Enterprises in China's Free Trade Zones Enter 2017 with New Options for Arbitration

Arthur Dong and Darren Mayberry

A recent Supreme People's Court Opinions has created a stir in China's international arbitration community. The Opinions was dated December 30, 2016 and it covers an array of matters relating to legal measures to expedite the development of Free Trade Zones.[1] Among other matters, the SPC sought to open the Free Trade Zones to further options regarding alternative dispute resolution. The great interest from the arbitration community stems almost entirely from the remarks made in Article 9. The SPC has effectively designated as Foreign *Per Se* any Wholly Foreign-Owned Enterprises which are registered in one of 11 current Free-Trade Zones. What amounts to a seemingly technical classification actually heralds a transformation of real significance. In three brief paragraphs, the SPC seems to have shifted the landscape for China-based arbitrations. The Opinions offers little tangible or immediate benefit to Chinese arbitration users. The immediate practical significance of the Opinions may remain humble and limited. Nonetheless, the world arbitration community will welcome the increased deference and jurisdictional purview the SPC meaningfully presents to foreign tribunals. Upon future reflection, Chinese businesses and arbitration professionals may recall this moment as the initial beginning for *ad hoc* arbitration in China.

This note will review background distinctions between institutional and ad hoc arbitration and visit the necessity for arbitral institutions under Chinese arbitration agreements. It will also examine the foreign-element requirement necessary to escape the Chinese arbitral institution requirement, while reminding that all China-registered enterprises are Chinese. After summarizing the landscape ahead of the Opinions, the note will then look at the substance of the Opinions. This note then proceeds to analyze what it styles as a new 'Foreign *Per Se*' classification. It will subsequently consider practical implications and the possible reception from various interested parties and organizations towards the Opinions. Before it concludes, this note will pose some open questions and make attempts at provisional answers and recommendations.

[1] *Opinions on Providing Judicial Protection for the Construction of Pilot Free Trade Zones*. December 30, 2016.

Ad Hoc versus Institutional Arbitration

Parties often designate a host institution to guide and manage the arbitration. This arrangement is known as institutional arbitration. In other cases, an arbitration clause will permit the parties themselves to decide on the procedure of the arbitration outside of institutional guidance. The latter such arrangement is known as *ad hoc* arbitration.

Ad hoc procedures produce awards which may be recognized and enforced worldwide. China is no exception; China's commitment to the New York Convention binds it to the enforcement of foreign awards. However, China draws a sharp line between disputes which are foreign-related or domestic. Domestic disputes must be resolved under the guidance of an arbitration institution.

The Necessity for the Selection of an Arbitration Institution under Chinese Law

In a basic sense, Chinese law confines its recognition of domestic awards to those supervised by arbitration institutions. Article 16 of China's Arbitration Act requires each arbitration agreement to designate an arbitration commission. Under Article 18 of the Act, lack of clarity on this point may defeat even the validity of the arbitration agreement, unless the parties can mutually arrive at a supplementary arrangement (after their dispute has arisen).

Foreign Arbitration Institutions and the Foreign Elements Requirement

As a matter of public policy or choice of law, Chinese courts can impose this requirement of the selection of an arbitration institution as to domestic arbitrations. On the other hand, Chinese courts will almost uniformly recognize and enforce the awards of foreign arbitration institutions (SIAC, HKIAC, LCIA, JAMS, etc), at least when those institutions supervise arbitrations between one or more foreign parties, or a number of genuine foreign elements arise throughout the transaction. Chinese courts must recognize foreign awards in accordance with China's adoption of the New York Convention. Nonetheless, Chinese courts may also prevent recognition and enforcement of awards supervised by foreign institutions whenever no foreign element appears.[2] Foreign elements must be present, otherwise the parties must designate the authority of a Chinese arbitration institution.[3] The foreign elements test will often be

