

# When Joint Ventures Go Bad

**After resolving a nearly eight-year dispute with its China partner, BorgWarner Inc. shares its cautionary tale**

**Stephanie Bransfield  
and Donald Schlueter**

**B**orgWarner South Asia Inc. (BorgWarner) and the Shiyan Automotive Transmission Factory (SATF), a unit of the Shiyan city government, Hubei, signed an agreement on June 2, 2004 that ended their longstanding, bitter dispute over the joint venture (JV) Huazhong Warner Transmission Co., Ltd. (Huazhong). The agreement called for SATF to return BorgWarner's technology and to pay BorgWarner a cash settlement in US dollars, and provided for termination of the JV without any further liability to, or legal action by, either party.

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**Donald Schlueter** has worked for 10 years with greenfield joint ventures in western China and is currently an independent consultant. He was general manager of the Huazhong Warner Transmission Co., Ltd. joint venture.

*BorgWarner established its first Chinese joint venture in Beijing in 1992 and currently has successful JVs in Beijing and Ningbo, Zhejiang. It continues to actively pursue automotive business opportunities throughout China.*

The agreement overturned the result of a trial and subsequent ruling of which BorgWarner had had no notice. The ruling had not only awarded all of Huazhong's assets to SATF, but also effectively stripped BorgWarner of its investment and technology.

The June agreement came only with the leadership of the Hubei Provincial People's Procuratorate and the US Commercial Service in Beijing and with the support and assistance of the Shiyan city and Hubei provincial people's governments. Credit also is due to the US Commercial Service and the US Department of Commerce, which, from the beginning, worked with the various PRC ministries and government departments to develop an environment for settlement, principles of transparency, and rule of law for the resolution of this matter.

BorgWarner's experiences are a must-read for foreign investors interested in the difficulties of resolving problems with Sino-foreign joint ventures that go awry.

## **Huazhong's rocky startup**

The saga began when the JV was formed in 1995 between BorgWarner and SATF, which

held 60 and 40 percent of equity, respectively, to manufacture five-speed manual transmissions for 1.5-ton light trucks to be produced by a Chinese truck manufacturer for the Chinese market. This was a greenfield JV, and each party committed to undertake certain responsibilities and follow a schedule for completing these activities. Otherwise, either party was entitled unilaterally to apply directly to the Hubei Commission on Foreign Trade and Economic Cooperation (COFTEC) for liquidation and termination. Hubei COFTEC approved the JV contract without any amendments.

BorgWarner supplied technology, a completed transmission design, and a completed prototype transmission within the time frames called for in the JV contract. SATF was to secure and improve a site for the manufacturing facility; secure a facility lessor to finance, build, and lease back the facility to the JV; and assist the JV in obtaining a supply agreement with the potential customer. But SATF fulfilled none of these commitments.

Huazhong's sole responsibility under the site lease was to make the specified site lease payments. All other costs to prepare the site, including the cost of connecting the utilities to the site,

were to be SATF's responsibility. SATF was repeatedly informed of its duties under the site lease, but never made any attempt to comply, nor did it acknowledge any responsibility to fulfill them.

As mentioned above, SATF was to obtain a facility lessor to finance, build, and lease back the manufacturing facility to Huazhong. But SATF identified only one company, a unit under the Shiyan city government, as having any interest in being the facility lessor. The JV contract specified a cost plus 3 percent construction contract. The potential facility lessor presented a formula that, as best could be determined, was cost plus 400 percent. Huazhong rejected the proposal and the facility lessor countered with a proposal that was even more expensive. In short, SATF never made a realistic effort to secure a viable facility lessor.

After its formation, Huazhong held a series of meetings with its potential customer, a Chinese truck manufacturer. In each of the meetings, a price was discussed in general terms, and the customer made clear that it had thoroughly tested and evaluated the BorgWarner-based prototype and found it to be the best one tested. Despite this, the customer was not prepared to sign a supply agreement. The impasse arose because the prices that the potential customer sought were roughly 30 percent below those specified in the feasibility study for the JV that the customer had itself prepared; the customer would offer no explanation for the disparity. It rapidly became clear that, pricing aside, the parties would be unable to reach a supply agreement in the time specified in the JV contract; the customer wanted Huazhong to complete the facility and begin production before the customer would even consider signing a supply agreement. Huazhong later discovered, from the minutes of a separate meeting between SATF and the customer, that the customer would be unable to pay the feasibility study prices and would only be able to take roughly 30 percent of the feasibility study volumes.

### Bringing in the board

By April 1996, BorgWarner's senior management in the United States was concerned with the status reports coming from Huazhong and requested a board of directors meeting. Donald Schlueter, Huazhong's general manager, reported that the JV had missed all of the SATF-supported deadlines to date. The SATF-appointed directors insisted that there was no problem and thus would not give any assurances that things would improve. BorgWarner suggested that the parties agree to a mutual termination of Huazhong as permitted in the JV contract. SATF rejected this suggestion. The parties agreed to meet again in June. BorgWarner informed SATF that BorgWarner was prepared to suspend its performance under the JV contract because of SATF's

nonperformance, but gave SATF an opportunity to comply with its responsibilities.

