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Demystifying the Settlement of Disputes in China – Roundtable Discussion on CIETAC Practice

Christian Borris (Freshfields Bruckhaus Deringer LLP) · Thursday, July 16th, 2009 · Freshfields Bruckhaus Deringer

As arbitration continues its upward trajectory in the world of dispute resolution, eyes have remained fixed on legal developments in China. With the significant growth of international transactions involving Chinese parties, there has been an equally staggering rise in the number of disputes. In China, arbitration has quickly become an accepted method of resolving international commercial disputes.Appreciating the importance of China as an investment – and consequently an arbitration – destination, Freshfields Bruckhaus Deringer's Cologne office recently hosted a conference on Chinese arbitration for German practitioners and members of the business community on 3 July 2009. Speaking at the event was a delegation from the China International Economic and Trade Arbitration Commission ("CIETAC"), including Xie Changquing, Secretary General, and Wang Chengjie, Deputy Secretary General. Together, they promoted the use of CIETAC, responding to traditional Western reservations towards arbitrating in China by discussing the recent changes made to the CIETAC Arbitration Rules ("Rules"), effective since 2005. Additionally, Helen H. Shi of the PRC law firm, Fangda Partners, focused her presentation on avoiding and managing disputes as a foreign investor in China.

Rise of Chinese Economy and Party Policy Favoring Foreign Investors:
The ever-growing city skylines of cities like Shenzen, Shantou, Zhuhai, and Shanghai have become quite visible measuring sticks for the West, evidencing the growth of the Chinese economy over the past few decades. China has dedicated substantial resources to establish an investment environment attractive to foreign investors, attempting to combat local protectionism and build the professional reputation and competence of the judiciary. Such efforts to revitalize the investment environment have been lauded, but further work remains to be done.

China has opened the country to foreign investors most notably by establishing Special Economic Zones like Shenzen where economic laws are more liberal than those typical to the rest of the country. In 1978, foreign investors were, in practice, confined to joint ventures with Chinese enterprises, but in 1992, wholly owned subsidiaries became the more regularly chosen vehicle, leading to a massive wave of foreign direct investment ("FDI"), reaching US$45 billion between 1997 and 1998, prior to the Thailand-centered Asian market crash.

Although FDI in China has steadily risen since the crash (US$92.4 billion and a 22.6% increase in 2007 alone), there has been close to a 20% decline since the current global crisis began. With its "socialist market economy," China has defied every traditional economics model applied to it in

the past, and is now confident in a rebound once the crisis subsides.

Chinese Arbitration Statistics:
While there are currently more than 200 local arbitration commissions in existence throughout China, CIETAC is the pre-eminent arbitration commission, also handling international cases. Such dominance is evidenced by its issuance, on average, of approximately 600 awards annually. In 2007 alone, CIETAC received 1,118 new arbitration references, a number representing twice as many new cases as received by the ICC in Paris.

The 3 Classifications of Chinese Arbitration:
One of the interesting – and for first-timers, slightly confusing – aspects of Chinese arbitration law is its three-tiered classification system, distinguishing between domestic, foreign-related and foreign arbitrations. These distinctions are important to understand because they affect various aspects of the arbitration, including the treatment of awards during the enforcement stage. Thus, parties must ensure that they are in compliance with their respective classification when drafting arbitration clauses.

Domestic arbitrations are exactly as they sound – arbitrations between Chinese parties involving Chinese transactions which may only be conducted within Chinese borders. Foreign-related arbitrations may be conducted both inside and outside China, and arise when at least one foreign party is involved or the transaction under which the dispute arose has a significant "foreign element" (as further defined by law), but the arbitration is conducted by a Chinese arbitral body. Foreign awards are only those arbitrations conducted completely outside of Chinese borders (including Hong Kong, as it is considered a separate jurisdiction). It is important for foreign parties to be aware that joint ventures operating within China are considered domestic legal persons for the purposes of these classifications and thus not considered foreign-related merely by the presence of a foreign equity holder.

These distinctions are clearly evident in the setting aside or non-enforcement of an award, a process which varies significantly between the three. While foreign awards and those foreign-related awards rendered outside of China are enforceable under the New York Convention or other bilateral enforcement treaties, domestic awards and those foreign-related rendered inside of China are reviewable under different legal instruments.
As such, only those awards rendered physically outside of China are covered by the New York Convention, whether the matter is foreign or foreign-related. As for those proceedings conducted inside China, enforcement is governed by Chinese domestic civil procedure, whether foreign-related or domestic (however, two different regimes will apply). In addition to enforcement, the classification of an arbitration as either foreign-related or domestic will be relevant when determining questions regarding fees and the panel of arbitrators.
Ad Hoc Arbitration in China
One of the most important, and often overlooked requirements of the Chinese Arbitration Law (https://www.cietac.org.cn/english/laws/laws_5.htm) relates to the availability of ad hoc arbitrations. Under the current law, any arbitration that takes place inside China must be institutional, conducted by one of the 200 nationally recognized institutions. If parties proceed with an ad hoc arbitration, it will be valid only to the extent that the parties may voluntarily comply with the award, but will be unenforceable in Chinese courts. In contrast, if conducted outside of the geographical borders of China, ad hoc arbitration is permissible and such awards are enforceable in China under the New York Convention. Thus, the prohibition goes to the conducting of ad hoc proceedings in China, not to the enforcement in China of an award in an ad hoc proceeding outside

of China. For practitioners, it is important to ensure that arbitration agreements do not include any ad hoc provisions to be conducted on Chinese soil.