[2] *See* Supreme Court Further Clarifies the Criteria for Determining the Validity of Foreign-Related Arbitration Clauses, Mar 25, 2015 (http://en.anjielaw.com/publications_detail/newsId=269.html).
[3] *See* China Supreme People's Court Holds That a Dispute Must Meet "Foreign-Related" Requirement for

satisfied when one of the parties is a foreign-registered company. When both parties are domestic entities, and no other element can connect the dispute to another jurisdiction, this can create an issue for the ultimate validity and recognition of an award. Therefore, only rarely did foreign arbitration institutions find the opportunity to supervise arbitration between two domestic parties. Even if foreign elements were present, the selection of a foreign arbitration institution could have created unnecessary risk and uncertainty.

WFOEs and FIEs are Domestic Chinese Entities

Wholly Foreign-Owned Enterprises ("WFOE") are foreign-owned Chinese entities. For a variety of reasons, it may be highly desirable for foreign enterprises to form a WFOE.[4] Similarly, Foreign Investment Enterprises (FIEs) are Chinese companies, even though they may be entirely foreign-owned (i.e., WFOEs) or only partially foreign owned (joint-ventures).

Enter the Opinions

FIEs may benefit from favorable treatment with regard to arbitration, but they must be registered in one of China's 11 Free-Trade Zones (FTZs). WFOEs within FTZs will receive particularly favorable arbitration treatment. FTZ-based enterprises generally may very possibly be able to engage in *ad hoc* arbitration, subject to rather stringent requirements.

First, the SPC has determined that two FTZ-registered WFOEs satisfy the foreign-element test such that they may submit to arbitration agreements seated in foreign countries. For now, at least, both parties must be WFOEs to qualify. As for FIEs more generally, the SPC has permitted courts to validate such agreements. Accordingly, people's courts are also to dismiss challenges to recognize or enforce resulting awards when the moving party has either (1) initiated arbitration or (2) failed to object during the arbitration procedure, at least as to challenges based on violation of public policy relating to the foreign-element test.

Arbitration at Foreign Arbitration Forums, Nov 22, 2013. (http://www.chinalawvision.com/2013/11/articles/china-arbitration-and-arbitrat/china-supreme-peoples-court-holds-that-a-dispute-must-meet-foreignrelated-requirement-for-arbitration-at-foreign-arbitration-forums/)

[4] Dude, Just Form a China WFOE, Dan Harris, Feb 11, 2016. (http://www.chinalawblog.com/2016/02/25645.html)

Second, the SPC states that FTZ-registered enterprises do **not** need to engage supervision of an arbitration commission for China-based arbitration procedures, but the arbitration clauses must be manifestly specific about three aspects of their procedure. This applies even FTZ enterprises without foreign investors. Importantly, the enforceability of any *ad hoc* arbitration will hinge on the satisfaction of three specific requirements. The arbitration clause must designate a specific particular place on the Mainland, a specific (set of) arbitrator(s), and a specific arbitration rule.

Domestic FTZ parties commencing arbitration under an *ad hoc* arbitration agreement, or even under an agreement designating a foreign institution, could face a challenge to jurisdiction. Such a challenge would most likely bring the matter before a People's Court. Only one assurance operates in favor of the arbitration agreement besides the possibility of validity; People's Courts declaring such clauses invalid must report these cases to the intermediate courts. Likewise, higher courts that agree with the lower court concerning the invalidity of the clause must also report to the Supreme People's Court.

