

A Tale of Two Companies



The Danone-Wahaha partnership once seemed ideal, but the companies' relationship has deteriorated. What lessons can be learned from the dispute?

Jingzhou Tao and Edward Hillier

The Danone-Wahaha dispute is a story of the relationship between two very different entities against a backdrop of incredible change. The dispute reveals many questions that China faces as it integrates into the world economy, such as what to do when rule of law leads to an unpopular result or harms a valued Chinese company.

The players

Group Danone SA, a Paris-based multinational corporation (MNC), is a giant in the global dairy product and bottled water markets. The MNC employs roughly 90,000 staff across five continents.

Though it is a beverage giant in China, the Hangzhou Wahaha Group Co., Ltd. is much smaller than Danone. Since its founding in the late 1980s, the company has grown from three people selling drinks to school children to become the largest Chinese bottled-water company today. This growth is mainly the result of the drive and talent of founder Zong Qinghou, who expanded the company by satisfying Chinese consumer demand and aligning his business strategy with government policy.

Danone and Wahaha formed their first joint venture (JV) in China in 1996. Over the years, the number of JVs grew from 5 to 39, and annual sales rose from a few hun-

dred million renminbi to more than ¥14 billion (\$2 billion) in 2006. Danone held a 51 percent stake in the JVs and appointed Zong chair of the JVs' board.

In the 12 years since the first JV's formation, China has taken a leading role on the world stage. Hong Kong and Macao returned to mainland China, China entered the World Trade Organization (WTO), and Beijing won its bid to host the 2008 Summer Olympics. Moreover, continuing reform and strong economic growth have dramatically changed not only China itself, but perceptions of the country, both at home and abroad. Finally, China's business environment has changed tremendously in the last 10 years. In many ways, China in 2008 is a world away from China in 1996.

News of the Danone-Wahaha dispute—in which Danone accused Zong of setting up mirror companies that illegally used the Wahaha trademark—burst into the public arena in April 2007. Since then, Chinese and foreign media have covered the dispute extensively. At times, both parties in the dispute have been unusually outspoken and vitriolic. Though many details are unclear, and much information remains private, the dispute illustrates issues that foreign-invested enterprises may face in China and the direction of China's development. The following summary of the dispute is based on media reports.

Brief outline of the dispute

By 2005, Danone had discovered that Zong had established “mirror” companies that were producing and selling products almost identical to those of the Danone-Wahaha JVs. The mirror companies allegedly rode piggy-back on the JVs’ advertising and sales networks, in clear breach of the JV agreement.

Danone and Zong negotiated over several months to resolve the conflict. In December 2006, the two parties reportedly reached an agreement to integrate the mirror companies into the JVs, in return for a payment of ¥4 billion (\$566 million) by Danone. Zong, however, allegedly reneged on this agreement, claiming that he had been “forced” to sign. According to Zong, in 2006, the mirror companies were worth ¥5.6 billion (\$792.3 million) in assets, far more than Danone’s offer, and had annual profits of ¥1.04 billion (\$147.2 million).

After negotiations failed, Danone requested arbitration in Stockholm, Sweden, and filed lawsuits in Los Angeles and other cities, mainly over trademark infringement and non-compete obligations (see Table).

Zong and his supporters responded in kind, requesting arbitration in Hangzhou, Zhejiang, to confirm that Hangzhou Wahaha Group—not the Danone-Wahaha JV—owned the Wahaha trademark. In a huge loss for Danone, the Hangzhou Arbitration Commission found that China’s Trademark Office had never approved the original transfer of the Wahaha trademark and that an exclusive license agreement for the trademark (meant to replace the original trademark transfer) had never been registered. Thus, ownership of the Wahaha trademark had never been transferred to the JV. Further fueling the dispute, several Wahaha companies initiated proceedings against Danone-nominated JV directors—accusing them of breaching non-compete obligations by serving simultaneously on the boards of the Danone-Wahaha JVs and other Chinese companies that were competitors of Wahaha.

The novel feature of the Danone-Wahaha dispute is the geographic and legal range of the various litigation. To date, the parties have initiated at least 12 lawsuits and arbitration cases within China and six other jurisdictions. With a dozen lawsuits initiated, the dispute has escalated into an international issue and has become one of the biggest JV disputes in China’s history. The dispute has been so high-profile that PRC President Hu Jintao and French President Nicolas Sarkozy discussed it at a meeting in November 2007.

In December 2007, Danone and Wahaha jointly announced a truce and that both sides were committed to resolving the dispute by negotiation. The parties originally

planned to negotiate through February 2008 but extended negotiations until the end of March. Wahaha rejected a mid-March proposal by Danone to merge the two companies’ China assets and list 20 percent of the new JV’s shares. Even after the PRC Ministry of Commerce (MOF-COM) and French Embassy facilitated talks on April 4, Danone and Wahaha failed to reach a settlement by April 10, the last day of an agreed courtroom truce. As the *CBR* went to press in mid-April, the partners had not yet agreed to continue negotiating.

