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ARTICLES

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Chinese Defendants

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and
Ellen Claar CAMPBELL

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Under the Context of State-owned Enterprise Reform

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CLASH OF SYSTEMS: DISCOVERY IN U.S. LITIGATION INVOLVING CHINESE DEFENDANTS

*Ray Worthy Campbell** and *Ellen Claar Campbell***

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I. INTRODUCTION

In recent years, substantial friction has been generated by United States litigation involving Chinese defendants. From the U.S. perspective, the litigation is primarily domestic in nature, seeking compensation for injuries caused on U.S. soil by parties that actively targeted the U.S. market. Aside from obtaining compensation for those injured, a purpose of the litigation is to create deterrence so as to discourage future violations. Obtaining discovery, which is critical to U.S. style litigation, is an essential part of that ‘after-the-fact regulation’ process.

From the Chinese perspective, foreign court systems imposing demands on Chinese defendants that need to be carried out on Chinese soil constitute an affront to Chinese sovereignty. Familiar with a system in which discovery is not at the core of the dispute resolution process, and in which litigant-driven discovery plays almost no part at all, they see no justification for U.S. courts requiring compliance with U.S. style discovery when that requires directing actions that must take place within China.¹

The different starting points have led the parties to an unstable standoff. By and large, neither the Chinese government nor the Chinese defendants have made it easy to get responses to discovery requests related to U.S. litigation. Finding Chinese responses to discovery requests made under the Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters unhelpful, U.S. litigants and courts have often chosen instead to seek discovery directly from those defendants over whom the court finds personal jurisdiction. In order to get the attention of Chinese defendants who consider themselves outside the proper reach of U.S. courts, courts impose substantial sanctions on parties who fail to respond—involving large sums of money or even the banning of the defendant company from selling any goods into the U.S. market. Because U.S. litigation serves important purposes above and

¹ See, e.g., 段东辉 (Duan Donghui), 海牙取证公约评述兼论海牙《民事诉讼程序公约》的历史演变和发展 [Commenting on the Hague Evidence Convention], 法学评论 [LAW REVIEW], issue 3, at 94 (1998); 陈力 (Chen Li), 海牙取证公约在我国涉外民商事审判中的适用 [The Implementation of Hague Evidence Convention in China's Civil and Commercial Litigation], 东方法学 [ORIENTAL LAW], issue 1, at 138, 146 (2010); 乔雄兵 (Qiao Xiongbing), 也论美国的审前证据开示制度 [Commenting on the American Pre-trial Discovery], 法学评论 [LAW REVIEW], issue 4, at 113, 116 (2010).

beyond resolving the instant dispute—including the making of new law and after-the-fact regulation of manufacturers who are given easy entry into U.S. markets—U.S. courts view the protection of their judicial power as imperative.

Part of what underlies the friction is a failure by each side to understand the terms of the dispute to the other side. Each country looks at discovery as discovery exists in its own system. Each system looks at discovery as a distinct feature, without understanding the overall system.

This is a mistake. Each country operates under its own unique system of governance, and each model of procedure is designed to reinforce these systemic goals. Litigation, and the obtaining of discovery in the course of that litigation, performs radically different functions in the two systems. In addition, issues of state sovereignty and state control do not translate point for point across the two systems.

This article looks at the issue from a systemic standpoint, exploring the central role litigation plays in U.S. governance and regulation, and the central role of discovery in U.S. litigation. It then looks at the Chinese system, which rejects vesting in courts the kind of policy making functions U.S. courts exercise even in routine commercial cases. It is hoped that one contribution of this article is helping each side understand the stakes to the other side.

If there is to be a solution to the problem—and it is to be hoped there can be, because the ongoing disputes over discovery dissipate goodwill that might be needed to resolve other conflicts—it must begin at a systems level. Put differently, it is not appropriate for either system to impose its mores on the other. The two sides should work together to develop a richer understanding of the stakes to the other side, and explore whether a solution exists that serves the needs of both sides without unnecessary conflict.

II. DISCOVERY IN NATIONAL CONTEXT

A. Discovery in the U.S. Context

1. Role of Litigation in the U.S. System of Governance

At a superficial level, litigation in various countries can seem quite similar. Witnesses give evidence. Lawyers make arguments.

Judges preside. At the end of the proceedings, the resolution of the dispute enjoys the enforcement power of the state.

As is so often the case, superficial similarities can obscure more profound differences. The United States system of litigation, in particular, has some unusual characteristics. These characteristics include not just the way the U.S. system for resolving disputes operates, but even more importantly the role litigation plays in the governance system in the US.

(a). After-the-Fact Regulation in the Context of Adversarial Legalism

The overall litigation system in the U.S. has been described as one of “adversarial legalism”²—adversarial because the process is driven by adversarial parties who have the power to control which facts and which legal arguments are presented to the court, and legalism because the dispute should be resolved by even handed application of rules of law. More than other systems, the U.S. entrusts the litigation system with roles far more general than just resolving disputes between parties. “The United States more often relies on lawyers, legal threats, and legal contestation in implementing public policies, compensating accident victims, striving to hold governmental officials accountable, and resolving business disputes.”³ The adversarial legalism approach gives courts and lawyers, even profit-driven private lawyers, important governance roles beyond resolving disputes, roles which are not always given to courts in other countries.⁴

² ROBERT A. KAGAN, *ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW* (2003); Richard L. Marcus, *Reining In the American Litigator: The New Role of American Judges*, 27 *HASTINGS INT’L & COMP. L. REV.* 3, 8 (2003) (“In sum, whereas European polities generally rely on hierarchically organized national bureaucracies to hold local officials accountable to national policies, the U.S. Congress mobilized a distinctly American army of enforcers—a decentralized, ideologically motivated array of private advocacy groups and lawyers . . .”).

³ ROBERT A. KAGAN, *ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW* 110–11 (2003).

⁴ See, e.g., Arthur R. Miller, *Simplified Pleading, Meaningful Days in Court, and Trials on the Merits: Reflections on the Deformation of Federal Procedure*, 88 *N.Y.U. L. REV.* 286, 299–300 (2013) (“The efforts of public interest attorneys go well beyond the classic civil rights and legislative reapportionment battles. Asbestos is held in check by the private bar. Tobacco is cabined by the private bar.

(i). Litigation as Lawmaking

As common law courts, U.S. courts make law in a way that is not the norm in civil systems. Each reported holding becomes precedent for resolving future disputes; final legal decisions entered by the highest court in a jurisdiction become binding law over future disputes in that jurisdiction. Inaccurate resolution of disputes can thus have a distorting effect on the development of the substantive law; taking the resolution of disputes away from U.S. courts to foreign courts impacts not just the dispute but the development of U.S. law.

(ii). Litigation in Lieu of Social Insurance

The court system also plays an important role in compensating victims of accidents. Compared to many O.E.C.D. countries, the scope of welfare and public health services provided by the U.S. government can be low. Recovery from tort-feasors thus becomes essential in order to support victims. What some systems achieve through social insurance is addressed in the U.S. by shifting costs to those who caused the harm.