Foreign *Per Se*

The SPC's Opinions newly opens a classification for WFOEs, one once reserved exclusively to strictly non-domestic companies. WFOEs registered in FTZs are Foreign *Per Se*. As for FTZ-based non-WFOE FIEs, the Opinions offers a path to enforcement of foreign awards, while also leaving a last opportunity for an opposing party to mount a jurisdictional challenge. This Foreign *Per Se* effect, as this note styles it, will for now extend only to a narrowly defined class of organizations, Wholly Foreign-Owned Enterprises, registered in one of 11 Free-Trade Zones. Two WFOEs, each registered in a Chinese FTZ, may securely arbitrate their disputes abroad. By designating such WFOEs as *Per Se* Foreign now, the Supreme People's Court has actually commenced a series of analyses, in classic *Marbury v Madison* style. Two caveats for the reader: the SPC never mentions the term 'Foreign *Per Se*.' It is this note's gloss. FTZ-registered WFOEs now find themselves in an otherwise nameless classification of their own. Additionally, Foreign *Per Se* emphatically cannot equate to actually-foreign. Unlike a completely foreign-registered company, a single WFOE contracting with a wholly domestic company outside an FTZ may be unable to satisfy the foreign elements test, depending on the specific circumstances and other factors, such as the overall nature of the underlying transaction.

Domestic arbitration institutions may well begin to push increasingly strongly for broader reforms in the domestic arena. Now they face competition, at least for truly

international arbitration. The Opinions may be the beginning step, therefore, and not the final word, towards the modernization of China's arbitration regime. And it follows a track not entirely unfamiliar; that of the pursuit of progress through a gradual opening to the outside. Foreign *Per Se* may be the eventual destiny for all China-based arbitration users, in one way or another.

The WFOE FTZ-registration as Foreign *Per Se* reflects existing Chinese case law. Two recent cases confronted matters concerning the recognition and enforcement of foreign arbitrations. In the 2015 *Golden Landmark v. Siemens ITL* Case, Shanghai's First Intermediate Court found a foreign-relation arose simply because both companies were registered in the Shanghai Free Trade Zone. Additionally, it was critical to the decision to enforce the SIAC award that the sources of capital, allocation of income, and governance of the companies were all closely related to foreign investors. Notably, the objecting party had already performed some of the award and had acquiesced to the SIAC tribunal's authority in other ways. As for the 2013 *Chaolaixinsheng* case, the SPC came to a different conclusion and refused to recognize or enforce a KCAB award. The Beijing-based companies had little reason to resolve their dispute abroad. The only foreign relation was tenuous; the owner of one of the companies was a Korean citizen. The recent Opinions clarifies that the divergent results were indeed a meaningful product of the differing factual circumstances.

Practical Implications

This note will make an early attempt to assess some immediate and several eventual practical implications of the SPC's Opinions. First, it considers the perspective of foreign jurisdictions, tribunals, and practitioners. Then it looks at the effect on Chinese enterprises in the FTZs, and thereafter WFOEs in the FTZs. Finally, it takes the possible approach and reception of various foreign arbitration institutions. One thing seems almost certain: the Opinions will have a wide impact which will ripple worldwide across the international arbitration landscape.

For Foreign Jurisdictions, Tribunals, Practitioners

The SPC appears to have left room for foreign tribunals to assume *kompetenz-kompetenz* over proceedings involving two Chinese parties (whether *ad hoc* or institutional). In other words, if an FTZ-based (non-WFOE) FIE bears an agreement which has seated the arbitration outside of China, a party challenging jurisdiction may raise the question to the tribunal of whether the foreign elements in the transaction are

sufficient to grant it jurisdiction. After all, the Opinions now instructs Chinese courts to recognize and enforce the final awards of foreign tribunals with regards to FTZ-centered FIEs. At the same time, it leaves open whether the commercial arrangements of such FIEs would contain foreign factors sufficient to allow for the validity of foreign arbitration.

This may lead to an interesting phenomenon. Non-Chinese jurisdictions, perhaps particularly Hong Kong and Singapore, may eventually develop 'foreign' case law resolving what particular circumstances may satisfy the various factors in the foreign elements test. After all, respondents would be well within their rights to raise objections to jurisdiction against non-WFOE FIEs under China's public policy prohibition against foreign institutions adjudicating domestic disputes.

