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A PRACTICAL GUIDE TO MANAGING AND RESOLVING BUSINESS DISPUTES IN CHINA

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A Practical Guide to Managing and Resolving Business Disputes in China

You are an American company expanding its business into China. You have just clinched a highly coveted multi-million-dollar deal, documented in a one hundred-page contract, that seems to have covered every conceivable hiccup. But that lucrative deal, which took months to close, may not be as airtight as you imagine. If a dispute arises between your company and your Chinese business partner, how can you resolve it?

You may think that disputes with your Chinese business partner are resolvable in the US courts, but if the Chinese business does not have assets in America, you will find it very difficult to enforce even a US judgment there. The Chinese business may have assets in China, but again it is difficult to enforce a US judgment in China: the two superpowers do not yet have reciprocal arrangements to recognize judgments from each other's courts.

In some contracts, the option to claim before the Chinese courts is simply not available. For example, those drafted for US. domestic use which provide that the US. court shall have "exclusive jurisdiction" to resolve any dispute. If such cases come before the Chinese courts, however, they can be rejected outright on the grounds that the Chinese courts are not the proper forum to hear the dispute.

This Guide explains how to manage and resolve such disputes, and where possible to avoid them altogether, by reference to a series of Frequently Asked Questions.

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Can we sue the Chinese party in the Chinese courts?

This depends on the wording of the contract, but for many, the thought of pursuing the Chinese party before the Chinese courts conjures up images of corruption and local Chinese protectionism. In recent years, the central Chinese authorities recognizing this problem, have made tremendous efforts to improve the judicial system. Nevertheless, foreign investors are still wary.

Can we resolve disputes without litigation in the international arena?

Many American companies in China have turned to arbitration. Arbitration is a private process in which an independent third party (the arbitrator) resolves a dispute by making a legally binding decision (the arbitral award).

Unlike a court judgment, an arbitral award of an international arbitration is generally more readily enforceable across borders. China signed the New York Convention which recognises arbitrations conducted around the world. More than 144 countries, including the US, are signatories to the New York Convention (www.uncitral.org).

What are the advantages of international arbitration?

- Cross-border enforceability of an arbitral award.
- Unlike court proceedings, arbitration hearings are usually private and confidential. Final decisions are not made public, nor are they directly accessible.
- Both sides get to pick their own arbitrators. This is particularly useful in disputes that involve technical expertise or specialized areas of law.
- Courts often have long waiting lists. Arbitration hearings are held at the convenience of the parties.
- Arbitration is useful in an emerging economy where the judicial system may not be on a par with that of a developed economy.

When should we consider arbitration?

Arbitration should be considered at the time a business contract is negotiated. Both parties must agree to arbitration beforehand as the method of resolving disputes, as, once a dispute has set in, it is often difficult for parties to agree to arbitrate once any damage has been done.

Where can we conduct an international arbitration?

International arbitration can be conducted in a neutral territory where neither party has a perceived "home base" advantage. Good arbitration centers are often located in "arbitration friendly" countries whose courts do not interfere unnecessarily with the arbitration process. It is no coincidence that these countries also have strong arbitration laws. Popular venues include Geneva, London, Paris, and Stockholm. In recent years, Asian cities, such as Hong Kong and Singapore, have become increasingly popular neutral venues, particularly for disputes between Western and Asian companies.

In China, disputing parties may be allowed to hold arbitrations in or outside China, depending on whether the disputed contract involves a "foreign element" (涉外合同). Given a choice, many foreign parties would rather conduct their arbitrations in neutral territories to minimize the chances of court interference in China. However, for commercial reasons, such as the stronger negotiating positions of the Chinese parties, this may not always be possible.

Where Chinese law prohibits an arbitration to be held outside its borders, particularly where a foreign investor has signed a contract through its Chinese subsidiary, the disputing parties can resolve their disputes through a reputable arbitration commission in China. The China International Economic and Trade Arbitration Commission (CIETAC) (www.cietac.org) is the main arbitration body in China for international disputes.