(iii). Litigation as After-the-Fact Regulation

No less important is the role of U.S. litigation in regulation of the economy. As one scholar has put it: “What is distinctive about the United States is the extent to which we regulate not entry but consequences. There is a significant difference between an unregulated market and a deregulated market featuring low entry

Defective pharmaceuticals such as diet drugs, Vioxx, and other products are removed from our midst. Illicit financial and market practices of companies such as Enron are halted by the private bar. Today, a number of attempts are underway to hold accountable some of those responsible for the recent financial crisis. Fewer Americans die or become incapacitated by defective products or toxic substances, and important social and economic policies are enforced because of the work of these lawyers.”); Richard L. Marcus, *Reining In the American Litigator: The New Role of American Judges*, 27 HASTINGS INT’L & COMP. L. REV. 3, 8 (2003) (“In sum, whereas European polities generally rely on hierarchically organized national bureaucracies to hold local officials accountable to national policies, the U.S. Congress mobilized a distinctly American army of enforcers—a decentralized, ideologically motivated array of private advocacy groups and lawyers.”).

costs but careful scrutiny after the fact.”⁵

Some countries, for example, tightly regulate entry into markets. For example, a country might require governmental approval before a company could issue securities, or require specific tests of pharmaceuticals before allowing them to be sold to consumers.⁶ While such regulation is not unknown in the US, on the whole it relies much more on after-the-fact regulation carried out significantly through private litigation.⁷ If a company misleads the public on a stock offering, or offers a product that proves unsafe, private litigants are able to pursue the company for damages. As part of this process, U.S. courts tend to be more plaintiff-friendly and give more damages, when damages are to be awarded.⁸ This approach calculates that companies internalize the costs of misconduct, and will act lawfully in order to avoid paying damages.

Not imposing before the fact regulation has many advantages in a fast moving modern economy. Companies and individuals have more freedom to innovate. Entry into a market is less expensive, allowing competitors to flourish who might be blocked in other systems. Entry into a market can happen much more quickly, which matters when time to market can determine the eventual survivors. Even corruption is affected, as corrupt officials are unable to impose a toll in the form of bribes to allow entry into the marketplace. This system requires, however, that tort-feasors can be brought to account in the courts.

2. The Role of Discovery in the U.S. Litigation System

Litigation in the United States follows, in federal court and in those state courts that have adopted rules based on federal practice, a process based on the Federal Rules of Civil Procedure. The Federal Rules, taken as a whole, constitute a system for resolving civil disputes. The system assumes as a starting point the culture

⁵ Samuel Issacharoff, *Regulating After the Fact*, 56 DEPAUL L. REV. 375, 377 (2007).

⁶ *Id.* at 378.

⁷ *Id.* at 382. (“[T]he idea that a sufficient level of state or federal regulation could effectively displace private litigation is almost inconceivable.”).

⁸ See, e.g., Donald Earl Childress III, *Escaping Federal Law in Transnational Cases: The Brave New World of Transnational Litigation*, 93 N.C. L. REV. 995, 997–98 (2015).

of “adversarial legalism” that marks United States’ litigation.⁹ The parties, as adversaries, have substantial control over deciding which facts and which legal arguments should drive the decision in the case. Judges, in the words of Chief Justice John Roberts, are to function as “umpires” rather than players, helping to decide the case in accordance with neutrally applied laws.¹⁰ In certain cases access to a jury trial further distinguishes the U.S. system.

Within this context, the Federal Rules included a number of distinctive approaches. Rather than strict fact pleading, the Rules veered toward ‘notice pleading,’ requiring only a “short and plain statement of the claim showing that the pleader is entitled to relief.”¹¹ In contrast to the common law, the Rules allowed flexible joinder of multiple claims and multiple parties. Rather than imposing a straightjacket based on the original pleadings, the Rules allowed flexible amendment of the claims in order to get to a just result. Under notice pleading, notably, substantial evidence is not necessary to get the case under way. That evidence is provided later, through adversarial discovery.

The adversarial U.S. discovery process has been called “[t]he most distinctive feature of American civil procedure.”¹² In the U.S., and consistent with the overall approach of adversarial legalism, this process is managed by the opposing attorneys, not the judge, and “depends on lawyers faithfully to execute their responsibility to produce all requested information,” under threat of harsh potential sanctions through Federal Rule of Civil Procedure 37. Even to U.S. clients, this can look disquietingly like their lawyer is “earnestly searching for compromising information to turn over to the adversary.”¹³ In U.S. discovery, the documents and objects to be sought typically cannot be named or described with names and dates, but must be described categorically (e.g., “all documents related to purchasing the ingredients from which the exported dry-wall was made” rather than “purchase order to XYZ supplier dated

⁹ ADVERSARIAL LEGALISM, *supra* note 3.

¹⁰ John Roberts, *Opening Statement during Nomination Hearings Before U.S. Senate*, CNN (Sep. 12, 2005), <http://www.cnn.com/2005/POLITICS/09/12/roberts.statement/>.

¹¹ Fed. R. Civ. P. 8(a)(2).

¹² SAMUEL ISSACHAROFF, *CIVIL PROCEDURE* 43 (2012).

¹³ *Id.* at 43–47.

mm/dd/yy.”) This allows attorneys to conceal their litigation strategy; and also collect all the information possibly relevant to their case. U.S. discovery is perceived as so broad, far-reaching, and expensive that it is often regarded with disfavor by civil law countries.¹⁴

Discovery and associated motion practice has, however, supplanted trial as how disputes are resolved in the U.S.¹⁵ Very few—perhaps less than two percent¹⁶—of U.S. cases ever reach trial. Through discovery and motion practice the contours of both the facts and the applicable law become known, and in the overwhelming majority of cases that are not abandoned or dismissed, the parties reach a voluntary settlement. Deterrence (and therefore the after-the-fact regulatory effect) is achieved through settlement payments negotiated after discovery reveals the basis for liability. For the U.S. system to function, discovery has to function.

The net is that discovery in private litigation is the leading edge of the U.S. regulatory scheme. Allowing—or not allowing—discovery amounts to allowing, or not allowing, regulation.¹⁷ As

¹⁴ See David W. Ogden & Sarah G. Rapawy, *Discovery in Transnational Litigation: Procedures and Procedural Issues*, ABA BUSINESS LAW SPRING SECTION MEETING, at 1 (Mar. 16, 2007) (“Many outside the U.S. consequently view U.S. discovery as an unrestrained ‘fishing expedition,’ and international discovery can give rise to significant tension.”).

¹⁵ Richard A. Nagareda, *1938 All Over Again? Pre-Trial as Trial in Complex Litigation*, 60 DEPAUL L. REV. 647 (2011); Steven Yeazell, *The Misunderstood Consequences of Modern Civil Process*, 1994 WIS. L. REV. 631, 636–37 (“When fewer than one in twenty filed cases reach trial, one can no longer accurately refer to the federal district courts as ‘trial’ courts or their judges as ‘trial’ judges The picture emerging from these statistics suggests that today’s federal judges have moved their focus away from trial to earlier stages of litigation.”); Todd D. Peterson, *Restoring Structural Checks on Judicial Power in the Era of Managerial Judging*, 29 U.C. DAVIS L. REV. 41, 62 (1995) (“The dramatic increase in caseload and the accompanying pressure to dispose of cases more quickly has helped to transform civil litigation from a trial system to a system focused substantially on pretrial.”).