What can Danone do now?

With the benefit of 12 years’ hindsight, it is easy to give advice on what Danone should have done in 1996.

Current knowledge on how to do business in China is light years ahead of where it was then, and the investment environment has changed substantially. Since many JVs created in the 1990s may face similar problems, perhaps a more relevant question is, what else could or should Danone do to manage the situation now and regain control of the JVs?

First, Danone should have a clear public relations strategy to manage how it appears in the Chinese media. Danone risks jeopardizing its future in China if Chinese consumers turn against it—Chinese nationalism should not be underestimated. Though Danone holds a

majority stake in the Danone-Wahaha JVs, the Chinese public generally regards Wahaha as a national treasure and Zong, in some respects, as a national hero. Zong commands tremendous loyalty among his workers, the Chinese media, and the general population. Since the dispute became public, the Chinese blogosphere has repeatedly discussed boycotting Danone products. Chinese media and business circles have discussed how Danone may be damaging its reputation in China and how Danone’s other Chinese JV relationships, such as its recently ended JVs with Mengniu Dairy Co. and Bright Dairy & Food Co., may have been affected by the dispute. On the other hand, critics point out that Zong has played the nationalist card masterfully in the past to protect his own personal and family interests. Recent news that Zong is under investigation for tax evasion has drawn further criticism of Zong’s nationalist credentials in the Chinese press and blogosphere.

A recent move by Danone demonstrates that the company may be on the right track. According to press reports, on January 16, 2008, Emmanuel Faber, the Danone-nominated chair of the JVs and a key actor in the dispute who replaced Zong in June 2007 against the wishes of employees loyal to Zong, resigned from his position in the JV. (Faber subsequently became chief

Quick Glance

- The Danone-Wahaha dispute highlights the intersection of public opinion, nationalism, and the rule of law in China.
- Disputing companies should pay close attention to their public relations efforts.
- In disputes with Chinese companies, foreign companies should be careful to avoid sparking a nationalist backlash.

operating officer of Danone and vice president of the Danone-Wahaha JV.) The personnel change could help reduce tension between Danone and Wahaha by depersonalizing the dispute, which would help resolve the impasse with Zong (who remains co-owner of the JV but is no longer on the board), and easing the stand-off within the company.

Broader implications of the dispute

Though this dispute makes a great case study for MNCs doing business in China, it also illustrates some bigger issues about public opinion, nationalism, and the rule of law.

Within China, the public generally holds one of two views about the dispute. Holders of the first view give unconditional support to Wahaha and view the company as a victim; they view Danone as a foreign “wolf” that intends to control the beverage market in China. Holders of the second view sympathize with Wahaha but believe the dispute should be resolved according to law and due process, however painful this may be, in the interest of China’s development as a market economy. These two views represent China’s central dilemma with regard to law and regulation of the marketplace. Many Chinese support the rule of law but believe that exceptions should be made when an issue has emotional appeal, especially if