There are also many other domestic arbitration commissions in China (such as the Beijing Arbitration Commission) that handle international arbitrations, provided both parties agree to use them.

Is arbitration in China impartial?

In recent years, arbitration has gained immense popularity with foreign investors who conduct cross-border businesses in the emerging economies of Asia, Latin America, Russia and Africa, where the judicial systems may not be on a par with those of developed economies. However, despite its popularity, foreign investors often question the impartiality of arbitrations held in such economies.

Much depends on the composition of the arbitral tribunal and the freedom to choose your own arbitrators. Where arbitrators are appointed by the parties or a reputable arbitration institution, the parties are more confident of the expertise and neutrality of the tribunal. The real difficulty though lies in the award enforcement process in China—a difficulty any party will face in any event, whether the award is made in China or elsewhere.

How should we negotiate and draft an arbitration clause in a Chinese contract?

For arbitrations to be held in China, the arbitration agreement must specify an arbitration commission.

Most arbitration institutions have their own recommended arbitration clauses for inclusion in business contracts. For example, CIETAC recommends the following arbitration clause:

"Any dispute arising from or in connection with this Contract shall be submitted to the China International Economic and Trade Arbitration Commission for arbitration which shall be conducted in accordance with the Commission's arbitration rules in effect at the time of applying for arbitration. The arbitral award is final and binding upon both parties."

In practice, foreign investors often get their experienced China practice lawyers to amend this clause to provide them greater protection.

When negotiating and drafting arbitration clauses involving Chinese contracts, two key questions arise relating to the choice of governing law of the contract and the location for resolving the dispute.

Can foreign parties choose non-Chinese law in their contracts?

Chinese law allows parties to a contract with a "foreign element" (涉外合同) to apply a law of their choice in their contracts. Chinese law defines a contract with a "foreign element" as one where:

- One or both parties to the contract are foreigners (a wholly foreign-owned Chinese company is not considered as "foreign");
- The subject matter of the contract is in a foreign country; or
- The contract was made, modified, or terminated in a foreign country.

There are exceptions to the "foreign element" rule, where it is mandatory to apply local law in the following situations:

- Chinese-foreign equity joint venture contracts
- Chinese-foreign cooperative joint venture contracts
- Contracts for Chinese-foreign cooperative exploration and development of natural resources to be carried out in China
- Contracts involving real estate in China

In practice, most Chinese parties negotiate for their contracts to be governed by Chinese law. In some situations, e.g., international sale and purchase agreements, a Chinese party may be persuaded to accept the governing law of another country.

Is Hong Kong law regarded as Chinese law?

Hong Kong and Macau are Special Administrative Regions. They are part of China, but continue to administer their own laws and regulations. China does not recognize Taiwan as a separate nation. Cases involving Hong Kong, Macau, and Taiwan are deemed "foreign-related" in China. Hong Kong law is a "foreign" law that may be acceptable to both foreign and Chinese parties, as Chinese parties who do business in Hong Kong, are familiar with Hong Kong law and hence may be more willing to accept it. Similarly, many foreign investors are familiar with Hong Kong law, as it is based on English law.

Can we stipulate all business disputes to be resolved outside China?

Chinese law allows parties to a contract with a "foreign element" to arbitrate in or outside China, provided this is clearly stated in the arbitration agreement. For this purpose, arbitrations in Hong Kong are considered as being conducted outside China.

Can a foreign party designate an international arbitration commission to conduct the arbitration in China?

Many foreign parties prefer to designate reputable international arbitration commissions, e.g., the International Chamber of Commerce or the American Arbitration Association, to conduct arbitrations in emerging economies. At the present time, Chinese law does not clearly allow a foreign arbitration institution to conduct arbitrations in China. Arbitrations in China should be conducted by a Chinese arbitration commission.

Can foreigners be appointed as arbitrators in arbitration in China?