¹⁶ Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. EMPIRICAL LEGAL STUD. 459, 459 (2004) (“The portion of federal civil cases resolved by trial fell from 11.5 percent in 1962 to 1.8 percent in 2002, continuing a long historic decline.”).

¹⁷ See, e.g., Paul D. Carrington, *Renovating Discovery*, 49 ALA. L. REV. 51, 54 (1997) (“We should keep clearly in mind that discovery is the American alternative to the administrative state . . . every day, hundreds of American lawyers caution their clients that an unlawful course of conduct will be accomplished by serious risk of exposure at the hands of some hundreds of thousands of lawyers,

one prominent U.S. federal judge put it: “Calibration of discovery is calibration of the level of enforcement of the social policy set by Congress.”¹⁸

3. The Changing Face of Discovery Within the U.S. System

Being such a core part of U.S. litigation and therefore U.S. governance, discovery has been a subject of great interest to U.S. scholars, judges and interest groups. This interest has affected U.S. discovery rules. In particular, recent decades have seen significant reduction in the scope and quantity of discovery allowed in a given case. Other changes have made it more difficult to get into court in the first place. Both trends have the effect of reducing discovery burdens.

(a). Changes in the Rules Governing Discovery

Recent decades have seen an ongoing process of narrowing the scope of allowable discovery, and subjecting that discovery which is allowed to greater oversight. These changes include:

- Changing the scope of permissible discovery from “relevant to the subject matter” of the action to “relevant to a claim or defense.” This precludes, for example, filing a breach of contract claim, and then conducting discovery irrelevant to that claim that might support a related antitrust action.¹⁹

each armed with a subpoena power by which misdeeds can be uncovered. Unless corresponding new powers are conferred on public officers, constricting discovery would diminish disincentives for lawless behavior across a wide spectrum of forbidden conduct.”)

¹⁸ Patrick Higginbotham, *Foreword*, 49 ALA. L. REV. 1, 4–5 (1997) (“Congress has elected to use the private suit, private attorneys-general as an enforcement mechanism for the anti-trust laws, the securities laws, environmental law, civil rights, and more. In the main, the plaintiff in these suits must discover evidence from the defendant. Calibration of discovery is calibration of the level of enforcement of the social policy set by Congress . . .”).

¹⁹ Fed. R. Civ. P. 26(b). In 2000, Rule 26 was amended to narrow the normal scope of discovery from “relevant to the subject matter involved in the pending action” to “relevant to the claim or defense of any party.” Discovery relevant to the subject matter remains available with leave of court. Fed. R. Civ. P. 26(b), Advisory Committee Notes (2000) (“The rule change . . . signals to the parties that they have no entitlement to discovery to develop new claims or defenses that are not already identified in the pleadings.”).

- Limiting the default amount and duration of most discovery devices, and requiring court or opposing party permission to seek discovery beyond the relatively tight limits.²⁰
- More common and frequent use of an old device, the protective order, to make sure that information disclosed is not made public or revealed to inappropriate people such as executives at a client company who may be engaged in competition.²¹
- Earlier and more frequent involvement by judges and magistrates in managing the discovery process, so as to reduce the opportunities for party driven abuse.²²
- Specifically highlighting the requirement that discovery be “proportional” to the stakes of the case, whether financial or otherwise.²³

²⁰ Fed. R. Civ. P. 30, 33. In 1993 the Rules were amended to impose limits on the use of discovery tools. Depositions were limited to ten in number. (“A[n] . . . objective is to emphasize that counsel have a professional obligation to develop a mutual cost-effective plan for discovery in the case.”) Fed. R. Civ. P. 30, Advisory Committee Notes (1993). Interrogatories were limited to 25, with discrete subparts counted against the number. (“The purpose of this revision is to reduce the frequency and increase the efficiency of interrogatory practice.”) Fed. R. Civ. P. 33, Advisory Committee Notes (1993). In 2000, the Rules were further amended to limit the normal duration of each deposition to one day of seven hours. (“The Committee has been informed that overlong depositions can result in undue costs and delays in some circumstances.”) Fed. R. Civ. P. 30(d)(1), Advisory Committee Notes (2000).

²¹ Axel Spies, *Global Data Protection: Whose Rules Govern?*, 12 SEDONA CONF. J. 105, 118 (2011). (“[T]he use of protective orders has increased as a counterbalance to the threats such discovery can pose to privacy . . .”).

²² Richard L. Marcus, *Reining In the American Litigator: The New Role of American Judges*, 27 HASTINGS INT’L & COMP. L. REV. 3, 28 (2003) (Reviewing the trend in U.S. litigation toward greater managerial involvement by judges, and concluding “the trend toward case management in America does not appear to be abating.”); Thomas D. Rowe, Jr., *Authorized Managerialism Under the Federal Rules—And the Extent of Convergence With Civil-Law Judging*, 36 SW. U. L. REV. 191, 193 (2007) (“If one theme can fairly be said to dominate in the rounds of Civil Rule amendments adopted since Professor Resnik’s article, that theme is the authorization of both numerous specific measures that district courts can use and the wide discretion they have in pretrial litigation management . . .”).

²³ The proportionality requirement was introduced into Rule 26 in the 1983 amendments, and then highlighted in the 2015 amendments. See Fed. R. Civ. P. 26, Advisory Committee Notes (1983) (“The elements of Rule 26(b)(1)(iii) address the problem of discovery that is disproportionate to the individual lawsuit as measured by such matters as its nature and complexity, the importance of the issues at stake in a case seeking damages, the limitations on a financially weak litigant to withstand extensive opposition to a discovery program or to respond to discovery requests, and the significance of the substantive issues, as measured in philosophic, social, or institutional terms. Thus the rule recognizes that many

In the aggregate, these changes have clipped the wings of unrestrained party driven discovery.²⁴ No longer can parties conduct endless discovery of matters only tangentially related to the claims in the case. The changed rules, reinforced with more active judicial oversight, bring the U.S. system closer to an also changing international norm that has seen more pretrial investigation allowed in other jurisdictions. In fact, the claim has been made that under current rules the U.S. system may allow less pretrial discovery than would be allowed under the rules requiring pretrial disclosure in the United Kingdom.²⁵

(b). Changes in Access to Courts

Changes outside the discovery rules themselves have also made a difference. Most important are two significant changes that make it less likely that a plaintiff will be able to get into court at all—changes in the pleading standard for federal cases, and changes in the scope of personal jurisdiction.

(i). Changed Pleading Standards

The Federal Rules were adopted with a goal of allowing disputes to be resolved on the merits rather than on technicalities. One

cases in public policy spheres, such as employment practices, free speech, and other matters, may have importance far beyond the monetary amount involved. The court must apply the standards in an even-handed manner that will prevent use of discovery to wage a war of attrition or as a device to coerce a party, whether financially weak or affluent.”).