By the next board of directors meeting, the situation had only gotten worse. Supply agreement talks had come to a standstill, the parties disagreed bitterly over who was to pay the fees for connecting electricity to the site (in spite of the clear language in the site lease placing this obligation on SATF), and SATF could not find a facility lessor that was interested in the terms and conditions specified in the JV contract. The differences between the parties were so great that the directors could not even agree to approve the minutes of the meeting.

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### From bad to worse

After the board meetings, Huazhong proposed termination of the site lease because of SATF's nonperformance. The majority of the board members (that is, those appointed by BorgWarner) approved the termination. In August 1996, BorgWarner terminated its technology transfer agreement with Huazhong because of the JV's nonpayment of fees.

The site lease specified that the China International Economic Trade Arbitration Commission (CIETAC) would provide the forum to settle disputes. In September, ignoring certain preliminary requirements in the site lease, SATF submitted a claim against Huazhong to CIETAC based upon the JV's termination of the site lease. The individual who submitted the claim on behalf of SATF was not only an SATF director but also the SATF-appointed chair of Huazhong. SATF then successfully influenced the Shiyan branch of China Construction Bank to prevent Huazhong from using its own funds to defend itself before CIETAC and also tried to prevent Schlueter from retaining legal counsel to defend the JV. BorgWarner was forced to front the funds for the JV's defense.

The JV then decided to audit its books and arranged for the JV's external auditor to travel to Shiyan. After the auditor had been at work for a short period, the SATF-appointed JV chair denied the auditor access to Huazhong's offices and would not allow him to complete his work. The auditor was nonetheless able to find one occasion on which the JV chair made

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an unauthorized and secret withdrawal of ¥710,000 (\$85,749).

Based upon its earlier termination of its technology transfer agreement with Huazhong, BorgWarner terminated its name license agreement with the JV in October 1996 and its trademark license agreement with the JV in November. It again requested the return of its technology. SATF removed the technology covered by the terminated technology transfer agreement from the potential customer's site and refused to release the technology to Schlueter so that it could be returned to BorgWarner. At the same time, SATF withdrew all of its technical personnel from Huazhong to work on SATF's own competing transmission project for the JV's would-be customer. To comply with the termination of the name license agreement, Huazhong tried to register a new name that did not include the word "Warner," but found that it was unable to do so without SATF's concurrence.

At this point, Schlueter solicited assistance from the Shiyan mayor, Hubei provincial government, and Hubei COFTEC. The Shiyan mayor never responded to the numerous requests for assistance. Hubei COFTEC and the provincial government both indicated that they would investigate.

By November 1996, Huazhong submitted to CIETAC its statement of defense and its coun-

terclaims against SATF regarding the site lease. Because Huazhong's counterclaims were so compelling, SATF immediately petitioned CIETAC to withdraw its claim against the JV and claimed that CIETAC did not have legal jurisdiction to hear the matter. CIETAC sought briefs from both parties on the issue.

Huazhong later learned, from minutes it uncovered of a meeting between SATF and the Shiyan city government, that the city was willing to finance legal actions to take the JV's assets. SATF assured the city that they would prevail.

By the end of 1996, the BorgWarner-led board of directors formally approved a resolution to close Huazhong's offices, return all employees to SATF, and secure all company records. The external auditor was scheduled to conduct the annual audit, make copies of all records for each party, and secure the originals with the JV. Once again, the JV chair prevented this from happening. BorgWarner applied to Hubei COFTEC to unilaterally terminate the JV, as was its right under the government-approved JV contract.

### 1997: Complete legal meltdown

In early January 1997, Schlueter was on annual leave, and CIETAC was still considering the site lease arbitration. On January 2, according to the court docket number, SATF sued Huazhong in local court based on the JV's alleged breach of the site lease. Huazhong's chair, who had previously submitted a claim on SATF's behalf against Huazhong with CIETAC, now appeared on Huazhong's behalf in local court on the same matter even though the JV contract did not permit him to do so. Another SATF-appointed Huazhong board member represented SATF against the JV. Unsurprisingly, SATF won the case. Besides the obvious conflicts of interest of the individuals appearing on both sides of the case, numerous Chinese procedural laws were broken during the trial. SATF both sued and represented the JV and sealed all of the trial records, keeping them from BorgWarner and Huazhong's general manager. The court decision was handed down on Saturday, January 18, a legal holiday for the court. To this day it is not clear if a trial actually took place.

