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

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On December 30, 2016, the Supreme People's Court ("SPC") issued a set of new Opinions. It covers an array of matters relating to legal measures to expedite the development of Free Trade Zones. (*Opinions on Providing Judicial Protection for the Construction of Pilot Free Trade Zones*, December 30, 2016). Among other matters, the SPC sought to open the Free Trade Zones to further options regarding alternative dispute resolution. Remarks made in Article 9 have effectively designated as Foreign Per Se any Wholly Foreign-Owned Enterprises which are registered in one of 11 current Free-Trade Zones. In three brief paragraphs, the SPC seems to have shifted the landscape for China-based arbitrations. The immediate practical significance of the Opinions may remain humble and limited. In time, the SPC's Opinions may permit increased deference and jurisdictional purview to foreign tribunals. It also may serve as the beginning of *ad hoc* arbitration in China.

This note will review 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 analyzes the expansion of foreign arbitral jurisdiction. It will subsequently consider practical implications. Before the note concludes, it will survey how the Opinions will affect arbitration practitioners and organizations related to the Free Trade Zones.

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

Chinese law mandates institutional arbitration of domestic disputes. 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.

Foreign Arbitration Institutions and the Foreign Elements Requirement

Chinese courts uniformly recognize and enforce foreign awards, including the awards of foreign arbitration institutions and *ad hoc* tribunals, provided that genuine foreign elements arise throughout the transaction. The foreign elements test will often be 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, selecting offshore arbitration can lead to unnecessary risk and uncertainty.

WFOEs and FIEs as Domestic Entities

Wholly Foreign-Owned Enterprises ("WFOE") are foreign-owned Chinese entities. 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 may 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 jurisdictions. 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 (or not). 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. Objections must challenge the violation of public policy relating to the foreign-element test.

Second, the SPC states that FTZ-registered enterprises may **not** need to engage supervision of an arbitration commission for China-based arbitration procedures. 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 the validity of that agreement. Such a challenge would most likely bring the matter before a People's Court. Before People's Courts can declare such clauses invalid, they must report these cases to the higher courts. Likewise, higher courts that agree with the lower court concerning the invalidity of the clause must also report to the SPC for final review.

Two WFOEs qualify as Foreign

The SPC's Opinions newly opens a classification for WFOEs, one once reserved exclusively to strictly non-domestic companies. WFOEs registered in FTZs are now foreign enterprises. 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 designation only encompasses those 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. Unlike a completely foreign-registered company, a single WFOE contracting with a domestic company outside an FTZ may be able or unable to satisfy the foreign elements test, depending on the specific circumstances, the overall nature of the transaction, and other factors.

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.

The WFOE FTZ-registration synthesizes existing notable Chinese cases. Two recent cases confronted matters concerning the recognition and enforcement of foreign arbitrations. In the 2015 *Golden Landmark v. Siemens ITL* case,[fn]*Siemens International Trading (Shanghai) Co., Ltd vs. Shanghai Golden Landmark Co., Ltd* (2013) *Hu Yi Zhong Min Ren (Wai Zhong) Zi No. 2* (2015) (Shanghai No. 1

Intermediate People's Court).[/fn] 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,[fn]*Beijing Chaolaixinsheng Sports and Leisure Co., Ltd. v Beijing Suowangzhixin Investment Consulting Co., Ltd.*, (2013) *Er Zhong Min Te Zi No. 10670* (2014) (Beijing No. 2 Intermediate People's Court).[/fn] 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. Initially 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.

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. 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 tribunals and district courts abroad should strive to apply the foreign-related tests faithfully, factually, and with special care. Otherwise, the SPC may exercise its power to issue corrective guidance to restrain too liberal findings of foreign-related elements.

On the other hand, no foreign case law may ultimately result regarding foreign-elements under Chinese law and public policy. Foreign arbitration institutions and foreign tribunals may reject all challenges to jurisdiction relating to non-WFOE FIE-involved arbitrations. For a number of reasons, Hong Kong and Singapore courts may define the approach that foreign courts follow when facing such controversies.

For Chinese Enterprises in the FTZs

Many questions and uncertainties remain regarding the opening of *ad hoc* arbitration. Therefore, the initial practical ramifications of the Opinions on *ad hoc* arbitration may prove limited. Commercial enterprises are unlikely to crowd towards *ad hoc* arrangements. Each such *ad hoc* arbitration agreement would entail a certain challenge to validity soon after commencement of arbitration. Nonetheless, the SPC has signaled that enterprises registered within Free Trade Zones may be able to operate arbitrations entirely differently than enterprises in regular areas. Careful drafters may 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.

Chinese enterprises will find the Opinions has cracked the door for *ad hoc* arbitration, but only just so. FTZ-based enterprises might reasonably fear what lies just on the other side. Not many Chinese enterprises will be too eager to experiment. And yet, the SPC may have nudged *ad hoc* arbitration forward just enough to gather some momentum.

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 validity of their agreements. Few WFOEs would have dared to arbitrate abroad before due to fears of enforcement complications. Now they can confidently opt to do so.

Concluding Remarks

Published on December 30, 2016, Article 9 of the SPC's Opinions relating to Free Trade Zones will influence Chinese arbitration well into the coming decade. 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. Both international and Chinese arbitration professionals must look now to the National People's Congress for further and more expansive reform. Presumably, everyone in the international arbitration community looks forward to the SPC resolving the open questions and subsequent controversies in a reasonable and pro-enforcement manner.