²⁴ That said, it must be noted that the vast expansion of discoverable materials due to digital creation of discoverable material has had an offsetting effect. At one time, documents were written by hand or typed. Today, text messages, social media exchanges, electronic drafts, and more have become some of the most important documents. The burdens of e-discovery are both substantial and the subject of ongoing examination and controversy. See Richard Marcus, *Only Yesterday: Reflections on Rulemaking Responses to E-Discovery*, 73 *FORDHAM L. REV.* 1 (2004), available at <http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=4005&context=flr>.

²⁵ See, e.g., Teresa Rosen Peacocke, *Will recent rule changes make US discovery more limited than UK disclosure?*, Lexology (Oct. 18, 2015), available at <http://www.lexology.com/library/detail.aspx?g=2bce8f8-dab0-47bb-bbf3-7534d1c853eb> (arguing that while historically U.S. discovery has been broader than the UK version (‘disclosure’), FRCP amendments effective December 2015 may make UK disclosure more expansive than U.S. discovery).

important aspect of that was moving away from the strict requirements of common law pleading and fact pleadings under the various reform codes, which contained outcome determinative traps for the unwary.²⁶ While avoiding the word ‘notice’ the solution adopted by the rules moved toward a system where pleadings were required primarily to provide notice that a claim of a certain broad type was being made. The lax requirements of this standard were ratified by the leading case of *Conley v. Gibson*,²⁷ which was understood to allow claims to go forward so long as any set of facts might emerge by trial that would support the claim.

That changed under two leading cases—*Twombly*²⁸ and *Iqbal*²⁹—issued by the Supreme Court in the 21st Century. Now, for each count and each defendant, parties are required to plead facts sufficient to show that the claims against each defendant are “plausible”—that is, to show that the facts alleged show that legally impermissible conduct was more likely to have occurred than permissible conduct. While judges retain discretion to allow some discovery at an early stage to see if these facts exist, that is up to the discretion of the trial judge, and broader discovery is unlikely to be allowed until the court determines whether a prima facie case can be made.

The impact of *Twombly* and *Iqbal* seems likely to be greater in some settings than others,³⁰ with those settings including ones

²⁶ In the era of common law pleading, for example, the facts proved at trial had to fit the writ—or the form matched to the legal theory—or the plaintiff would lose, even if the facts showed that recovery would be proper on another legal theory. When the U.S. moved to a system of fact pleading in most jurisdictions, problems still arose with characterizing pleadings as either factual (allowed) or legal conclusions (not allowed). Since many common relationships contain an element of both—say, whether a given woman is someone’s wife—the ground could be treacherous. Problems could also arise if the facts proved at trial differed or went beyond the facts set forth in the pleadings. These problems led to claims that a “sporting” approach to legal disputes had supplanted a search for justice. See generally, Ray Worthy Campbell, *Getting a Clue: Two Stage Complaint Pleading as a Solution to the Conley-Iqbal Dilemma*, 114 PENN. ST. L. REV. 1191, 1198–1202 (2010).

²⁷ *Conley v. Gibson*, 78 S. Ct. 99 (1957).

²⁸ *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007).

²⁹ *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

³⁰ See, e.g., Alexander A. Reinert, *Measuring the Impact of Plausibility Pleading*, 101 VA. L. REV. 2117 (2015) (finding that prior studies had understated the impact of *Iqbal* and *Twombly* on rates of dismissal); Patricia Hatamyar Moore, *An Updated Quantitative Study of Iqbal’s Impact on 12(b)(6) Motions*,

where foreign defendants might be involved.³¹ For example, *Twombly* involved determining whether facts sufficient to allege an illegal antitrust conspiracy (rather than permissible independent conduct) had been pleaded, and *Iqbal* looked at whether the pleadings supported the inclusion of certain defendants.

(ii). Changed Personal Jurisdiction Standards

Another important change has been the narrowing of U.S. personal jurisdiction standards. There are aspects of U.S. personal jurisdiction law that are exceptional—for example, the assertion of presence or ‘tag’ jurisdiction over individual defendants who are bodily in a jurisdiction, even though the jurisdiction has no other connection to the dispute, and the upholding of unread consents to jurisdiction contained in form contracts of adhesion.³² Tag jurisdiction does not apply to corporate defendants,³³ and while unread consents buried in contracts of adhesion might theoretically apply, it would be the unusual case where they apply to important litigation involving a corporate defendant.

More commonly, U.S. personal jurisdiction applies a ‘minimum contacts’ test, looking to whether the defendant’s contacts with the jurisdiction are sufficient to allow jurisdiction to be asserted consistent with due process concerns.³⁴ Within minimum

46 U. RICH. L. REV. 603 (2012) (finding a statistically significant increase in likelihood judge will dismiss case without leave to amend pursuant to Fed. R. Civ. P. 12(b)(6)); Scott Dodson, *A New Look: Dismissal Rates of Federal Civil Claims*, 96 JUDICATURE 127 (2012).

³¹ For example, products liability cases often present causation issues that are susceptible to *Iqbal* challenges. See William M. Janssen, *Iqbal “Plausibility” in Pharmaceutical and Medical Device Litigation*, 71 LA. L. REV. 541, 636 (2011) (“[L]itigants are pressing *Iqbal* as a source for greater product defect particularization at the pleading stage, and meeting limited, but some, success in doing so . . .”).

³² *Burnham v. Superior Court of California*, 495 U.S. 604 (1990) (personal jurisdiction can be established by service on a human being voluntarily present in the jurisdiction, despite a lack of minimum contacts); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991) (consent to personal jurisdiction in a form contract of adhesion upheld).

³³ *Martinez v. Aero Caribbean*, 764 F.3d 1062 (9th Cir. 2014), *cert. denied*, No. 14-835 (May 18, 2015) (personal jurisdiction cannot be obtained by service on an officer of a corporation who is present in the jurisdiction without minimum contacts for the corporation).

³⁴ *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). See generally WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE §1067 (4th ed.).

contacts are two types of jurisdiction based on minimum contacts—general jurisdiction, asserted when a defendant has ongoing connections with the forum not necessarily related to the current case, and specific jurisdiction, where the contacts must be related to the claims at issue.³⁵

The change came in the understanding of general, or dispute blind, jurisdiction. Many, probably most, and perhaps nearly all, U.S. lawyers understood general jurisdiction to lie when a party had “systematic and continuous” contacts with the forum state.³⁶ For example, a company that had operated a large factory in the forum state, or that maintained multiple offices that engaged in significant amounts of business, might be understood to be subject to general personal jurisdiction.

First in the *Goodyear*³⁷ case and then in the *Daimler*³⁸ case the Court made clear that general jurisdiction was much narrower than that, and lies only when a defendant can be said to be “at home” in the jurisdiction. In *Daimler*, the Court identified two situations where companies were at home—in their state of incorporation, and in the state where they have their principal place of business. The *Daimler* facts make clear how this change can matter to foreign defendants. The parent company in *Daimler* had sold cars in California virtually since the invention of the automobile, and had maintained for generations extensive operations supporting substantial sales. Because neither its headquarters nor principal place of business were there, those actions did not avail to create general jurisdiction. The Court left open the possibility of other settings for general jurisdiction, but the facts of *Daimler* make clear that the other settings will involve unusual if not unique circumstances.³⁹

³⁵ See generally WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE §1067 (4th ed.).

