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Chinese Court Enforces HKIAC Awards Despite Alleged Violations of PRC Regulations

Arthur Ma and Joanna Du (Herbert Smith Freehills LLP) · Wednesday, March 18th, 2015

The terms 'variable interest entity' ('VIE'), 'valuation adjustment mechanism' ('VAM') and 'public (social) interest of China' (otherwise, Chinese 'public policy') each entail complex legal issues. They have in the past caused heated debate in China as to their legality (in the cases of VIE and VAM) and their boundaries in the context of enforcement of foreign arbitral awards (in the case of public policy). Thus, when a recent PRC court ruling linked all three topics, it instantly became a leading judicial precedent.

Introduction

On 5 November 2014, the Fuzhou Intermediate People's Court ('the Fuzhou Court' or 'the Court') handed down a civil ruling in *Fujian Across Express Information Technology Co Ltd and others v China MediaExpress Holdings Inc* (2014) Rong Zhi Jian Zi No 51 ('the *Fujian Across Express* case'). The ruling confirmed that two HKIAC awards concerning related transactions should be enforced in Mainland China under the Arrangement on the Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region (1999) ('the Arrangement').

The two HKIAC awards

Cheng Zheng was a shareholder in China MediaExpress Holdings Inc ('China MediaExpress'). Cheng was also the legal representative of Fujian Across Express Information Technology Co Ltd ('Across') and Fujian Fenzhong Media Co Ltd ('Fenzhong'). In 2009, China MediaExpress went public in the United States via a reverse takeover. In January 2010, Starr Investments Cayman II Inc ('Starr') entered into a Share Purchase Agreement ('SPA') and Investor's Rights Agreement ('IRA') with China MediaExpress.

Following closure of the transaction, Starr discovered that Cheng and others had been involved in secret dealings that violated the SPA and IRA. To protect its interest, Starr commenced arbitration before HKIAC against Cheng and the three companies (collectively, the 'Applicants'). On 19 December 2012, the arbitral tribunal rendered two arbitral awards ordering the Applicants to compensate Starr for losses incurred.

Enforcement of the awards

Starr subsequently applied to the Fuzhou Court for enforcement of the awards under the

Arrangement.

The Applicants submitted that the HKIAC awards seriously violated the 'public interest of the Mainland'. They contended that (1) the VIE structure adopted in the underlying transactions was prohibited by mandatory provisions of Chinese law; (2) the VAM arrangement in the SPA infringed the interests of China MediaExpress, its creditors and other shareholders; and (3) the arbitration agreement had applied US law with the purpose of sidestepping mandatory provisions of Chinese law.

Starr responded that enforcing the awards would not violate the 'public interest of the Mainland'. It contended that (1) the wording of article 7 of the Arrangement required the court only to examine whether the consequences of enforcement would violate the public interest, not the a violation of the applicable law would do so; (2) enforcing the awards would force the Applicants to compensate the losses incurred by Starr and therefore encourage people to abide by agreements into which they had entered; and (3) the term 'public interest of the Mainland' was not equivalent to mandatory rules in the Mainland; it should be interpreted only as referring to the basic legal system of China and the fundamental interest of society.

The Fuzhou Court ruled in Starr's favour. Firstly, it agreed with Starr that enforcing the awards would encourage people to abide by agreements they had entered into, uphold the spirit of contract law and act in accordance with the public interest.

Secondly, the Court relied upon a decision of the Supreme People's Court ('SPC') in a previous case in concluding that violations of certain regulations concerning VIE and VAM did not necessarily constitute a violation of the 'public interest of the Mainland'.

VIE and its legal status under PRC law

A VIE arrangement in China refers to a business structure that typically involves an onshore wholly foreign-owned enterprise ('WFOE') or foreign-invested enterprise ('FIE') owned by overseas investors (and sometimes Mainland Chinese founders). This in turn controls a domestic company, which holds the necessary licence to operate in China in certain sectors in which foreigners are restricted or prohibited and is therefore widely used by foreign investors to bypass China's stringent rules on foreign ownership in certain sectors. The legality of the VIE is, however, currently unclear. It is controversial in practice because it circumvents (1) China's regulations on foreign investment in certain restricted or prohibited sectors, and (2) approvals required from relevant government authorities in China.

VAM and its legal status under PRC law

VAM is even more problematic because this investment tool commonly used by private equity houses was declared unlawful under certain circumstances by the Chinese courts in 2012. This mechanism incentivises investors by mitigating uncertainties and risks associated with an investee company's financial performance following the investment. Typically, a VAM provides that if the investee company meets (or fails to meet) certain financial targets within an agreed period following the investment, the investee company's valuation will be adjusted accordingly. For example, it is usually agreed that if the investee company fails to meet agreed financial targets, investors would be compensated either by additional shares or cash.

The legality of VAM under PRC law remained unclear until the decision in *Haifu v Shiheng*,

Wisdom Asia and Lu Bo (2012) Min Ti Zi No 11, in which the SPC ruled that a VAM arrangement under a capital increase agreement was (1) as between the original shareholders and the investors, valid and enforceable, but (2) as between the investee company and the investors, invalid and unenforceable. The SPC's ruling provides some comfort to investors who are uncertain of VAM's legal status in China.

Public policy as a ground for refusing enforcement of foreign awards in China

When the SPC drafted the Arrangement in 1999, inspiration was taken from the Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 (the 'New York Convention') in setting thresholds for non-enforcement of arbitral awards made in Hong Kong. One of these thresholds is violation of the 'public interest of the Mainland'. Article 7(3) of the Arrangement stipulates that if a Mainland court believes that the enforcement of a Hong Kong arbitral award would violate the 'public interest of the Mainland', the court may refuse its enforcement.

This ground for non-enforcement mirrors article V.2(b) of the New York Convention, which allows the court in the country where recognition and enforcement are sought to refuse to recognise and enforce an award if it finds that to do so would "be contrary to the public policy of that country".

Notably, since China's accession to the New York Convention, the SPC has held a very tight line in interpreting 'public policy'. On a number of occasions, Chinese courts have held that a mere breach of mandatory provisions of Chinese law or regulations does not amount to a violation of the public policy of China. In an earlier case, the SPC expressed the view that –

"the issue of public policy shall only be restricted to the circumstances where recognising the arbitral award will violate Chinese basic legal system and damage Chinese basic social interest [*sic*]."

(See SPC's *Reply to Request for Instructions regarding Haikou Intermediate People's Court's Refusal to Recognise and Enforce the Arbitral Award of the Stockholm Chamber of Commerce,* 13 July 2005; SPC's *Reply to the Request for Instructions on Non-Recognition of No 07-11 (Tokyo) Arbitral Award of the Japan Commercial Arbitration Association,* 29 June 2010.)

The significance of the Fuzhou Court decision

In conclusion, the *Fujian Across Express* case is significant in at least two regards.

Firstly, the decision makes clear that, when determining a challenge to enforcement of an award brought under the Arrangement on the ground of an alleged violation of the 'public interest of the Mainland', the court should focus on the effect or consequences of enforcement, rather than on the content of or substantive issues in the award.

Secondly and more significantly, the decision clarifies that the 'public interest of the Mainland' or 'public policy' in China is by no means equal to mandatory provisions of Chinese law or regulations. A mere violation of government regulations would therefore be insufficient to establish a case of violation of 'public interest' or 'public policy' of the Mainland.

On a broader level, the *Fujian Across Express* case once again evidences the narrow approach of the PRC courts in their interpretation of public policy and their commitment to enforcing Hong

Kong awards under the Arrangement, thus reinforcing an excellent record of enforcement.

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