



Dispute Resolution Law

Mainland Court's Standards for Identifying Social Public Interests When Recognizing Off-Shore Arbitration Awards

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Case Briefs

At the end of 2009, China Media Express Holdings Inc. ("Media Express") was listed in the U.S. through Reverse Take-Over (RTO). In January 2010, Starr Cayman Investment Co. ("Starr Co.") executed a Share Purchase Agreement and an Investor Rights Agreement with Media Express, to purchase 1,000,000 shares of convertible preferred stock at the price of \$ 30,000,000 and 1,545,455 warrants at the price of \$ 9,999,093.85. After the completion of the transaction, Starr Co. believed Cheng Zheng, as Media Express's founders, and other parties embezzled and misappropriated investment funds, as well as violated the aforesaid agreements in other ways. Starr Co. accordingly instituted arbitration in Hong Kong International Arbitration Center.

On December 19, 2012, Hong Kong International Arbitration Center gave arbitration awards HKICA/A11030 and HKICA/A11098 ("Arbitration Awards"), which ruled that Fujian Zongheng High-Speed Information Technology Co., Ltd., Fujian Focus Media Co., Ltd., and Chengzheng (collectively referred to as "Enforcees") shall be liable for damages to Starr on grounds of breach of Share Purchase Agreement and Investor Rights Agreement.

After such Arbitration Awards entered into force, according to Supreme People's Court's Arrangement for Reciprocal Enforcement of Arbitration Awards between Mainland China and Hong Kong Special Administrative Region ("Arrangement"), Starr Co. petitioned Fuzhou Intermediate People's Court ("Fuzhou Inter. Court") for enforcement of the awards. Fuzhou Inter. Court accepted the case on August 9, 2013 and rendered Enforcement Rulings (2013) Rong Zhi Zi No.511 and No 512 ("Enforcement Rulings") in accordance with laws, which ruled to freeze (allot) the Enforcees' deposits equivalent to the amount of damages or seal (seize/freeze) its property of the same value.

The Enforcees refused to accept such rulings and applied to Fuzhou Inter. Court for ordering not to

enforce the Arbitration Awards in accordance with Article 7 of the Arrangement, on grounds that the enforcement of such awards may violate social public interests in Mainland China. On October 9, 2014, Fuzhou Inter. Court held a hearing about the case and finally rejected the petition of the Enforcees and rendered Ruling (2014) Rong Zhi Jian Zi No. 51 (“No.51 Ruling”).

Case Analysis

The focus of disputes in this case is whether recognition and enforcement of arbitration awards involving VIE (Variable Interest Entities) structure arrangement and VAM (Valuation Adjustment Mechanism) will violate social public interests.

In disagreement with the Enforcement Rulings, Enforcees contend that VIE structure arrangement and VAM involved in arbitration breach regulations set forth under *Provisions on the Administration of Telecommunications Enterprises with Foreign Investment*¹ (*Provisions*) promulgated by State Council, *Notice on Strengthening Administration of Operation in Value-Added Telecommunications Service by Enterprises with Foreign Investment*² issued by Ministry of Information Industry and *Regulations on Implementation of Security Review System Relating to Acquisition of Domestic Enterprises by Foreign Investors*³ promulgated by Ministry of Commerce. Therefore, Enforcees believe that the court should deny to enforce the Arbitration Awards in compliance with Article 7 of the Arrangement, which prescribes that “mainland court may rule not to enforce the Hong Kong arbitration award in mainland areas if such court believes enforcement of such award shall violate public interests thereof”.

Against the claims proposed by the Enforcees, Starr Co. proposes the following counterarguments.

- (1) The court is only authorized to inspect whether the outcome of the enforcement of such arbitration award, rather than the application of laws on substantial legal issues of such arbitration award, will violate the social public interests.
- (2) The claim of Starr Co. is that the Enforcees shall pay damages arising out of its breach of the

¹ Article 17 of Provisions on the Administration of Telecommunications Enterprises with Foreign Investment stipulates that where telecommunications enterprises with foreign investment intent to operate trans-boundary telecommunication services, such operation shall be subject to approval of departments of authorization of industry and information in State Council and shall be conducted through International Telecommunications Entrance and Exit Bureau established with approval from such competent departments.

² Article 1.1 of Notice on Strengthening Administration of Foreign Investors' Investment and Operation in Value-Added Telecommunications Services stipulates that, where foreign investors intent to invest in and operate telecommunications services, they shall strictly comply with requirements set forth under the *Provisions* by submitting applications for establishment of telecommunications enterprises with foreign investment and applying for corresponding operation license. Foreign investors, which fail to found such telecommunications enterprises in accordance with laws or get relevant operation license, shall be prohibited from operating telecommunications services in our country.