³⁶ Judy M. Cornett & Michael M. Hoffheimer, *Good-Bye Significant Contacts: General Jurisdiction After Daimler AG v. Bauman*, 76 OHIO ST. L.J. 101, 104 (2015) (“[D]espite the Court’s assurance that its decisions are guided by tradition, *Daimler* departs from settled law under which corporations have been subject to jurisdiction for all claims in states where they maintained a sufficient permanent presence or engaged in a comparable substantial level of business.”).

³⁷ *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 564 U.S. 915 (2011).

³⁸ *Daimler AG v. Bauman*, 134 S. Ct. 746 (2014).

³⁹ Scholars have speculated that the corporate history of Boeing might provide an example—founding and major operations in Washington State for nearly a century, but corporate headquarters moved to Illinois.

The practical impact of *Daimler* is huge. In the past, plaintiffs would routinely expect that personal jurisdiction could be asserted in any setting where the defendant had ongoing and significant operations. Today, those operations have to be related to the case at bar, or jurisdiction will not lie.

An example of where *Daimler* could matter is the *Gucci* litigation.⁴⁰ In that case, the principal claim was against a client of the Bank of China. The client allegedly was engaged in an ongoing scheme to sell counterfeit Gucci products into the US. In connection with a discovery order related to the banking records of the client, the District Court found jurisdiction against the Bank of China, which had substantial and ongoing operations in New York. The District Court then issued an injunction requiring the Bank of China to produce banking records of the alleged infringer, notwithstanding claims by the bank that to do so would violate Chinese law.⁴¹ In order to encourage compliance with U.S. rather than Chinese law, the District Court imposed heavy daily cash fines.⁴²

On appeal, the Second Circuit did not reach the issue of whether the injunction was appropriate. Rather, it questioned whether personal jurisdiction existed.⁴³ It found that under *Daimler* general jurisdiction would not lie, and remanded for a determination of whether the bank's activities related to its allegedly infringing client were sufficiently connected to New York to allow an assertion of specific jurisdiction.⁴⁴

The overall impact of *Daimler* is to leave U.S. assertions of jurisdiction at least in alignment with international norms, and perhaps more restrictive than international norms.⁴⁵ An ongoing presence in the U.S. will not be enough. Rather, the plaintiff must show

⁴⁰ *Gucci Am., Inc. v. Weixing Li*, 2011 U.S. Dist. LEXIS 97814 (S.D.N.Y. Aug. 23, 2011); *Gucci Am., Inc. v. Weixing Li*, 2012 U.S. Dist. LEXIS 171520 (S.D.N.Y. Nov. 15, 2012).

⁴¹ *Gucci Am., Inc. v. Weixing Li*, 2011 U.S. Dist. LEXIS 97814, at *5 (S.D.N.Y. Aug. 23, 2011).

⁴² *Gucci Am., Inc. v. Weixing Li*, 2012 U.S. Dist. LEXIS 171520 (S.D.N.Y. Nov. 15, 2012).

⁴³ *Gucci Am. v. Bank of China*, 768 F.3d 122 (2d Cir. 2014).

⁴⁴ *Id.* The *Gucci* litigation is ongoing. The district court had little trouble finding specific jurisdiction on remand. *Gucci Am., Inc. v. Weixing Li*, 135 F. Supp. 3d 87 (S.D.N.Y. 2015).

⁴⁵ See generally CEDRIC RYNGAERT, JURISDICTION IN INTERNATIONAL LAW (2d ed. 2015).

something like purposeful availment of the forum state in a way closely related to the claims at bar. Cases involving Chinese defendants in U.S. courts have often been dismissed when personal jurisdiction is not found because of insufficient purposeful availment of the forum state.⁴⁶

4. Reprise: Litigation and Discovery are Core Aspects of U.S. Sovereignty

Two themes should be apparent from this discussion. First, the reach and exceptionality of U.S. discovery is not what it once was, and not what it is often perceived to be. Discovery itself has been narrowed to be closer to international common-law norms, and the conditions under which a defendant may be required to submit to the discovery process have been narrowed, again making U.S. practice closer to—and perhaps more conservative than some—international norms.

Second, frustration of U.S. discovery and U.S. judicial process does not involve merely private issues between the parties. It involves public issues, most importantly the U.S. system of regulation. A foreign country that works to put its citizens beyond the reach of U.S. discovery works to put them beyond the scope not just of the U.S. judiciary but of the U.S. system for regulating its markets and the safety of the products sold on its soil.

B. Discovery in the Chinese Context

1. Courts Do Not Play the Same Expansive Role in China

Chinese courts do not play the same broad role in governance that courts play in the U.S.⁴⁷ In the U.S. political power is shared between separate state and federal governments, and within a governmental level power is shared among different branches.

⁴⁶ See, e.g., *C.S.B. Commodities, Inc. v. Urban Trend (HK) Ltd.*, 626 F. Supp. 2d 837 (N.D. Ill. 2009) (reprising that presence at a trade show is insufficient for personal jurisdiction); *Black & Decker, Inc. v. Shanghai Xing Te Hao Indus. Co.*, No. 02 C 4615, 2003 U.S. Dist. LEXIS 10127 (N.D. Ill. June 13, 2003) (stating that mere presence at a trade conference was insufficient for personal jurisdiction).

⁴⁷ See generally PITMAN POTTER, *CHINA'S LEGAL SYSTEM* (Wiley 2014).

By way of contrast, power in China is centralized under the People's Congress, which in turn is under the direction of the Communist Party of China. Only the People's Congress can make law. Beyond that, formal interpretation of laws also has been reserved to the People's Congress. The Supreme People's Court does issue influential guidance on how to administer laws. In practice, this resembles interstitial interpretation,⁴⁸ but the theoretical primacy of the People's Congress is clear.

Nor do courts play a central role in regulation. For the most part, China does not follow an after-the-fact regulation scheme as is followed in the U.S., but requires prior governmental approval for many actions that in the U.S. would require no prior approval. In the event of something like a mass tort, the principal responses would flow through the relevant governmental ministries.⁴⁹

Courts in China are thus charged with a narrower role than courts are given in the U.S. They resolve disputes in accordance with the law and applicable governmental policies. While judicial interpretations serve some of the functions of precedential cases, and while local courts can issue guidance on how to address specific issues,⁵⁰ courts do not make common law. Devices that enhance deterrence, such as punitive damages and routine aggregation of plaintiffs into class actions,⁵¹ are not a significant part of the Chinese system.

⁴⁸ See generally Susan Finder, *The Supreme People's Court and Interpreting the Law Revisited*, SUPREME PEOPLE'S COURT MONITOR (July 10, 2015), <https://supremepeoplescourtmonitor.com/2015/07/10/the-supreme-peoples-court-and-interpreting-the-law-revisited-part-one/>.