Therefore, the SPC's clarification of Chinese law on the jurisdiction of foreign tribunal and foreign-related elements may do more than simply provide a foundation for foreign tribunals to handle disputes from China-based parties. It could open a small aspect of Chinese law to the world. Small perhaps, but potentially very influential.

Foreign practitioners and arbitrators would do well to regard the boundaries with a fair acknowledgement of their limitations, as well as the limitations of the SPC. Hopefully foreign tribunals and representatives can treat the according responsibility of resolving such questions with the care and deference it deserves. Certainly the SPC will exercise the power to issue corrective guidance if outsider tribunals simply rubber-stamp jurisdiction with regard to their analyses of foreign-related elements. All the more reason for foreign tribunals and district courts abroad to strive to apply the foreign-related tests faithfully and factually.

On the other hand, this speculation could prove unfounded. Ultimately, no foreign case law may result regarding foreign-elements under Chinese law and public policy. Foreign arbitration institutions and foreign tribunals may uphold all challenges to jurisdiction relating to non-WFOE FIE-involved arbitrations. Foreign courts may then uniformly sustain those challenges. For a number of reasons, Hong Kong and Singapore courts may define the approach that foreign courts follow when facing such controversies. Indeed, the number of those controversies which may arise may be rather few.

For Chinese Enterprises in the FTZs

It appears that the Opinions reinforce the conception that domestic FTZ-enterprises may engage the services of foreign institutions, as long as the arbitrations are seated in China. The *Longlide* case[5] addressed, and ultimately approved, just such a scenario. The Opinions confirms the principle as first advanced in the *Longlide* case. Nevertheless, a China-seated SIAC or HKIAC institutional arbitration may lead to uncertain prospects. Chinese users already face a rich array of domestic arbitration institutions. Taken together, the three restrictions on the validity and enforceability of such arbitrations would make drafting such an agreement rather cumbersome.

As for *ad hoc* arbitration, too many questions and uncertainties remain. Therefore, the practical ramifications of the Opinions on *ad hoc* arbitration may be limited, at least initially. It seems unlikely that commercial enterprises will crowd towards *ad hoc* arrangements. Each such arbitration agreement would entail a certain challenge to validity that would arise once a party brought an *ad hoc* agreement to arbitration. Nonetheless, the Supreme People's Court has signaled that the Free Trade Zones are so non-domestic in character that enterprises registered within them may be able to operate arbitrations entirely differently than enterprises in regular areas. Careful drafters will certainly avoid the controversy and eschew *ad hoc* arbitration altogether. Likewise, the Opinions demands too many special requirements to save the handful of 'mistakenly' drafted arbitration clauses that are already out there and that would still be regarded as invalid.

Chinese enterprises will find the Opinions have left the door ajar to *ad hoc* arbitration. Yet, FTZ-based enterprises might reasonably fear what lies just on the other side. Certainly, no Chinese enterprise will be eager to experiment with how it feels to have the doorway shut on the validity of their arbitration clause. In any case, the SPC has certainly done remarkably much for *ad hoc* arbitration within the potential offered by the present parameters.

For Wholly Foreign-Owned Enterprises in the FTZs

The SPC and its Opinions have just handed WFOEs registered in FTZs an unambiguous windfall. They can arbitrate abroad without fear of challenge to the

[5] A case the SPC released on March 25, 2013 involving Chinese Anhui Longlide Wrapping and Printing Co., Ltd., Italian BP Agnati S.R.L and another party.

validity of their agreements. Very few WFOEs would have dared to arbitrate abroad before. Now they can opt to do so, confident that their awards will be enforced in China.

