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Beijing Court Rejects Jurisdictional Challenge in Investment Agreement Dispute – a Step Forward for PRC Arbitrability Jurisprudence?

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Introduction[1)]

Agreements governing the relationship of shareholders to each other and to the company (*e.g.*, shareholders', investment or subscription agreements) (collectively, "**SHAs**") frequently address matters of corporate law. In the Chinese context, this creates uncertainty whether a given SHA dispute would be arbitrable as a "*contractual dispute*" or "*property rights dispute*", as required by Article 2 of the PRC Arbitration Law.[2)] In its June 2019 decision in *DAI Zheng vs. QUE Dengfeng and Tianzhou Culture Stock Limited Company* ("***DAI***")[3)] the Beijing No. 4 Intermediate Court provides more clarity that SHA disputes are, generally speaking, arbitrable.[4)]

The Beijing court's approach to arbitrability resonates with recent decisions in leading pro-arbitration jurisdictions such as Germany,[5)] Singapore,[6)] and Hong Kong,[7)] and this will be reassuring to parties arbitrating SHA disputes in non-mainland PRC seats when a party against whom enforcement is sought (including another shareholder or the subject company) is located in mainland PRC. There remain, however, established and potential limitations on arbitrability of certain issues arising under SHAs where PRC Arbitration Law is applicable.

Background

In 2015 the parties concluded an investment agreement governing *Tianzhou's* subscription of new "*registered capital*" (*i.e.,* equity) in *Juesheng* Education Science and Technology Group Stock Limited Company ("**Juesheng**"). Shortly thereafter, they concluded a supplemental agreement requiring petitioner *DAI Zheng* and respondent *QUE Dengfeng* (the controlling shareholders) to repurchase *Tianzhou's* shares at cost plus an agreed profit margin on the occurrence of certain events. The agreements contained identical arbitration clauses, providing for submission of "*disputes arising from performance of this agreement*" to binding arbitration in Beijing administered by the China International Economic and Trade Arbitration Commission ("**CIETAC**").

In 2018 Juesheng amended its articles of association ("**AoAs**") to include a new Article 26, requiring the board to claw-back profits derived by "*directors, supervisors or senior management personnel of the company, or shareholders holding in excess of 5%*" from purchase and resale, or sale and repurchase, of Company shares within six months. In the event of the board's failure to do so within 30 days of a shareholder's demand to perform, the notifying shareholder could bring suit for the benefit of the company in People's Court.

After *Juesheng's* serious losses triggered the repurchase obligation, *Tianzhou* commenced arbitration to compel performance and *DAI Zheng* brought a jurisdictional challenge in the Beijing court, seeking a declaration that the arbitration clauses were invalid. *Dai Zheng* argued that because he, *QUE Dengfeng*, and *Tianzhou* each had shareholdings in excess of 5%, the People's Court had jurisdiction over the dispute pursuant to Article 26 of the AoAs.

Holding and Rationale

The court rejected *DAI Zheng's* claim as "*lacking a basis in fact and law*" following a three step analysis. First, it determined that the arbitration clauses satisfied the formal requirements of Article 16 of the Arbitration Law, and second confirmed the absence of any of the invalidating circumstances listed at Article 17 of the Law. The court then considered petitioner's argument that the litigation forum clause in the AoAs replaced, and therefore invalidated, the arbitration clauses. Observing that the former involved claw-back of trading profits obtained by specific company personnel and individual holders of more 5% of the company's shares, while the latter encompassed the terms of *Tianzhou's* subscription of *Juesheng's* newly increased registered capital "*as an investor*" (and related terms), the court determined that the two "*defined completely different legal relationships*". While the third step is a useful scope analysis of inconsistent forum clauses, it is the second step that further clarifies arbitrability of SHA disputes, as discussed below.

Comments

DAI appears to be the broadest affirmation of SHA disputes arbitrability by a Chinese court to date, but what does this mean for Chinese arbitrability jurisprudence? While *DAI* does not have precedential value *per se*, it does form part of a growing body of "*soft precedent*" that increasingly has reference value for other Chinese courts.[8] A 2017 PRC Supreme People's Court ("**SPC**") directive requires People's Courts at all levels to establish a system for "*searching . . . similar . . . and relevant cases, to ensure a uniform judgment standard for similar cases, and the uniform application of law*".[9] Accordingly, it is reasonable to view *DAI* as representing mainstream judicial views on SHA dispute arbitrability in China, thus making a noteworthy contribution to China's emerging *jurisprudence constante* in this area. Within these parameters, *DAI* is consistent with pro-arbitration policies and is instructive in at least four ways:

First, it supports a broad presumption of arbitrability of SHA disputes by (i) listing specific matters within the scope of the arbitration agreement and (ii) finding that nothing in the arbitration agreement violated Article 17 of the Arbitration Law, including 17(1): "*matters outside the legally mandated scope of arbitration*". The matters identified include: registered capital increase and subscription thereof, an investor's right to transfer its shares, pre-emptive rights, co-sale rights,

controlling shareholders' obligations to repurchase the investor's shares or provide compensation in kind and terms governing share repurchase and compensation.