⁴⁹ See, e.g., FRANCIS SNYDER, *FOOD SAFETY LAW IN CHINA* (2016).

⁵⁰ See Susan Finder, *Shenzhen Courts Steer the Way in Divorce and Shadow Banking Law*, SUPREME PEOPLE'S COURT MONITOR (Mar. 27, 2015), <https://supremepeoplescourtmonitor.com/2015/03/27/shenzhen-courts-steer-the-way-in-divorce-and-shadow-banking-law/>.

⁵¹ There has been an active discussion of expanding the role of aggregate litigation in China. See Richard Wigley, *China's Civil Procedure Law Reported to be Amended to Broaden Definition of Types of Litigants Allowed to File Class-action Lawsuits*, CHINALAWINSIGHT (Sep. 13, 2012), <http://www.chinalawinsight.com/2012/09/articles/dispute-resolution/chinas-civil-procedure-law-reported-to-be-amended-to-broaden-definition-of-types-of-litigants-allowed-to-file-class-action-law>. For a variety of reasons, that has not yet taken hold at the level it has in the U.S.

2. Discovery Does Not Work the Same in the Chinese System

Nor does discovery play the same role in dispute resolution as it does in the United States. The Chinese system, while aiming as the U.S. does at the efficient and fair resolution of civil disputes, constitutes a very different solution to the problem. As a civil law country, where litigation is judge-driven rather than adversarial in nature, the judge does have authority under the PRC Civil Procedure Law to “investigat[e] and collect[] evidence.”⁵² The parties can be required to exchange evidence, and parties can petition for an order for evidence preservation, if it is possible the evidence might be destroyed, lost, or difficult to obtain later. The judge decides whether or not to allow this, and the judge keeps control over the evidence if this is allowed.⁵³ While the 2015 Interpretation of the PRC Rules of Civil Procedure newly allows a pre-trial conference between parties to coordinate evidence exchange⁵⁴ reminiscent of Federal Rule of Civil Procedure 26(f), in practice judges maintain control over evidence. The only way an adversarial party can leverage such evidence is by petitioning that an expert writes a report using it. Even so, such an expert will usually be court-appointed⁵⁵ and not chosen by the litigating parties.

The model for dispute resolution remains the trial, although

⁵² See Judge Elizabeth Fahey & Judge Zhirong Tao, *The Pretrial Discovery Process in Civil Cases: A Comparison of Evidence Discovery Between China and the United States*, 37 BOSTON COLLEGE INT’L & COMP. L. REV. 281, 283 (2014). Note the scope and type of evidence that can be collected is limited by Articles 15 & 17 of Some Provisions of the Supreme People’s Court on Evidence in Civil Procedures (Revised) [最高人民法院关于民事诉讼证据的若干规定(已被修订)], Dec. 21, 2001, <http://www.lawinfochina.com/display.aspx?lib=law&id=2197&CGid=>.

⁵³ 最高人民法院关于适用《中华人民共和国民事诉讼法》的解释[Interpretation of the Supreme People’s Court on the Application of the Civil Procedure Law of the People’s Republic of China] (promulgated by the Sup. People’s Ct., Jan. 30, 2015, effective Feb. 4, 2015) art. 94(3), CLI.3.242703 CHINALAWINFO. (“A party concerned and the agent ad litem thereof may apply in writing to a people’s court for investigation and collection of evidence that is unable to be collected by themselves for reasons beyond their control before expiration of the period for adducing evidence.”), available at <http://www.hshfy.sh.cn/shfy/English/view.jsp?pa=aaWQ9MzY4ODU3Jnh0PTEmbG1kbT1FTl8wNAPdcssPdcssz&jdfwkey=xemdj2>.

⁵⁴ *Id.* art. 225.

⁵⁵ See Richard W. Wigley & Xu Jing, *Evidence Collection and Alternatives to “Discovery,”* CHINA LAW INSIGHT (Apr. 15, 2011).

the parties usually will be encouraged to negotiate or mediate under the supervision of the court. Litigant-run pretrial has in no sense supplanted the expectation of trial.⁵⁶

3. Extraterritoriality is a Hot Button Issue in China

As important to the discussion as differences in judicial regimes are the varying perspectives each country brings to the issue of extraterritorial legal activity within its borders. China's perspective on this undoubtedly is shaped by its history in the colonial era,⁵⁷ a history that is not well known to rank and file American lawyers. A history of foreign powers operating their own judicial systems against Chinese citizens on Chinese soil, in derogation of Chinese laws and Chinese processes, makes extraterritoriality a sensitive issue.⁵⁸

In the era leading up to the Opium Wars in the mid-19th century, issues arose between western powers doing business in China and China itself. China, quite naturally, wished to assert its laws against foreigners who committed offenses on Chinese soil. This led to pushback from foreign powers, who were uncomfortable both with Chinese processes and Chinese laws.⁵⁹

The tension was resolved through military force during the Opium Wars. Along with taking Hong Kong as a colony, Britain insisted on the extraterritorial application of British law to British subjects within China. While this extraterritorial jurisdiction was

⁵⁶ Note that the reasons for this go above and beyond the impact of pre-trial discovery. Among other reasons, trials are less expensive and time-consuming in China, so there is less economic incentive to settle before trial.

⁵⁷ See generally ZHENG WANG, NEVER FORGET NATIONAL HUMILIATION: HISTORICAL MEMORY IN CHINA (2012).

⁵⁸ See generally Randall Peerenboom, *China Stands Up: 100 Years of Humiliation, Sovereignty Concerns, and Resistance to Foreign Pressure on PRC Courts*, 24 EMORY INT'L L. REV. 653, (2010); Teemu Ruskola, *Colonialism Without Colonies: On the Extraterritorial Jurisprudence of the U.S. Court for China*, 71 LAW & CONTEMP. PROBS. 217, (2008).

⁵⁹ See, e.g., Gustavus Ohlinger, *Extra-Territorial Jurisdiction in China*, 4 MICH. L. REV. 339, 341 (1906) ("The barbarity and severity of the punishments which the callousness of the natives render necessary were also revolting to western ideas. No European government could consent to its subjects remaining the victims of such a system.")

originally criminal, it extended over time to some civil issues.⁶⁰

Other western powers, such as the United States, also claimed through most favored nation clauses this same extraterritorial right. U.S. citizens, like British citizens, were subject to the law and processes of their homeland even when they committed offenses within China against Chinese citizens. The United States even operated a federal district court in Shanghai up until 1943. That China was never a U.S. colony means many U.S. citizens are unaware of this history, but it nonetheless remains a kind of extraterritorial imperialism.⁶¹

Being powerless to enforce its own laws on its own soil was humiliating for the Chinese of that era.⁶² One of the signature achievements of Communist rule has been ending the exercise of such extraterritorial power within China. For obvious reasons, returning to anything that smacks of such extraterritorial imposition of western rules within China will be fiercely resisted.

Americans, as evidenced by their expansive acceptance of foreign discovery discussed below, do not view with the same intensity the exercise of foreign legal processes on American soil.⁶³ The intensity of the Chinese reaction might be more easily understood if, however, one imagines an alternate history in which the U.S. had undergone a similar experience.⁶⁴

⁶⁰ *Id.* at 342–44 (describing the jurisdiction clause of the Chefoo Convention).