Upon returning to China, and still unaware of the court proceedings the previous month, Schlueter met with representatives of Hubei COFTEC and a vice governor in mid-February. Hubei COFTEC told him that it would need about a month to complete formalities for the termination. The vice governor said he would investigate, do what the findings dictated, and get back to the JV with a report. This never happened.

On March 7, 1997, Schlueter and BorgWarner first learned of the court decision when Huazhong received a fax from its SATF-appointed

### Hoping to Avoid Joint Venture Problems?

Follow these practical tips:

1. Conduct comprehensive, independent due diligence on
  - the history and reputation not only of the prospective joint venture (JV) partner, but also of its principal officers and the individuals proposed as directors and officers of the JV
  - the history and reputation of the local government
  - all assumptions on which the feasibility study is based
2. Ensure sufficient control of the JV's board to be able to bring critical actions to pass
3. Establish a strong relationship with the local government as early as possible in the JV creation process
4. Realize that no matter how just your cause, no one within the various levels and departments of government will cause another person or department to lose face
5. Explore as many avenues as possible for resolving a dispute or bringing pressure to bear on officials
6. Be persistent and patient, and things will come your way eventually

—Stephanie Bransfield and Donald Schlueter

ed chair informing it of the suit in Shiyan Court. The chair went on to say that he had represented Huazhong against SATF and lost, and claimed that the parties would need to contribute additional funds to cover the shortfall between the court's award to SATF and the funds that had already been seized from Huazhong's accounts. By the day that Huazhong received the fax, the time had run out for an appeal.

A few days later, Huazhong received another fax, this one from Hubei COFTEC, rejecting the application for termination because it had not been approved by both parties' JV board members. Hubei COFTEC disallowed the unilateral termination provisions of the JV contract that it had originally approved. Although it arrived in March, the rejection notice was dated and stamped on Sunday, January 19, 1997—the day after the court decision. Huazhong then received notice that CIETAC agreed with SATF's position that, because both parties to the arbitration were Chinese legal persons, it did not have legal jurisdiction despite the arbitration provisions of the site lease.

Huazhong and BorgWarner, with the assistance of the US Commercial Service in Beijing and US Ambassador to China James R. Sasser, petitioned numerous PRC ministries and leaders, including the Supreme People's Court and the Hubei governor, with no visible results. With the assistance of Alan Turley and Bob Bannerman of the US Commercial Service, a number of meetings were arranged with the Ministry of Foreign Affairs and the former Ministry of Foreign Trade and Economic Cooperation (MOFTEC). Huazhong was told that, because it had by this time petitioned the Supreme People's Court, the matter was now in the hands of the courts, and MOFTEC could do nothing until the courts took action. At the same time, BorgWarner contacted numerous nongovernmental organizations, including the US-China Business Council (publisher of the *CBR*), to discuss this matter and get their support to petition government officials. (And many consultants eagerly offered their services, but of course would not give assurances as to any results.)

In February 1998, BorgWarner petitioned the Supreme People's Procuratorate and forwarded the petition to the Hubei Provincial People's Procuratorate (HPPP). The HPPP heard Huazhong's testimony and decided to accept the

case. The HPPP conducted a thorough investigation and in July 1999 issued its report, which upheld Huazhong's and BorgWarner's position and instructed the Hubei Provincial High Court to either overturn the erroneous court decision and return the funds to the JV or to conduct a retrial. Although by law the Hubei High Court was required to follow the HPPP recommendation, there were no time limits in the relevant statutes by which the court had to respond. The result was no action.

## **New Hubei and Shiyan leaders save the day**

The HPPP, under the leadership of Xu Hanming, Ma Weimin, and Xiang Jinqiao, continued to press the Hubei High Court and the Shiyan city government to take action and correct this matter, with few, if any, visible results. With the continued efforts of Schlueter and the Beacon Law Firm of Beijing, the HPPP recommendation gradually gained support over the next several years from the Hubei government and Provincial Communist Party Secretary Yu Zhengsheng. At the same time, the US secretaries of Commerce continually raised the Huazhong Warner issue: William M. Daley at the US-China Joint Commission on Commerce and Trade meetings and later Donald L. Evans with PRC State Councilor Wu Yi. Assistant Secretary of Commerce William H. Lash raised the issue whenever he met with PRC counterparts.

Over the past year, Minister Counselor for Commerce Affairs Craig Allen and HPPP Vice President Xu Hanming's strong support and assistance were key to resolving this dispute. But the final boost needed to reach the settlement came from the new leadership in Shiyan—Mayor Zhao Bin and Party Secretary Chen Tianhui—who led Shiyan in a positive new direction.

This settlement does not fully uphold the rule of law or the JV contract, but considering the circumstances surrounding the dispute, the settlement is a major step toward ensuring that foreign investments will be protected under PRC law and that approved contracts will be upheld in Shiyan and in Hubei. BorgWarner and the US Commercial Service are satisfied with the settlement and are pleased that, after nearly eight years, the dispute is finally resolved. 完