

The “Do’s And Don’ts” of Drafting Arbitration Clauses When Doing Business with Chinese Parties

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When non-Chinese parties conduct business in China, or with a Chinese party, several factors must be considered when crafting an arbitration clause to ensure it is enforceable and provides for an effective form of dispute resolution.

Issues to Consider and Their Implications

Where to Arbitrate?

Of China’s 200-plus arbitration institutions, the China International Economic and Trade Arbitration Commission (CIETAC) is the most commonly used by foreign parties. However, CIETAC proceedings are typically more inquisitorial in approach than adversarial. For simpler, shorter-term contracts or contracts involving smaller amounts of money, CIETAC may be preferred for its fast-tracked and economical approach. For more complicated, higher-stakes, or longer-term contracts, offshore arbitration is generally preferable as it allows a foreign party the time it wishes to have before the tribunal, which is generally needed to make detailed legal submissions, and to test the evidence of the other party’s fact witnesses and experts.

Outside of China, parties have a plethora of institutions to pick from. In Asia, the leading arbitral institutions are the Hong Kong International Arbitration Centre (HKIAC) and Singapore International Arbitration Centre (SIAC), which are widely used and well respected. Other top institutions are the International Chamber of Commerce (ICC), the London Court of International Arbitration (LCIA), and the International Centre for Dispute Resolution (ICDR). Alternatively, parties may opt for ad hoc arbitration, i.e., arbitration that is not administered by an institution.

Specific Requirements for Arbitrating In China

Although parties should strive to keep arbitration clauses simple, it is advisable to provide for certain requirements and preferences that a foreign party may find beneficial. First, parties are encouraged to require that the arbitration

be conducted in English only, or in English and Chinese. If this is not explicitly stated, there is a risk that the language of the proceedings will be just Chinese as it is under the CIETAC rules, for example. Second, a foreign party may benefit from noting that in a CIETAC arbitration, appointments of arbitrators may include individuals not included on CIETAC's panel of arbitrators, granting it access to a wider array of candidate arbitrators. Finally, it is strongly suggested that the parties agree that the presiding arbitrator be of a neutral nationality.

How to Ensure Your Preference to Arbitrate Outside of China Is Enforceable

The dispute must be foreign-related

Under Article 128 of the People's Republic of China (PRC or China) Contract Law, domestic disputes must be arbitrated in China. Only disputes that are "foreign-related" may be arbitrated outside of China. A dispute is foreign-related if it has any of the elements below:

- At least one of the parties is foreign;
- At least one of the parties habitually resides outside of China;
- The subject matter of the dispute is outside of China;
- The legal facts that lead to the establishment, change, or termination of the transaction occurred outside of China;
- Other circumstances under which the transaction may be deemed foreign-related.

Therefore, for an offshore arbitration clause governed by Chinese law to be valid, the dispute must be "foreign-related." While the definition seems straightforward, its application has led to considerably more controversial results.

Under Chinese law, Foreign Invested Enterprises (FIEs) registered in China are domestic entities. This includes joint ventures and wholly foreign-owned enterprises (WFOEs) that are registered in China. This was confirmed in the 2014 case of *Beijing Chaolaixinsheng Sports and Leisures Co Ltd* and *Beijing Suowangzhixin Investment Consulting Co Ltd*. The Supreme People's Court confirmed for the first time that arbitral awards are unenforceable where domestic contracts provide for arbitration outside China. In that case, a Chinese company and a wholly foreign-owned company registered in Beijing and owned by a Korean citizen entered into a contract to operate a golf course in Beijing. The contract provided for dispute settlement via the Korean Commercial Arbitration Board (KCAB). After a dispute arose, the parties obtained an award from the KCAB and the prevailing party sought enforcement in China. The Supreme People's Court held that the dispute was not "foreign-related" because (i) the subject matter of the dispute was in China, (ii) the contract was concluded and performed in China, and (iii) both parties were domestic entities as they were both registered in China. The Court ultimately held that the arbitration clause was invalid and denied enforcement of the award.