For Foreign Arbitral Institutions

Foreign arbitration institutions may surely greet this set of Opinions with cautious praise. Foreign institutions have a substantial win here. The Foreign *Per Se* classification offers substantial and welcome clarity: FTZ WFOEs can validly take their arbitrations abroad, and their awards will be enforced. Prior to the Opinions, the *Golden Landmark* case was only an unexpected individual success, but the *Chaolaixinsheng* case offered a clear warning. The conflict could provide no certain standard. Even without the defeat of the *Chaolaixinsheng* award, Chinese case law creates another challenge to a standard since it operates on a non-precedential basis. The Opinions may very well inspire in foreign arbitration institutions a sense of unexpected relief. FTZ FIEs may freely choose to take their arbitrations abroad. Indeed, it would be hard to see how foreign institutions could avoid some benefit from such a newfound inclination. Yet, it may be best for foreign institutions to decline to encourage such conduct, given the risks of a jurisdictional challenge. Even tribunals seated abroad may question whether they really have been endowed with *kompetenz-kompetenz*, or whether they must dismiss the arbitration when immediately confronted with a party's facially valid objection. The Opinions appears rather vague as to this point. Foreign institutions might be even more wary of accepting an arbitration between two domestic enterprises; it might result in an intervention of Chinese courts into the procedure to determine whether the three special criteria had been satisfied. Quasi-foreign-related arbitrations supervised at foreign institutions will present special challenges and difficulties. Nonetheless, the SPC's Opinions offers a steady step forward.

The Opinions does provide unambiguous support to the power of waiver of objection with relation to jurisdictional matters. Potentially, the Opinions might prove ultimately rather influential in this regard, even for cases entirely without FTZ-registered parties. After all, a party opposing arbitration at a foreign institution against an FTZ-FIE must present a ready and timely objection.

Open Questions

As with all momentous undertakings, the Opinions inevitably leaves a number of future possible issues unresolved. We attempt to address, or at least broach, several of the questions which the Opinions present for possible discussion.

1. Will the 'specific arbitration rule' criterion require adoption of a particular set of arbitration rules?

Potential *ad hoc* arbitration adopters may question whether Mainland arbitrations require the assumption of a Mainland set of Rules, or the assumption of Rules for foreign institutions with representative offices in the Shanghai FTZ (i.e. HKIAC, SIAC, JAMS, etc.), or whether any manner of UNCITRAL or other established Rules renowned and accepted worldwide are acceptable.

For now, AnJie recommends that potential users select their Rules rather conservatively. Users should have a detailed look at each Rule's procedures for the replacement of arbitrators.

2. Will the 'specific arbitrator(s)' requirement allow for a list of acceptable arbitrators rather than absolutely specific names?

Another question is whether the parties can nominate a list of five or nine or 17 or some higher number of acceptable candidates from which the parties may select one or three final arbitrators. It is unclear, at least from the face of the Opinions, whether the SPC's requirement of the assignment of specific arbitrators seeks to avoid selection of arbitrator disputes, or whether the SPC simply wants to review the arbitrators and assure they are qualified. The SPC may even have entirely other aims with this provision.

A potential problem lurks for parties that select an arbitrator only to have the arbitrator possibly refuse the appointment, be challenged and removed, or be unavailable for reasons of incapacity. Seemingly a valid 'specific arbitration rule' will outline a clear and workable procedure in case these kinds of calamities arise.

3. How specific must 'place in the Mainland' be?

One of the three criteria of ad hoc or institutional arbitration at a foreign institution requires the specific identification of a '特定地点.' What level of specificity is required is unclear. A city or province should be more than sufficient. AnJie reminds users that 特定地点, as used in the Opinions, likely means the seat of the arbitration, and not exactly the place of the hearing. Although parties can certainly feel free to designate with detail the building where the hearing may take place, they should take all due care to endeavor to hold the hearing itself near some good restaurants and fine dining. In fact, it is likely that 'place in the Mainland' means any designation of any identifiable place in mainland China. The Opinions may simply specify 'the Mainland' simply to exclude enforcement of a clause which sets the seat as simply 'in China' whenever the parties or a foreign court interprets 'in China' to include seats outside 'the Mainland,' i.e. in Hong Kong. Best practice counsels against specifying only 'China' when even designation of 'Mainland China' should suffice to satisfy this criterion.