The 2005 CIETAC Rules (https://www.cietac.org.cn/english/rules/rules.htm) and the Concerns Raised at the Conference:
The 2005 Rules have brought CIETAC arbitration more in line with the procedures provided for by the rules of the ICC and other Western arbitral institutions. These changes have alleviated some concerns of foreign parties, evidenced by the steady increase of CIETAC arbitrations as the Rules have been revised to bring them closer in line with international standards. However, there are still a few areas where foreign parties remain worried, a fact reinforced by questions raised at the conference. Traditionally, two peculiarities of Chinese arbitration predominate discussions – (1) the integration of mediation in the arbitration process and (2) the rules which govern the selection of the arbitral tribunal – and this event was no different.

Firstly, the "Arb-Med" process is something unique to CIETAC arbitration, a concept traced to a historic focus on amicable resolution and an aversion to litigation (a cultural trait present since Confucius). Both the Arbitration Law and the 2005 Rules provide for mediation at all stages of the dispute resolution process. Article 40 of the 2005 Rules not only encourages arbitral parties to mediate, but allows for the tribunal to "approach" a reluctant party and advise reaching a settlement.

During the presentations, several concerns were raised about arbitrators effectively transforming themselves into mediators, a position that could elicit information which would not have been offered in arbitration. In this scenario, if a settlement is not reached, the arbitrator-turned-mediator can return as an arbitrator, privy to confidential information received in caucus. Although instructed to disregard all information obtained as a mediator, the receipt causes genuine angst in even the most seasoned counsel.

If a settlement is reached, it may be transformed into an enforceable award as long as there is a valid CIETAC clause. Although ICC Article 26 and Rule 30 of the Model Law also provide for similar procedures, the major difference lies in the discretion provided to the tribunal in the ICC and Model Law provisions to refuse issuing an award. Instead, the CIETAC provision, Article 40(6), states that the tribunal "will close the case and render an arbitral award," effectively ridding the tribunal of any discretion in the matter.

The other central concern raised by the audience has to do with the nomination of arbitrators. Under the 2005 Rules, when parties cannot agree to the appointment of a chairman (common in the adversarial process), Article 22(3) allows the Chairman of the institution to decide. While an accepted practice, absent from the Rules is a nationality restriction which is included in other institutional rules like the ICC. Instead, the Chairman may appoint anyone, including a Chinese national as the chairman, even if the Chinese party has nominated a Chinese arbitrator themselves. In fact, only in a few rare instances is this not the case. Whether or not a true bias exists, the perception of the process leaves parties apprehensive.

A major change in Article 21 allows parties to nominate arbitrators from outside CIETAC's official Panel of Arbitrators. Previously, parties could only appoint arbitrators included on the list (currently including more than 530 Chinese and 126 Western arbitrators), but today, if both parties agree and the CIETAC Chairman approves, then the parties are free to choose arbitrators from outside the list. While this does give the parties more autonomy, the presumption of panel

appointment remains unless a clear provision is found in the arbitration agreement.

Another more general, but significant change is the default nature of the Rules, giving parties the power to alter the CIETAC rules as they wish, a huge step in achieving the desired party autonomy.

The Reporting System:
During the presentations, one of the characteristics of Chinese arbitration receiving the most intrigue was the reporting mechanism used at the enforcement stage. The current mechanism requires an Intermediate People's Court intending to vacate a foreign-related or foreign award to report to the relevant High People's Court ("HPC"). If the HPC affirms, then the Supreme People's Court ("SPC") makes the ultimate decision. The mechanism has significantly helped to avoid biased or protectionist decisions at the local levels, a development which overcomes criticisms about the time delays in obtaining a final decision caused by such reporting. While certain panelists conceded that changes are needed to better protect the parties, the clear message of the delegation was that it has significantly improved the standards of Chinese enforcement – a position supported by the results.

China as an Arbitration Location – Enforcement Obstacles:
As the government has done much to improve the judiciary, enforcement appears to be less of a problem than generally perceived given that very few awards are actually vacated in China. In reality, the problem is often that local protectionism and Party politics create serious obstacles to recovery, a different creature than enforcement.

An enforcement order from the courts is worth its weight in… well… paper, if there is nothing to enforce that award against. Even with the significant steps taken by Chinese officials to combat local protectionism, it still poses a serious obstacle to recovery. In order to protect influential companies – especially state-run enterprises – who provide significant tax revenue, it is possible for judges to use dilatory tactics, allowing the local party time to create a "pseudo-insolvency" by siphoning off money from the liable entity to subsidiaries and partnerships out of the reach of an enforcement proceeding. Although this may not be a common occurrence, it is a possibility which must be addressed by parties looking to enter into arbitration agreements in China.

Conclusion:
In revising the 2005 Rules, CIETAC has made significant steps towards improving the acceptance of arbitrating international commercial disputes under those rules. While some foreign parties continue to harbor reservations about Chinese arbitration, CIETAC's policy of promoting its rules outside of China and engaging in open discussions – tackling sometimes critical and difficult questions – will further assist in aligning CIETAC's practice with internationally accepted principles. By demystifying Chinese arbitration through such candid dialogue, openly addressing such concerns in the coming years, this policy will go a long way in alleviating those concerns remaining in some Western parties.

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