In 2015, in a notable ruling, a PRC court held for the first time that a dispute between two PRC parties resulting in a foreign arbitral award was indeed "foreign-related" by considering "other circumstances" under which the contract may be deemed foreign-related – the fifth prong of the "foreign-related" test. *The Shanghai Golden Landmark Co. Ltd v. Siemens International Trade Co. Ltd* case involved two WFOEs incorporated in the Shanghai Pilot Free Trade Zone (FTZ) and the subject matter, *i.e.* a sale of goods contract, was to be performed in China. The dispute resolution clause provided for arbitration in Singapore and the prevailing party sought enforcement of the foreign award in Shanghai. The Shanghai Court noted that both parties were domestic entities, the place of delivery for the goods was China, and the goods were at the time of the dispute in China. Despite this, the court ruled that the dispute was foreign related because (i) both parties were incorporated as WFOEs in the Shanghai FTZ which has a policy of encouraging foreign trade and investment, (ii) the sources of the registered capital, the ultimate beneficiaries, and management and control of both parties were closely connected to foreign investors, and (iii) the contract, although for goods to be delivered in China, resembled an international sale of goods contract because the goods had to be imported from abroad via a special customs regulatory policy in use by the FTZ.

Although the *Golden Landmark* case might be seen as a sign that Chinese courts are expanding the definition of “foreign-related” disputes, it still remains to be seen if other courts will similarly adopt a broader approach in non-Shanghai FTZ cases. In the meantime, parties may not want to rely exclusively on the “other circumstances” prong in determining whether their dispute resolution clause may call for an arbitral forum outside of China.

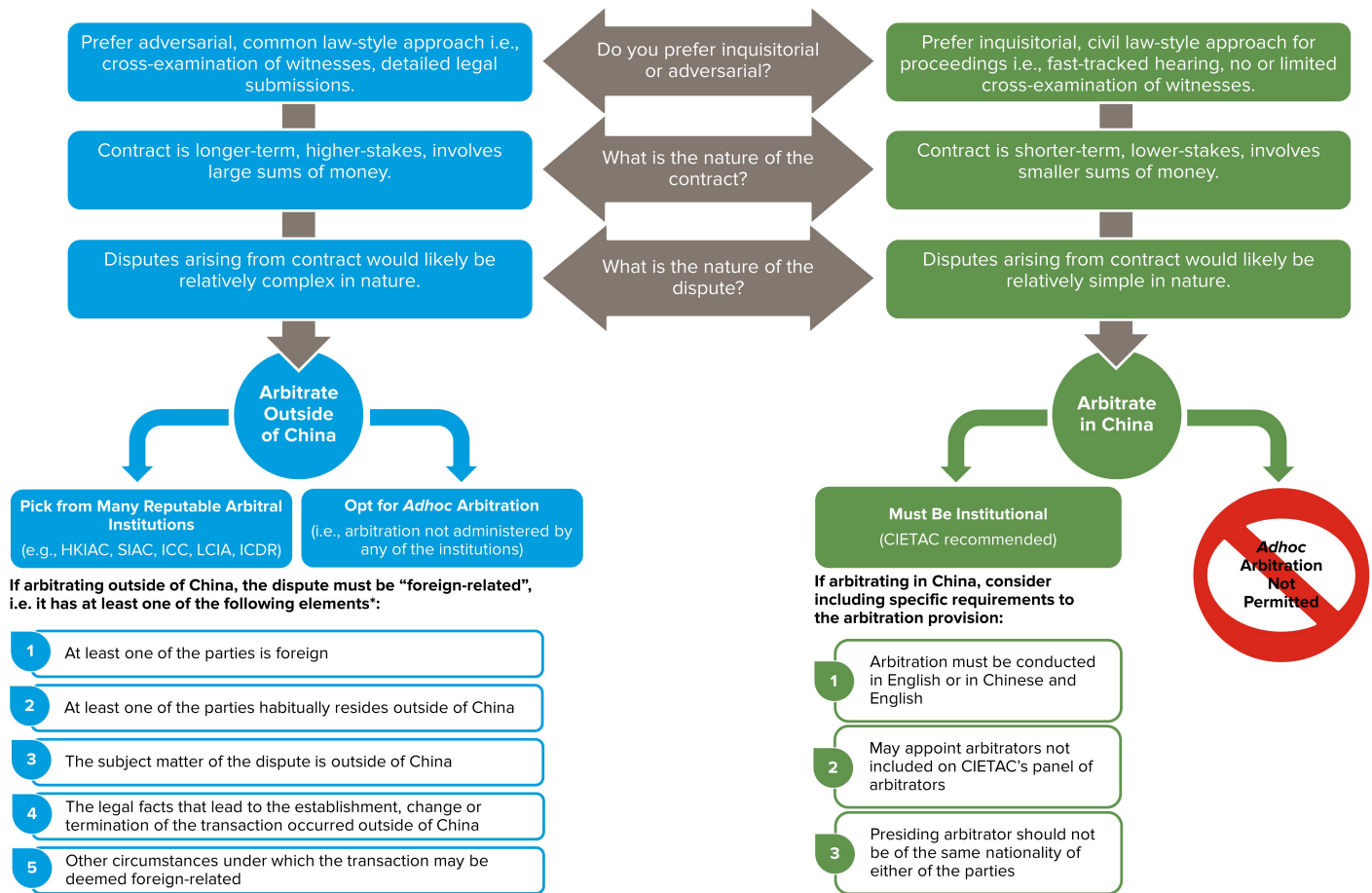
To enforce the award in China the arbitration clause must be valid under Chinese law. Thus, the PRC “foreign-related” test should only apply if the law of the arbitration clause is PRC law. However, Chinese courts have a tendency to apply Chinese law even if the law of the arbitration clause — or even the substantive law of the contract — is not Chinese law. For example, in the *Beijing Chaolaixinsheng* case (discussed above), the Supreme People’s Court stated that “the applicable law of the underlying contract and its arbitration clause, whether explicitly or [implicitly] agreed by the parties, shall be deemed as PRC law.” Therefore, when electing to submit disputes to an arbitration outside of China, as a precaution parties should assess whether the claim would be considered “foreign-related” regardless of the applicable law.

