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To Be or Not to Be: The Practical Implications of Choosing Foreign Arbitration for Purely Domestic Contracts

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The 2014 case of *Application for the Recognition and Enforcement of Foreign Arbitral Awards between Beijing Chaolaixinsheng Sports and Leisure Co Ltd and Beijing Suowangzhixin Investment Consulting Co Ltd.*

The *Beijing Chaolaixinsheng* case is the first occasion on which China's Supreme People's Court (SPC) has confirmed that arbitral awards are unenforceable in China where purely domestic contracts provide for arbitration at an overseas venue. This case was followed by the publication of China's Draft Foreign Investment Law on 19 January 2015 and the promulgation on 4 February 2015 of a new *Interpretation of the Supreme People's Court on the Application of the Civil Procedure Law of the PRC* (Fa Shi [2015] No 5, 30 January 2015) (the SPC *Interpretation*). In the light of these developments, this posting considers the consequences of choosing foreign arbitration to resolve disputes where a foreign investor enters into a domestic contract with a Chinese counter-party.

The relevant provisions that apply to clauses of this kind (referred to collectively in this posting as 'the Provisions') are as follows.

- Article 128 of the PRC Contract Law states that parties to a foreign-related contract *may* apply for arbitration either to a Chinese arbitral institution or to *any other* arbitral institution.
- Article 271 of the PRC Civil Procedure Law provides that (1) where any dispute arises out of foreign economic relations and trade or foreign-related transport and maritime activities, and (2) if the parties have agreed to arbitrate at a PRC arbitral institution or at *any other* arbitral institution, an action may not be brought before a PRC court.
- Article 304 of the *Opinions of the Supreme People's Court on Several Issues Concerning the Application of the Civil Procedure Law of the PRC* (Fa Fa [1992] No 22, 14 July 1992) (the *Opinions*) states that a civil case is 'foreign-related' where (1) either contracting party is a foreign citizen, enterprise or organisation; (2) the facts that trigger, change, or terminate the civil relationship take place outside PRC territory; or (3) the subject-matter is located outside PRC territory.

Taken collectively, these Provisions imply that parties *may* submit a dispute to a foreign arbitral institution if the contract has a foreign element. The SPC has traditionally interpreted them to mean that arbitration before a foreign institution is *only* available for disputes with a foreign element.

Few cases, however, have come to the SPC for a determination of whether a resultant award is enforceable in China.

The *Beijing Chaolaixinsheng* case involved a contract to operate a golf course in Beijing concluded between a Chinese company and a wholly foreign-owned enterprise (WFOE) that was registered in Beijing and owned by a Korean citizen. The arbitration clause provided for arbitration at the Korean Commercial Arbitration Board (KCAB) in Seoul. A dispute involving a claim for compensation was so referred. The Beijing Second Intermediate People's Court (the Beijing Court) proposed to hold that the award renderedby the KCAB tribunal was unenforceable. This holding was confirmed by the SPC, pursuant to its function of reviewing such proposals under the pre-reporting system.

On the basis of the Provisions, the SPC concluded that there were no foreign elements in the contract, given that the subject-matter was located in China, the contract was concluded and performed in China and the WFOE had the status of a Chinese enterprise. Further, the SPC stated that "the applicable law of the underlying contract and its arbitration clause, whether explicitly or [implicitly] agreed [upon] by the parties, shall be deemed as PRC law." The SPC went on to hold that PRC law did not authorise the parties to refer domestic disputes not containing a foreign element to foreign arbitration. Accordingly, the arbitration clause was invalid and the KCAB tribunal therefore had no jurisdiction over the dispute.

The SPC also upheld article V.1(a) (invalid arbitration clause) of the New York Convention as a ground for rejecting the recognition and enforcement of the KCAB award. Significantly, the SPC rejected a proposal by the Beijing Court to rely also on article V.2(b) of the Convention (public policy) as a ground for refusing enforcement, stating that "to apply the public policy ground provided for in Article V(2)(b) of the New York Convention is inappropriate and should be corrected." The SPC's tendency to invoke public policy grounds sparingly will be welcomed by the arbitration community.

The SPC *Interpretation* replaced the *Opinions* with effect from 4 February 2015. Article 522 of the *Interpretation* replaces article 304 of the *Opinions* and subsumes the three categories that constituted a 'foreign element' under the latter. Article 522, however, adds two new sub-clauses aimed at broadening the definition. A civil case may now also be foreign-related where (1) the habitual residence of either or both contracting parties is located outside PRC terrritory, and (2) there exist "other circumstances" that can constitute a foreign-related element. This residual provision may give the PRC courts more discretion in characterising a case as either foreign-related or domestic. It may also be noted that article 522 of the *Interpretation* has the same wording as a pre-existing provision, article 1 of the SPC *Interpretations (I) on Several Issues Concerning the Law on the Application of Laws to Foreign-Related Civil Relations* (Fa Shi [2012] No 24, 28 December 2012) (the 2012 *Interpretations*), which was complemented by the *Opinions.* The courts have not, however, applied the 2012 *Interpretations* in defining foreign-related civil cases, but have instead preferred to apply article 304 of the *Opinions*.

For the first time, the new Draft Foreign Investment Law provides a definition of 'foreign investor' for the purposes of that draft law. Article 11 provides that domestic enterprises controlled by a foreign citizen, enterprise or organisation are deemed to be foreign investors, thus giving rise to the question whether having a foreign-invested domestic enterprise as a contracting party might render the contract 'foreign-related'.

It will be interesting to see how the PRC courts approach these new developments and whether the categorisation of ‘foreign-related’ cases will indeed broaden their scope.