Second, it supports the proposition that the mere fact that a given matter is also addressed by the PRC Company Law[10] does not derogate from its arbitrability as a "*contract dispute*" or "*property rights dispute*". "*Registered capital increase*", for example, is subject to approval by a 2/3 majority of voting shares under Article 43 of the Company Law, while proposed transfers to non-shareholders are subject to approval and pre-emptive rights of incumbent shareholders under Article 72. The DAI opinion specifically identifies both of these matters, implicitly affirming that they do not offend Article 17(1).

Third, *DAI* suggests that Chinese courts will closely scrutinize the scope of inconsistent forum clauses by considering the specific matters addressed in the underlying commercial agreements, to assess the integrity of the parties' expressed intent to arbitrate the subject dispute.

Fourth, *DAI* helps extend Chinese SHA dispute arbitrability jurisprudence beyond the context of foreign invested enterprise ("**FIE**") joint venture contracts, in which most earlier rulings on dispute arbitrability are found.[11] The fact that the PRC Equity Joint Venture Law[12], specifies administered arbitration as a primary dispute resolution option, while the Company Law is silent on arbitration, tends to limit the value of these precedents when arbitrating non-FIE SHA disputes. *DAI* helps to fill this void.

Established and potential restrictions on SHA dispute arbitrability remain, however.[13] The SPC has drawn a "*bright line*" in holding unilateral company dissolution actions involving management deadlock pursuant to Company Law Article 182 to be non-arbitrable.[14] A shareholder dispute falling within the scope of "*core*" bankruptcy issues, likewise, is probably non-arbitrable.[15] Consequently, notwithstanding an otherwise valid arbitration agreement, a bankruptcy court would likely assert exclusive jurisdiction over a dispute involving claims that an unfunded commitment under a subscription agreement formed part of the bankruptcy estate.

Considerations discussed by the SPC when holding company dissolutions to be non-arbitrable could also support jurisdictional challenges in other SHA dispute contexts. The SPC has observed, for example, that the company is an essential party to proceedings seeking its dissolution, and also that dissolutions implicate both corporate matters and non-party stakeholder interests.[16] Since Company Law, Article 33, provides the basis for a shareholder's right to company information and creates a permissive right of action in court when the company denies access, the company is also arguably an essential party when information rights are at issue. Where the Company Law imposes minimum shareholder voting thresholds (such as registered capital increase, noted above), there is also an argument that shareholders representing the specified proportion must be parties to the arbitration agreement in order to establish valid consent to arbitrate the matter.

Although beyond the scope of the post, other shareholder dispute contexts also bear further examination, such as anti-trust, unfair competition and shareholder resolutions. As economic headwinds continue to foment arbitrated SHA disputes involving Chinese companies, jurisprudence in these and other areas should continue steadily to evolve.

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References

?1 All citations of People's Republic of China ("**PRC**") sources refer to original Chinese language materials, except for the Tsinghua China Law Review. Title translations are provided by the author.

?2 Arbitration Law of the People's Republic of China (rev. 2017) (hereinafter, "**PRC Arbitration Law**"), Article 2.

?3 Beijing No. 4 Intermediate People's Court, Case No. (2019) Jing04MinTe250Hao, 2 June 2019, Applicant: *DAI Zheng*, Respondents: *QUE Dengfeng*, *Tianzhou* Culture Stock Limited Company.

?4 *See also*, discussion of *DAI* in Zhang Zhen'an, "Agreement Among Shareholders is Independent of Company Articles of Association, the Two Define Different Legal Relationships (Beijing No. 4 Intermediate Court)", Ad-hoc Arbitration ADA WeChat Official Account, July 12, 2019.

?5 See discussion in an earlier Blog post.

?6 *See, e.g.* BTY *v* BUA and other matters [2018] SGHC 213.

?7 *See* an earlier Blog post.

?8 Susan Finder, *China's Evolving Case Law System in Practice*, 9 Tsingua China Law Review 245 (2017).

?9 SPC Opinion on Putting a Judicial Responsibility System in Place and Improving Mechanisms for Trial Oversight and Management (Provisional), *FaFa (2017) 11 Hao*, *cited at* Finder, *supra*, at 256.

?10 PRC Company Law (Third Amendment, effective March 1, 2014) (hereinafter "**Company Law**").

?11 *See*, *e.g.*, cases discussed in Corporate and Commercial Practice Research Committee, "Summary of Lectures on 'Questions of Arbitrability of Several Types of Corporate Disputes'" (20 December 2018) (hereinafter, "**Arbitrability of Corporate Disputes**").

?12 Sino-Foreign Equity Joint Venture Law of the PRC (2001 rev.), Art. 15.

?13 *See*, Arbitrability of Corporate Disputes, parts III and IV.

?14 *See*, cases and other authorities discussed at Arbitrability of Corporate Disputes, sub-part III(3).

?15 *See*, Arbitrability of Corporate Disputes, sub-part IV(2)3.(II).

?16 *See*, SPC Reply to Request in Case Regarding Vacatur of CIETAC Award (2009) CIETACBJ (0355), [2011] *Min Si Ta Zi di 13*, at part V.(2).