4. Will a Chinese People's Court award reasonable attorney's fees to the party forced to defend against a challenge to enforce a facially valid award, at least under the language of these Opinions?

Perhaps the Opinions empower a moving party to recover attorney's fees in connection with the recognition and enforcement of an award. This should be a consideration at least when a challenging party strenuously resists enforcement on the foreign-relation grounds. After all, the Opinions very clearly place these FTZ-based WFOEs in a special class that this note has designated 'Foreign *Per Se*.' Likewise, disputes between two FTZ-based FIEs are almost certainly foreign-related. Chinese courts might entertain applications for attorney's fees to compensate against the effect of especially frivolous challenges to the most obviously foreign-related of awards.

5. Would an otherwise belated challenge to jurisdiction which was nonetheless initiated before the conclusion of the arbitration procedure constitute full waiver such that it would bar a public policy challenge to an award's enforcement?

This scenario entertains the effect of a party opposing jurisdiction against an FTZ-FIE, but where that party also files its jurisdictional challenge after the expiration of time under the applicable institutional rules, and yet also before (or at) the final hearing. Consider the implications of the Rules adopted by the parties. Strictly for this example, contemplate the effect of the SIAC Rules 2016; Rule 28.3 demands that party outline

their objections to jurisdiction by the Statement of Defense stage, or within 14 days after the tribunal exceeds its scope of jurisdiction. Under the Opinions, People's Courts are instructed to dismiss challenges notwithstanding their merits whenever: "the other party failed to raise challenge on the validity of the arbitration agreement during the arbitration procedure . . . ." Would a late objection, i.e. one delivered after the Statement of Defense, constitute a waiver of objection? (This case is particularly thorny because SIAC Rule 28.3 also provides that "The Tribunal may admit an objection raised by a party outside the time limits under this Rule 28.3 if it considers the delay justified." Surely the justifiable reasons would be strictly factual or procedural, and not at all related to special public policy concerns.) Nonetheless, the Opinions offers little guidance as to the timing of the objection; i.e., whether "在仲裁程序中" saves a late objection which occurs before conclusion of the arbitration procedure. Nor do the Opinions definitely resolve whether a late objection would be outside the parameters of the arbitration procedure selected by the parties.

6. Could a FTZ-based FIE challenge jurisdiction as respondent on the ground that it is not sufficiently foreign-related?

The Opinions clearly states that a party initiating arbitration would be prohibited from prevailing on a subsequent challenge of enforcement of the award, at least when FTZ-FIEs are involved. Left unclear is whether the FIE based in the FTZ could challenge jurisdiction on the basis of insufficient foreign elements, even though that FIE's presence in the FTZ would be the possible lynchpin of jurisdiction and perhaps not the initiating party (which might be a domestic entity, either within or outside of the FTZ). Could a foreign-related but domestic entity 'defend' Chinese public policy in this manner? The Opinions leaves open for further review as to what circumstances would permit an FIE to meritoriously challenge enforcement.

Concluding Remarks

Published on December 30, 2016, Article 9 of the SPC's Opinions relating to Free Trade Zones will influence Chinese arbitration even beyond the next few years. The Opinions certainly provides for favorable arbitration treatment for enterprises within the Free Trade Zones. That treatment will favor WFOEs in particular, and FIEs generally. Foreign enterprises and foreign arbitral institutions will find much to welcome within the brief three paragraphs of the Opinions. The SPC has done nearly as much as professionals and users of arbitration, international or Chinese, could reasonably expect or request. Both international and Chinese arbitration professionals

must look now to the National People's Congress for further and more expansive reform. Presumably, in the meantime, international businesses, Chinese enterprises in the FTZs, and the arbitration community all look forward to the SPC resolving the open questions and subsequent controversies in a reasonable and pro-enforcement manner.