⁶¹ TEEMU RUSKOLA, *LEGAL ORIENTALISM* 20 (2013) (“The United States’ invocation of extraterritorial jurisdiction in China and throughout the Orient constitutes a prime example of the kind of nonterritorial colonialism that law can become—a form of jurisdictional imperialism this book characterizes as extraterritorial empire.”).

⁶² William P. Alford, *Of Arsenic and Old Laws: Looking Anew at Criminal Justice in Late Imperial China*, 72 *CAL. L. REV.* 1180, 1191 n.45 (1984) (“To understand ‘extraterritoriality,’ it is necessary to review briefly the early history of Sino-British legal relations . . . Needless to say, extraterritoriality was profoundly humiliating to the Chinese . . .”).

⁶³ See *infra* The Problem on the Ground: Implementing U.S. Discovery against Chinese Defendants, Section A: The Hague Convention, Part 1: Good Intentions Gone Awry.

⁶⁴ Indeed, while the histories are far from the same, it is worth noting that the U.S. once fought an eight-year war in part to be free of an analogous problem. See THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776) (“The history of the present King of Great Britain is a history of repeated injuries and usurpations . . . He has combined with others to subject us to a jurisdiction foreign to our consti-

C. Net: Actors in Profoundly Different Systems That Risk Not Understanding the Context and Nuances of the Other System

From the Chinese perspective, discovery looks like a relatively minor part of a private dispute resolution process. From the U.S. perspective, discovery is the most essential element of a regulatory process that plays the important public purposes of making law and regulating the marketplace. From the Chinese perspective, not providing discovery in foreign based cases may appear no more of an imposition than requiring service by hand rather than service by mail, and will seem an important assertion of China's sovereign right to control judicial processes on its own soil. From a U.S. perspective, denying discovery, and therefore after-the-fact regulation, more closely resembles a declaration that a sovereign country cannot use its method of choice to regulate the safety of its citizens. From the U.S. perspective, issues of sovereignty seem not to be triggered by the operation of foreign legal processes on U.S. soil. For China, the prospect of foreign powers operating their legal systems against Chinese citizens within Chinese territory brings quickly to mind the era of colonial encroachment on Chinese sovereignty.

III. THE PROBLEM ON THE GROUND: IMPLEMENTING U.S.
DISCOVERY AGAINST CHINESE DEFENDANTS

A. The Hague Convention

1. Good Intentions Gone Awry

Both China and the United States have ratified the Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters, which sets ground rules to facilitate obtaining extraterritorial evidence.⁶⁵ However, each country's respective dec-

tution, and unacknowledged by our laws; giving his Assent to their Acts of pretended Legislation: For Quartering large bodies of armed troops among us; For protecting them, by a mock Trial, from punishment for any Murders which they should commit on the Inhabitants of these States . . .").

⁶⁵ Three basic methods of taking evidence exist under the Hague Evidence Convention. on the Taking of Evidence Abroad in Civil or Commercial Matters.

larations and reservations to this treaty typify their national attitudes towards evidence discovery.

The U.S. declarations are expansive in nature, allowing more discovery than is required under the convention itself.⁶⁶ For example, the U.S. will allow foreign diplomatic officers to take non-compelled evidence for proceedings in the state they represent without prior permission, and if such evidence must be compelled, the local district court may compel it on the diplomat's behalf.⁶⁷ The permissive U.S. declarations make clear that the U.S. does not view foreign discovery on U.S. soil as an important intrusion on its sovereignty.

China has taken a different approach. While using the Hague Evidence Convention would limit methods of discovery to what China has *ex ante* deemed acceptable,⁶⁸ China disallows through reservation all of Chapter II except Article 15. While such reservations are allowed without violating the treaty's object and purpose so China remains a full participant in the treaty, the reservations effectively exclude most of the discovery that U.S. litigators would want and would expect to receive in a U.S. case. For example, the reservations mean that U.S. diplomatic officers may not appeal to Chinese authorities to compel production of evidence, U.S. diplomatic officers or "commissioners" may not take even voluntary evidence from Chinese and foreign nationals, and even when evidence is given voluntarily by U.S. nationals on Chinese soil, dip-

First, a "letter of request" may be sent from the trial court to the appropriate authority in the foreign country, requesting evidence. Second, a diplomatic officer or consular agent of the trial court's nationality can take the evidence personally. Third, a commissioner is appointed by the trial court or the foreign court to take the evidence. Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, *opened for signature* Mar. 18, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444, 847 U.N.T.S. 231 [hereinafter Hague Evidence Convention], *available at* <https://www.hcch.net/en/instruments/conventions/full-text/?cid=82> (China entry into force Feb. 6, 1998, U.S. entry into force Oct. 7, 1972).

⁶⁶ Hague Evidence Convention U.S. Declarations, HCCH, *available at* <https://www.hcch.net/en/instruments/conventions/status-table/notifications/?csid=565&disp=resdn> (last visited November 12, 2016).

⁶⁷ *Id.*

⁶⁸ See Bernard H. Oxman, *The Choice Between Direct Discovery and Other Means of Obtaining Evidence Abroad: The Impact of the Hague Evidence Convention*, 37 U. MIAMI L. REV. 733, 762 (1983).

omatic officers must request permission from the Chinese government before taking such evidence.⁶⁹ For example, in the *Taishan* case discussed below, the deposed had to go to Hong Kong to give their depositions because taking evidence from Chinese nationals was not allowed on mainland soil.⁷⁰ China additionally narrowly limits requests for pre-trial discovery of documents.⁷¹ So at best, in pre-trial jurisdictional discovery, Chinese authorities will deliver a very limited Request Letter to the relevant party.

The likelihood of successfully acquiring information through the Hague Evidence Convention when submitting a Letter of Request to China is low. The process is protracted.⁷² The Ministry of Justice first receives the request and processes it internally. Requests are then transmitted to the Chinese Supreme Court. The court may narrow the scope of the request, or outright reject the request if disclosure would violate PRC law, or state sovereignty, security, or public interest.⁷³ The request must be quite detailed in order to be approved; so detailed that the request itself runs the risk of revealing the plaintiff's ultimate litigation strategy.⁷⁴ A complete list of questions to the witness must be submitted. If the request is deemed acceptable, the Supreme Court will transmit it to

⁶⁹ Hague Evidence Convention PRC, Hong Kong & Macau Reservations, HCCH, available at <https://www.hcch.net/en/instruments/conventions/status-table/notifications/?csid=493&disp=resdn> (last visited Nov. 16, 2016).

⁷⁰ Order & Reasons on Personal Jurisdiction Discovery, In Re: Chinese Manufactured Drywall Products Liability Litigation, MDL No. 2047 (Sep. 9, 2011, E.D. La.) [henceforth "Taishan Discovery Order"]; see also Legal Considerations: China, Travel. State. Gov., <http://travel.state.gov/content/travel/en/legal-considerations/judicial/country/china.html> (last updated Nov. 15, 2013) ("China does **not** permit attorneys to take depositions in China for use in foreign courts.").