³ Article 9 of Regulations on Implementation of Security Review System Relating to Acquisition of Domestic Enterprises by Foreign Investors stipulates that, where foreign investors intent to acquire domestic enterprises, economic security review authority shall judge whether such acquisition needs security review based on the substantive facts of the transaction and actual impact caused thereby. Such foreign investors shall not substantially evade security review by any means, which include but is not limited to nominal shareholding, trust, multilevel reinvestment, lease, credit, protocol control, foreign trade, etc.

agreements, rather than to continue to perform such agreements which is in adherence to contract spirit and therefore is not in violation of social public interests.

- (3) Violation of mandatory requirements prescribed in administrative regulations and departmental rules does not necessarily constitute breach of public policies. Departmental rules are not part of basic legal system and do not fall within the scope of social public interests.

Fuzhou Inter. Court adopts the Starr Co.'s views and reasons as follows in No.51 Ruling.

- (1) Arbitration Awards given by Hong Kong International Arbitration Center demand Enforcees to pay damages to Starr Co. as a result of its breach of Share Purchase Agreement and Investor Rights Agreement, rather than require Enforcees and Starr Co. continue performing such agreements. In accordance with the provisions set forth under the Arrangement, the court ruled to enforce the Arbitration Awards by demanding Enforcees to bear liability for the breach, which complies with basic legal principles and social public interests, such as contract sanctity and good faith.
- (2) In its Reply to Haikou Intermediate People's Court's referral for Non-Recognition and Enforcement of the Arbitration Award Given by Arbitration Institute of the Stockholm Chamber of Commerce, Supreme People's Court indicates that violation of mandatory requirements prescribed in administrative regulations and departmental rules does not necessarily constitute breach of public policies. In light of such instruction, this court believes that whether the involved transaction has relation to VIE structure arrangement and VAM or whether it involves breach of departmental rules promulgated by State Council, Ministry of Information Industry and Ministry of Commerce does not necessarily determines constitution of violation of social public interests. Therefore, the claim of Enforcees that the court should reject enforcement in compliance with Article 7 is not tenable on grounds of insufficient evidence.

Our Observations

This case explains again the "standard" of people's court for identifying public policies and social public interests in relation to recognizing and enforcing foreign arbitration awards, which indicates that "violation of public policies shall be limited to the scope that the outcome of recognition of off-shore arbitration awards violates basic legal system or damages fundamental social interests in our country"⁴.

We understand that such standard has twofold meanings. First, in identifying whether the enforcement of off-shore arbitration awards will violate public policies, it is whether the outcome of such enforcement, rather than application of laws on substantial matters of the case will breach

⁴ In its *Reply to Referral for Non-Recognition of Arbitration Award Tokyo No.07-11 rendered by Japan Commercial Arbitration Association*, the Supreme Court indicates that violation of public policies shall be limited to the scope that "the outcome of recognition of off-shore arbitration awards violates basic legal system or damages fundamental social interests in our country"

social public interests that shall be inspected. In this case, Fuzhou Inter. Court determines that Arbitration Awards given by Hong Kong International Arbitration Center demand Enforcees to pay damages to Starr Co. as a result of its breach of Share Purchase Agreement and Investor Rights Agreement, rather than require Enforcees and enforcement applicant to continue performing such agreements. Such determination reflects that it is the outcome of enforcement that matters.

Second, the “standard” emphasizes that the violation of public policies means the breach of basic legal system or fundamental social interests in our country. In this case, the court does not directly comment on the legal effects of VIE structure arrangement or VAM. Nevertheless, in light of the No.51 Ruling and law application in respect of this case, even if substantive matters involved in the off-shore arbitration may violate some mandatory requirements prescribed in departmental rules, this does not necessarily constitute violation of basic legal system and fundamental social interests in our country. Hence, court shall not refuse to recognize or enforce off-shore arbitration awards merely on grounds that substantive matters involved in such arbitration breach domestic laws and regulations.

Furthermore, the results in this case have significant impacts upon protection of interests of investors in VIE structure.

Currently, there are no PRC laws and regulations explicitly stipulating on validity of VIE structure as well as VAM and therefore, relevant agreements are exposed to risks of being recognized as invalid. However, when deciding on whether a foreign arbitration award concerning “VIE structure arrangement” and VAM constitutes breach of social public interests, the court does not identify the circumstances under which recognition of off-shore arbitration award shall be denied directly with the circumstances where a contract shall be deemed as invalid. To some extent, such prudence can prevent the principle of social public interests from being abused, and facilitate the protection of investor’s rights and interests.

Important Announcement

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