Disputing parties in an arbitration case can choose their own arbitrators. The number of arbitrators in a Chinese tribunal is usually three. Each party nominates its own arbitrator, with the third being appointed by a pre-agreed appointing body (usually the arbitration commission), in the event that both parties disagree on the selection of the third arbitrator.

The foreign party typically nominates a foreign national as an arbitrator, while the Chinese party nominates a Chinese national as an arbitrator. CIETAC in most cases appoints a Chinese national as the presiding arbitrator, which can cause concern to the foreign party. To pre-empt this, the arbitration clause should stipulate that the presiding arbitrator must not be a national of either party.

What is the language of arbitration in China?

Chinese (Mandarin) is the official language used in arbitrations in China. However, both parties may agree to use English or any other languages. Witnesses may choose to testify in any language and have their testimonies translated to the agreed language of the arbitration. In addition, all documents are translated into the agreed language. Some contracts provide for two languages to be used in arbitrations - this increases costs.

Is there discovery of documents?

In some countries, such as England and the US, arbitration involves discovery or disclosure of documents, a process in which each party provides the other side with all the relevant documents in their possession. In Chinese arbitrations, there is generally no discovery unless both parties expressly agree to it.

Is it easy to enforce arbitral awards in China? Can the Chinese courts refuse to enforce arbitral awards?

There are three types of arbitral awards in China: awards made outside China, awards rendered in China that are foreign-related, and domestic awards.

As a signatory to the New York Convention, China is committed to enforcing foreign arbitral awards (involving commercial relationships) issued in other signatory countries.

According to the terms of the Convention, it is very difficult for a signatory country to refuse to enforce a Convention award. (An award rendered in Hong Kong is enforceable in mainland China under a regime similar to the New York Convention.) Likewise, for awards rendered in China for foreign-related disputes, the grounds for refusing to enforce the award are very limited, similar to those for a Convention award.

The legal position for enforcing domestic awards in China is different: Chinese law provides wider grounds for refusing to enforce a domestic award than for a foreign or foreign-related award. The domestic award is subject to merits review by the Chinese People's Courts. This means that the unsuccessful party can appeal to the Chinese courts to review the case, thereby putting the dispute resolution process into the hands of the Chinese courts—the very thing a foreign party wants to avoid in choosing arbitration in the first place.

In recent years the Chinese judiciary has taken steps to minimize erroneous decisions at the local courts. These include a "reporting back" procedure whereby a lower court may refuse to enforce a foreign-related award, provided a higher court also approves the refusal.The approval process goes all the way up to the Supreme People's Court, China's highest court. The purpose is to prevent the local courts from abusing their discretionary powers in refusing to enforce arbitral awards. The procedure does not apply to domestic awards.

Is it easy to locate assets in China?

The Chinese People's Courts have powers to enforce an arbitral award by:

- Freezing and seizing the assets of a debtor;
- Holding financial institutions liable if they release the assets without permission; or
- Seizing the outstanding income of the person.

However, even if an award is recognized in China, it is questionable whether the paying party has sufficient assets to satisfy the award. In many developed economies, information on a company's assets can be obtained from public sources. Such information may not be readily available in China.

What is China's track record on enforcing awards?

Put simply - modest. There are no reliable statistics available. A survey conducted several years ago by the Arbitration Research Institute (an organization affiliated with CIETAC) showed that approximately 75 percent of enforcement applications of CIETAC arbitral awards were allowed.

Anecdotal evidence seems to suggest otherwise. A study carried out by an American academic showed more startling figures: of seventy-two cases studied in the survey, (both CIETAC and foreign awards), only 50 percent were enforced in China with some recovery actually realized. Compare this with statistics in the US, where the refusal rate was only 13 percent.

More recent statistics suggest that only a small number of foreign-related awards were denied enforcement due to the "reporting back" procedure. However, while the court may recognise an arbitral award, the debtor may not have the assets to satisfy the award.

Are there other methods of resolving disputes?