Moreover, China’s Supreme People’s Court has held that if the parties have not explicitly agreed on the law governing the validity of the arbitration agreement (even if they have selected the substantive law of the entire agreement), then the law of the seat of the arbitration will apply. If no seat is chosen, then the law of the forum, i.e., Chinese law, will apply.

When is ad hoc arbitration permissible?

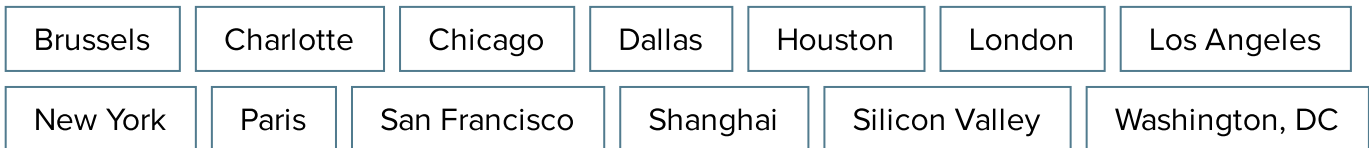
Under Chinese law, ad hoc arbitration is not permitted where the seat is in China but it is allowed for arbitrations seated offshore. If parties are opting for ad hoc arbitration outside of China, it is important that the contract affirmatively state the governing foreign law of the arbitration clause. In the absence of the governing law, a PRC court may interpret the arbitration clause as being governed by Chinese law. As such, an arbitration clause calling for ad hoc arbitration would be deemed invalid.

The graphic below summarizes the considerations, limitations and requirements discussed above.

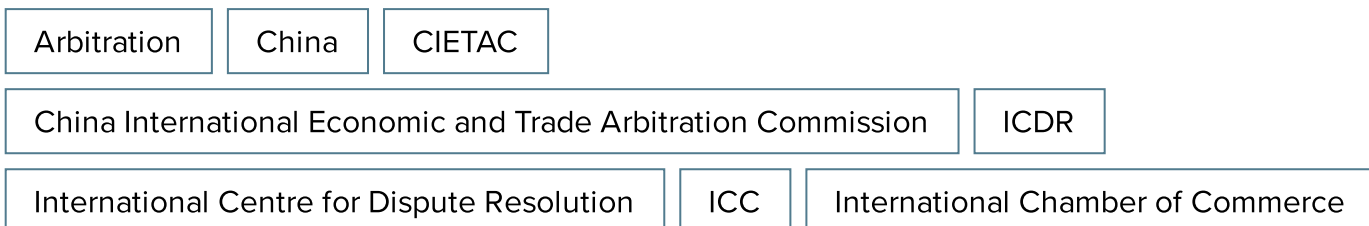


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