Publicly Known Arbitrations and Court Actions in the Danone-Wahaha Dispute

Month that case was filed or accepted

Month that case was filed or accepted	Tribunal	Claimant	Respondent	Type of Dispute	Claim	Status
05/07	Arbitration Institute of the Stockholm Chamber of Commerce, Sweden	Danone Asia Pte Ltd. and its wholly owned subsidiaries	Hangzhou Wahaha Group Co. Ltd.; three Wahaha mirror companies; Zong Qinghou	Joint venture (JV) disputes	Violation of JV contract; violation of service agreement	Pending
06/07	California courts	Group Danone SA; Danone Asia	Two Wahaha mirror companies; Zong’s wife and daughter	Unfair competition	Illegal sales of same products and illegal use of Wahaha JVs’ resources	Pending
06/07	Hangzhou Arbitration Commission, Zhejiang	Hangzhou Wahaha Group Co., Ltd.	Danone-Wahaha JVs	Trademark transfer	The trademark transfer was invalid	Claimant successful
06/07	French courts	Danone Asia	French equipment suppliers of Wahaha	Unfair competition	Supplying Wahaha with equipment in violation of non-competition duties	Claimant unsuccessful
07/07	Shenyang Intermediate People’s Court (IPC), Liaoning	Chinese shareholder of Shenyang Wahaha Drinks Co. Ltd.	Danone-nominated directors of JVs	Directors duties: non-competition obligations	Scope of non-competition duty	Pending
07/07	Jilin IPC	Jilin Wahaha Drinks Co. Ltd.	Danone-nominated directors of JVs	Directors duties: non-competition obligations	Scope of non-competition duty	Pending
07/07	Italian courts	Danone Asia and its three subsidiaries	Italian subsidiary of French equipment suppliers of Wahaha	Unfair competition	Supplying Wahaha with equipment in violation of non-competition duties	Claimant unsuccessful
07/07	Italian courts	Danone Asia and its three subsidiaries	Italian equipment suppliers of Wahaha	Unfair competition	Supplying Wahaha with equipment in violation of non-competition duties	Claimant unsuccessful
11/07	Guilin IPC	Wahaha Group; Guilin Xiang Sheng Industrial and Commerce Co., Ltd.	Danone-nominated directors of JVs	Directors duties: non-competition obligations	Scope of non-competition duty	Claimant successful
11/07	British Virgin Islands courts	Danone Asia and its three subsidiaries	Eight Wahaha offshore companies	Unfair competition	Jointly owning the shares of Wahaha mirror companies and impairing the claimants’ interests	Mirror companies placed in receivership and assets frozen
Fall 2007	Samoa courts	Danone Asia and its three subsidiaries	Two Wahaha offshore companies	Unfair competition	Conducting business activities in direct competition with Wahaha JVs	Mirror companies placed in receivership and assets frozen
Fall 2007	Xinjiang IPC	Jinjia Investment Co. Ltd.	Zong Qinghou	Director’s fiduciary duties: conflict of interest	Scope of fiduciary duties	Claimant unsuccessful

Sources: Jingzhou Tao and Edward Hillier

it concerns major Chinese companies or famous Chinese brands. This view fits the concept of PRC law as an instrument of policy (rule by law)—instead of policy implemented within the law, as is in classical Western conceptions of the rule of law. Interestingly, Chinese sympathies lie almost universally with Wahaha, regardless of whether courts and arbitral tribunals judge that it acted wrongfully.

maintaining the support of the domestic population. Even resolution of the dispute by legal procedure could be a no-win situation for China. If Wahaha wins the dispute, the decision could have negative repercussions internationally; if Danone wins, the outcome could have negative consequences domestically. Any legal decision will likely be interpreted as an unequivocal indication of China's current business environment. The PRC government,

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The big question for China is whether it should reward old-style entrepreneurs—complicated characters who may use dubious measures to achieve their aims and manipulate nationalist sentiment for personal ends—or bite the bullet, reinforce the supremacy of the law, and ensure that disputes are dealt with on a strictly legal basis. The answer mainly depends on how the PRC government wishes China to be perceived by the international and domestic business communities and the Chinese public. In the last year and a half, the foreign press has discussed the rise of economic nationalism and protectionism in China. The PRC government's official policy, however, is to focus on encouraging the types of investment that will help China move up the value chain and meet environmental and other goals.

The Danone-Wahaha dispute lies at the heart of this PRC government policy dilemma—how to present China as a positive environment for international business while

therefore, must do everything it can to encourage the dispute to be resolved as quietly and privately as possible without recourse to legal procedure.

In fact, this is exactly what seems to be happening. The December talks in which Danone and Wahaha called a truce were presided over by MOFCOM officials. The government appears to have realized what is at stake—China's image—and is attempting to help resolve the situation.

The importance of corporate governance and rule of law

Many observers have said that the Danone-Wahaha JV dispute likely occurred in part because Danone seems to have considered profits more important than good corporate governance. Reportedly, Danone did not involve itself in the daily management and operation of its China JVs, a strategy that seems to have backfired in many respects. The MNC may have missed out on acquiring crucial commercial expertise in China and may have lost customers because of bad press.

This dispute is a reality check for China. It represents the current challenge to China's integration into world markets—that internationalization of business entails the separation of national and commercial interests. The crucial question is whether China will take the next step toward world markets and continue to strengthen its legal environment. Chinese companies, the media, and the PRC government should be careful not to exaggerate every commercial dispute between Chinese and foreign companies into a nationalist issue. If nationalism plays a role in more commercial disputes, more people around the world will believe that China is a country where the rule of law comes second to vested interests. 完

Dispute Resolution Tips in China

Companies in a joint venture may face ups and downs in their relationship. But because news—whether accurate or inaccurate—travels fast, it pays for companies to focus on their public relations efforts. Here are a few basic tips:

- Stay calm and do not get involved with personal invective. This will nearly always backfire in the PRC media.
- Say as little as possible about the dispute. Any comment can be counter-productive.
- Lobbying high-level government officials may not help resolve a dispute because it can give lower-level officials an excuse to do nothing.
- Any strategy must be carefully and pragmatically planned based on the circumstances of the dispute. There is no magic formula.

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