Chinese contracts often require the disputing parties to go through a period of consultation or negotiation before commencing formal court or arbitration proceedings. This "cooling off" period gives both parties some time to resolve disputes amicably without "losing face," an important concept in Chinese social relations. Typically, disputes in China are resolved through informal negotiations between business parties. This is an important exercise for parties who have had a good business relationship between them and want to maintain goodwill for the long term.

If informal negotiations fail, parties sometimes turn to conciliation or mediation (negotiation methods with the help of a neutral conciliator). The conciliator tries to help each party see the other position, as well as its own case weaknesses. The conciliator encourages mutual concessions by the parties and suggests possible areas for compromise. The objective of the process is to lead to a settlement agreement. A disputing party can invoke the conciliation process before or during the formal dispute resolution process.

In China conciliation can be combined with arbitration proceedings before CIETAC, with the arbitrators or other persons taking on the role of conciliators.

How can we reduce the risk of business disputes in China?

- Check with local Chinese authorities - One of the major challenges of doing business in China is the ambiguity of local laws and regulations. Different government departments can issue laws in China, which can appear to contradict one another. In other cases, the laws appear to be clear but are interpreted differently by the local authorities. Where the laws are ambiguous, it is wise to check with the local authorities. As it is necessary for foreign investors to get authorization at the local level, it is often prudent to accept the local level interpretation of the laws. In some instances, laws and regulations in China are not strictly enforced.

- Amend the Chinese form of contract to international standards - A frequent source of dispute lies in contract terms not being comprehensive enough and not dealing with the essential issues. For example, some government standard forms of contract do not make adequate provisions for termination, confidentiality, insurance, and indemnity. Even where the standard forms do deal with these issues, the terms are not always drafted properly. The Chinese form of contracts is often brief, and it is up to the foreign party to amend these forms so that the contract terms are up to par with international standards. If Chinese law applies, have a China-practice lawyer explain some of the key differences with the law you are familiar with.

- Draft your contract in plain English and in simple terms - International lawyers who are unfamiliar with Chinese local practices tend to be overly zealous in introducing contract terms and legal-speak that are totally inappropriate in the Chinese context. For example, American lawyers typically draw up US-style contracts, complete with lengthy documents, detailed clauses and procedures for notices. Some of these clauses are not fully appreciated by the Chinese party due to the language barrier. Some clauses may be deemed unfair and therefore not enforceable in China. The Chinese party, in its eagerness to close the business deal, often accepts onerous terms, even though it does not fully understand them, and hopes to challenge these terms if a dispute arises later on.

To avoid such problems, one recommendation is to use plain English and draft clauses in simple terms. This paves the way for more accurate and readable translations in Chinese.

- Be aware of translation issues - English-speaking lawyers who do not read Chinese tend to draft, review, and amend contracts based on the English version. Unless the Chinese party is a sophisticated enterprise with competent linguistic capability, it is always helpful to have a Chinese translation of the contract and send both versions to the Chinese party for review. While this prolongs the period of negotiations and turnaround in drafts, it greatly reduces the risk of disputes later on.

- Understand the Chinese business culture - While knowledge of rules and procedures is important, equally important is the understanding of how these rules and procedures are applied in China.

- People skills are also critical in business dealings in China - Foreign investors (and their international lawyers) who adopt a congenial style when dealing with the Chinese often do very well. For example, the Chinese are known to avoid confrontation, especially in face-to-face meetings. When faced with a dilemma, the Chinese often sidestep the difficulty by deferring decision-making. When the Chinese say they "can consider" a proposition, what they sometimes mean is that they cannot accept the proposition the way it is. Reading between the lines is a fine art for the Chinese, but often a major entanglement for foreigners.

Conclusion

As the Chinese would say, "How can one catch tiger cubs without entering the tiger's lair?" Indeed, all business ventures in this Middle Kingdom (中国) entail some forms of risk. But with the appropriate arbitration clauses written into your multi-million-dollar business contract, you may well be on your way to catching a handsome ambush of tiger cubs.

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