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Bold move by Shanghai Court in interpreting the phrase 'foreign-related element': A direction to follow?

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Introduction

As noted this firm's previous post on the *Chaolaixinsheng* case (see Cao Lijun & Lu Leilei, *To Be or Not to Be? The Practical Implications of Choosing Foreign Arbitration for Domestic Contracts*, 6 March 2015), the Supreme People's Court of China (the SPC) expressly ruled that foreign arbitral awards made in relation to purely domestic contracts lacking a 'foreign-related element' were unenforceable. In particular, the SPC did not consider the fact that a wholly foreign-owned enterprise (WFOE) was a party to a dispute was a 'foreign-related element'. On 27 November 2015, however, the Shanghai No 1 Intermediate People's Court (the Court) issued a decision recognising and enforcing an arbitral award made by a Singapore International Arbitration Centre (SIAC) tribunal in a dispute involving two WFOEs (the Decision). Encouraging as the Decision may be, it will be interesting to see whether the method employed by the Court to interpret the scope of the phrase 'foreign-related elements will be endorsed by the SPC or followed by other courts in similar circumstances.

PRC law specifies what constitutes a 'foreign-related element' in a dispute by virtue of the SPC *Interpretation on Several Issues Concerning the Law of the People's Republic of China on the Application of Laws to Foreign-related Civil Relations (I)*, Fa Shi [2012] No 24 (28 December 2012, effective 7 January 2013) (the Interpretation). Under article 1 of the Interpretation, a dispute may be considered 'foreign-related' if (a) at least one of the parties to the dispute is a foreign citizen, foreign legal entity or other organisation or individual without nationality; (b) the habitual residence of one or both parties is outside the PRC; (c) the subject-matter of the dispute is located outside the PRC; (d) the legal facts establishing, changing or terminating the parties' civil relationship occurred outside the PRC; or (e) there are other circumstances that may be considered as foreign-related civil relations. Despite the broad nature of this provision, in particular category (e), the PRC courts have maintained a conservative approach towards interpreting the phrase "foreign-related elements".

The dispute and the tribunal's award

In a bold move, the Court in this case departed from its long-standing position. The dispute concerned a claim for breach of contract under an equipment supply agreement entered into on 23 September 2005 between Siemens International Trading (Shanghai) Co Ltd (Siemens) as seller and Shanghai Golden Landmark Co Ltd (Golden Landmark) as buyer, both of which were WFOEs and

considered as Chinese companies under PRC law. The arbitration clause in the contract provided for the dispute to be resolved by arbitration administered by SIAC in Singapore, with the governing law of the contract being PRC law. Golden Landmark commenced arbitration proceedings against Siemens and Siemens filed counter-claims during the arbitration. The SIAC tribunal accepted the case and issued an award in favour of Siemens on 16 August 2011 (the Award).

Golden Landmark having failed to fulfil some of monetary obligations stipulated in the Award, Siemens applied to the Court to recognise and enforce it on 14 June 2013. Golden Landmark challenged enforcement on several grounds, most notably on the basis that the dispute contained no 'foreign-related elements', thus rendering the arbitration clause invalid under PRC law. Golden Landmark also raised violation of public policy as a ground for resisting enforcement.

The Court's decision

In its Decision, the Court held that the dispute was foreign-related and rejected each of Golden Landmark's arguments against enforcement. The Court noted that, at first glance, the dispute seemed to contain no 'foreign-related element', given that (1) both parties were Chinese enterprises, (2) the agreed place of delivery was in China, and (3) the equipment under dispute was also currently located there. However, a closer examination of the related parties and the characteristics of performance differentiated the dispute in the present case from a typical domestic contractual dispute. The Court took the following factors into account.