In light of the above, and subject to any further clarifications from the SPC, parties should be aware of the following risks if they choose to use foreign arbitration clauses for disputes without a foreign element.

Firstly, where a foreign investor initiates foreign arbitration proceedings, it may be uncertain whether the Chinese counterparty would challenge the validity of such a clause and if so, in which court. The validity of such clauses has consistently been denied by the Chinese courts.

Secondly, instead of going to a PRC court, a party may make relevant objections in the arbitration, in order to preserve rights to challenge later the award or its enforcement.

Thirdly, the Chinese party may also initiate parallel proceedings on the merits of the case in the PRC courts. This may give rise to a dilemma for the foreign investor. On the one hand, participation by that party may give rise to a negative inference as to the validity of foreign arbitration proceedings already initiated. On the other hand, non-participation may result in an unfavourable default judgment in court.

Multiple proceedings or additional objections would involve increased costs and may also cause delays, which could give the relevant party time to divest itself of assets in an attempt to frustrate an award made against it.

The authors are aware of a number if alternative clauses used by foreign investors They may not, however, be as useful as they appear.

A party may wish to include a foreign parent company as guarantor of performance of the contract, in the hope that this would constitute a ‘foreign element’. Although issues with the guarantee itself may be arbitrated at a foreign arbitral institution, the problems previously discussed may still apply if a tribunal appointed by that institution hears the main contract.

Foreign investors may try to use foreign arbitration with China as the seat of arbitration, for example through the ICC in China. Although the SPC confirmed the validity of such clauses in 2014, their enforcement remains uncertain.

Foreign parties may wish to choose arbitration through the CIETAC Hong Kong Arbitration Center. A special chapter of the CIETAC Arbitration Rules 2015, however, distinguishes CIETAC Hong Kong from the CIETAC in Mainland China. It is very likely that the PRC courts would consider CIETAC Hong Kong a ‘foreign’ arbitral institution, thus giving it the same legal status as foreign arbitration institutions proper.

In the light of these problems, it is recommended that a properly tailored and well-drafted domestic arbitration clause should be used, one which would have exclusive jurisdiction over domestic disputes without a foreign element. Importantly, under PRC law, property and evidence preservation orders by PRC courts are available only in support of arbitrations conducted at domestic institutions.

There is also scope within the CIETAC Rules to tailor the arbitration to the parties’ needs, for example, by the parties appointing foreign arbitrators from outside the CIETAC panel list, and also

appointing their own presiding arbitrator in order to avoid an appointment by CIETAC. In an important development, the SPC has confirmed the validity of arbitration clauses that provide for CIETAC arbitration under the UNCITRAL Arbitration Rules (see Zhe Yong Zhong Que Zi No 4, 17 March 2014). In such proceedings, CIETAC may form an international tribunal with a presiding arbitrator from a country neutral to the parties involved. The tribunal may then ensure that the proceedings comply with international standards; but more importantly, CIETAC tends to adopt international practices where the tribunal is international.

Using a tribunal comprising international arbitrators would be just as effective as conducting arbitration overseas, but with the important assurance that the arbitration clause and the corresponding award would be valid and enforceable in China.

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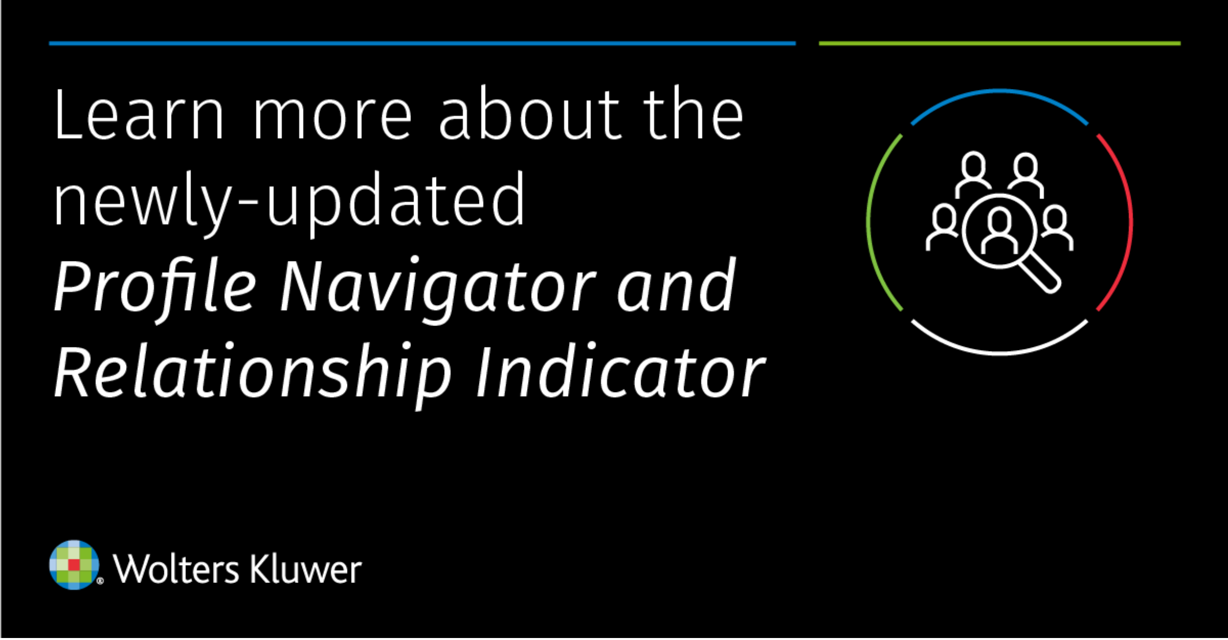

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