chinese companies see the company as their own property. It is therefore critical to insist that the Chinese side recognize and formally agree to any structure that will result in the foreign partner to a JV exercising control. The foreign party should never assume the Chinese side understands the implications of a JV 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, it will take action to correct the situation, as is the case in the Wahaha JV.

• Do not expect a 51% ownership interest in a JV will provide effective control
The Chinese see a 51/49 JV as fundamentally no different to 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.

For foreign investors that decide to go forward with a 51/49 structure, it is important not to rely on control of the board of directors as a means to exercise control over the JV. In Chinese corporations, the managing director and the general manager of the company have the actual power to dictate operations. A foreign party intending to exercise control over a JV must thus ensure it has the power to control and appoint both the managing director and the general manager.

• Do not proceed with a JV 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, when this transfer was rejected, rather than terminate the venture or restructure, the parties to the JV elected to enter into a license agreement. 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 JV in the face of such potential illegality means the foreign party cannot enforce its rights because the terms will never be enforced by a Chinese court. For the Chinese side, though, there is little or no risk. If the venture fails, it has the advantage of having received funds from the foreign venture. If the venture succeeds, it simply takes over.

The Wahaha Group and 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.

• The foreign party must actively supervise or participate in the day-to-day management of the JV
Danone did not actively participate in the management of the JV – they left it to their JV partner and its chairman, 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 created resentment and a desire 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-JV factory or company manufacturing the same product is one of the most common ways this is done.

To prevent such issues from arising, active day-to-day participation in the management of the JV 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 JV will view the foreign partner as a mere exploiter of Chinese labor 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 Zong, and they see the Danone side as foreigners. Zong has 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 to make it work. Foreign investors who are not willing to do this should expect that problems similar to those afflicting the Wahaha JV will arise if the JV is ultimately successful.

Steven M. Dickinson is a partner at the Shanghai office of Harris & Moure PLLC. Allen John Lawyers, Shanghai, assisted with the factual portion of this report. Harris & Moure is a boutique law firm based in Seattle whose primary focus is to assist small and medium-sized enterprises with their international law needs. Steve also writes for the China Law Blog.

The facts of the case are presented to the best of our knowledge, with the understanding that the parties *are still in the process of legal resolution*

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