- Firstly both parties to the contract were to some extent foreign-related, being WFOEs with registered offices in the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ). The source of capital, ultimate beneficiary interests and decision-making powers of these companies were closely connected to the foreign investors of each party; these factors, the Court reasoned, distinguished the two parties from purely domestic companies. The Court stated further that, against the background of facilitating foreign investment and trade within the Shanghai FTZ, particular attention should be paid to these factors when deciding whether a dispute contained a 'foreign-related element'.
- Secondly, the performance of the contract had foreign-related characteristics. The equipment was first shipped from abroad to the Shanghai FTZ, where it underwent bonded supervision and customs clearance before being eventually delivered to the designated inland construction site. The Court held that the whole process of transfer of equipment from the Shanghai FTZ under special customs regulations bore similar features to the international sale of goods process.

Taking all the circumstances into consideration, the Court concluded that the factors outlined above constituted "*other circumstances* that may be considered as foreign-related civil relations" under article 1(e) of the Interpretation (authors' emphasis). The Court therefore held that the arbitration clause providing for SIAC arbitration was valid. It also dismissed the public policy challenge.

It should be noted that Golden Landmark was the party that initiated arbitration proceedings, that it did not contest the validity of the arbitration clause at any time during the entire proceedings and that it also performed part of the Award. Accordingly, the Court ruled that Golden Landmark's challenge to recognition and enforcement of the Award contravened the widely-adopted legal principles of estoppel, good faith, fairness and reasonableness. Interestingly, Siemens had itself unsuccessfully challenged the jurisdiction of the SIAC tribunal during the arbitration proceedings

on the ground of lack of ‘foreign-related elements’.

Commentary

To the authors’ knowledge, this was the first occasion on which a Chinese court applied the ‘other circumstances’ provision in article 1(e) of the Interpretation to support a finding of a ‘foreign-related element’ and thus to affirm the enforceability of a foreign award. The practical approach adopted by the Court in examining the business practice underlying the dispute seems to provide increased assurance to WFOEs that have agreed to refer disputes to a foreign arbitral institution despite restrictions under PRC law. It is interesting to note that the new definition of ‘foreign investor’ in the Draft Foreign Investment Law published on 19 January 2015 also ategorises WFOEs as foreign investors.

There are, however, several caveats of which advisers should be aware. Firstly, the Decision was made by a first instance court, since an affirmative decision to recognise and enforce an award did not require approval by the SPC under the pre-reporting system. It remains to be seen whether the SPC would look at the situation with similar flexibility and practicality. Secondly, by making special reference to the policy of the Shanghai FTZ, the Decision could be easily distinguished by other courts if the activities underlying disputes have no connections with free trade zones.

Moreover, the Decision has attracted criticism because the Court directly applied PRC law without discussing the governing law of the arbitration clause. If Singapore law were applicable as the law of the seat of arbitration, ‘foreign-related elements’ would not be an issue affecting the validity of the arbitration clause. The Court’s approach was not, however, surprising and may reflect the tendency of Chinese courts to apply PRC law when applying a foreign law would lead to a conflicting result.

In fact, in the 2014 *Chaolaixinsheng* case, the SPC explicitly ruled that the governing law of a non-foreign-related contract and arbitration clause, whether expressly or implicitly agreed, shall exclusively be PRC law.

With the recent opening of Mainland offices by the HKIAC, SIAC and ICC in the Shanghai FTZ, questions may arise as to whether restrictions on tribunals of these institutions to hear disputes lacking a ‘foreign-related element’ will be relaxed, in particular if the new offices are ultimately permitted to administer cases on the ground. As it takes time for a dispute to develop and be determined in a final award, there is a chance that, by the time such an award is rendered, the lack of a ‘foreign-related element’ may not be an obstacle to its recognition and enforcement as a result of further developments in the law.

In practice, the authors have seen a number of cases in which foreign investors have assigned their rights and obligations in contracts to their domestic entities in order to facilitate performance of those contracts, under which all contractual parties have become domestic entities. On the other hand, domestic parties may transfer their contractual rights and obligations to their foreign affiliates as a result of corporate restructuring. Such assignments may add a ‘foreign-related element’ to an otherwise purely domestic contractual relationship.

Conclusion

In light of the above, it is important for advisers to examine closely the facts underlying a dispute that appears to lack a ‘foreign-related element’ and take developments in the law into consideration when deciding arbitration strategy.

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