⁷¹ Hague Evidence Convention, PRC, Hong Kong & Macau Reservations, *supra* note 69.

⁷² See Jason Lien & Jesse Mondry, *Litigation: The hurdles of seeking discovery from non-parties based in China*, INSIDECOUNSEL (Oct. 10, 2013), <http://www.insidecounsel.com/2013/10/10/litigation-the-hurdles-of-seeking-discovery-from-n>; Meg Utterback & Holly Blackwell, *China: Obtaining Discovery in China for Use in U.S. Litigation*, MONDAQ, <http://www.mondaq.com/china/x/162784/Disclosure+Electronic+Discovery/Obtaining+Discovery+in+C+hina+for+Use+in+US+Litigation> (last updated Jan. 31, 2012).

⁷³ See 民事诉讼法 [Civil Procedure Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 31, 2012, effective Jan. 1, 2013) art. 282, CLI.1.183386 CHINALAWINFO.

⁷⁴ This is based on discussions by the authors with practicing lawyers in this area.

the local court, and on down the line. Relatively few requests are approved at all,⁷⁵ but if they are, the transmissions usually take at least a year.

Inquiries on behalf of the authors to the Ministry of Justice showed that at present about 40 requests under the Hague Convention are received each year from all countries. In 2014, twenty-three percent of the requests were approved and processed. Twenty-five percent were still under review or processing in April 2016. Fifty-two percent of the requests were rejected for the following three major reasons: that the requests were not made in English (required by the Hague Evidence Convention), that the request was for an audio or video deposition (all rejected because Chinese courts are not technically capable to get witness testimony on tape), or that the request did not have enough information.

“Enough information” means information that is specific enough for Chinese courts to locate or identify a person, a building, or a location. For instance, if a foreign party asks to get witness testimony, the party needs to provide the Chinese citizenship ID number, passport number, Hukou address, or residence address. Effectively, to get discovery in China through the Hague Convention, a litigant needs the information they would normally get through discovery. Due to all of the above, the Hague Evidence Convention is often considered practically useless as a way to get timely evidence discovery from China.⁷⁶

2. Net: Not Useful, Not Used

The Hague Convention has not proved to be a useful tool for resolving discovery issues involving Chinese defendants. The extensive reservations imposed by the Chinese make it effectively inapplicable to most discovery settings. When it is employed, the long delays interfere with effective case processing.

As a result, given the option to bypass it, litigants have done just that, seeking discovery directly through U.S. judges. Article 27 of the Hague Evidence Convention expressly states that this convention is not the exclusive means to get evidence abroad. It

⁷⁵ Inquiries on behalf of the authors to the China Ministry of Justice.

⁷⁶ See Lien & Mondry, *supra* note 72; Utterback & Blackwell, *supra* note 72.

establishes a floor, not a ceiling.⁷⁷

B. International Discovery under the FRCP

1. Personal Jurisdiction and the *Aerospatiale* Factors

In determining whether to require that discovery moves forward under the Hague Convention instead of the FRCP, U.S. courts make case-by-case determinations as ordered by the Supreme Court in *Societe Nationale Industrielle Aerospatiale v. U.S. District Court* (henceforth *Aerospatiale*).⁷⁸ U.S. courts balance three factors: the importance of the information given the particular facts of the case, sovereign interests, and the likelihood that resort to the Convention will prove effective.⁷⁹

Despite the U.S. judiciary's willingness to impose their own procedural rules, it is worth noting that this power is confined in many ways. The court will use its own discovery processes only when there is personal jurisdiction over defendant—or at least reason to conduct discovery into personal jurisdiction, in the post-*Twiqbal* pleading regime. In the ordinary commercial or product liability case, the current U.S. requirements for personal jurisdiction are effectively quite strict—requiring something like purposeful availment of the U.S. forum (perhaps of the very U.S. state). In comparison to, say, France, which will assert personal jurisdiction against defendants despite the lack of any connection to France so long as the plaintiff is French,⁸⁰ the U.S. will require sufficient knowing contacts with the forum, related to the dispute, so that the defendant should reasonably have foreseen the likelihood of appearing in the U.S. court.⁸¹

Given personal jurisdiction, however, the odds that a U.S.

⁷⁷ See Tony Abdollahi, *The Hague Convention: A Medium for International Discovery*, 15 N.C. J. INT'L L. & COM. REG. 1, 8–10 (2015). This article states that the Hague Convention is only followed when U.S. courts do not have personal jurisdiction over foreign witnesses—which raises a chicken-or-egg problem when the discovery is designed to determine whether personal jurisdiction exists.

⁷⁸ *Societe Nationale Industrielle Aerospatiale v. U.S. Dist. Court for S. Dist. of Iowa*, 482 U.S. 522 (1987).

⁷⁹ *Id.* at 544 (applying a “reasonableness test”).

⁸⁰ Kevin Clermont & John R.B. Palmer, *Exorbitant Jurisdiction*, 58 ME. L. REV. 474, 482–86 (2006).

⁸¹ *World-Wide Volkswagen Corp v. Woodson*, 444 U.S. 286 (1980).

judge will go through the FRCP instead of the Hague Convention are high. Some judges have required litigants to go through the Hague Evidence Convention, in spite of the logistical near-impossibility of getting results through it, in order to respect international comity.⁸² More commonly, the *Aerospatiale* reasonableness test does not check full FRCP discovery on foreign defendants; busy lower courts generally authorize FRCP over the Hague Evidence Convention because they are drawn to familiar, faster procedures.⁸³ For the last three decades, when applying the *Aerospatiale* balancing test, U.S. courts “ruled almost unanimously in favor of U.S. interests and the judiciary’s power to reach foreign documents or assets.”⁸⁴

2. The Overlap between Chinese and U.S. Judicial Sovereignty

A U.S. judge applying the Federal Rules of Civil Procedure to discovery within China usurps the Chinese judge’s authority and infringes on Chinese judicial sovereignty.⁸⁵ Chinese civil-law judges are traditionally in control of what discovery is allowed—this is their wheelhouse. Providing certain types of discovery may violate Chinese law. Thus, American discovery requests under the FRCP run strong risk of stepping on Chinese toes.

However, the inability to get discovery through the Hague Convention from Chinese defendants also infringes on U.S. judicial sovereignty. When the U.S. court invokes its process, it invokes that process not just to resolve the dispute, but in order to make law on the true facts and to give effect to the U.S. after-the-fact regulatory system. The issues involved are not just private, but

⁸² See *Tiffany (NJ) LLC v. Forbse*, No. 11 Civ. 4976(NRB), WL 1918866, at *10 (S.D.N.Y. May 23, 2012) (“Given the Chinese government’s stated intention to cooperate with such a request, as well as the near certainty that this issue will continue to arise in future litigation, we consider it appropriate to require Tiffany to direct its discovery requests for ICBC and CMB through the Hague Convention in the first instance.”).

⁸³ See Patrick J. Borchers, *The Incredible Shrinking Hague Evidence Convention*, 38 TEXAS INT’L L. J. 73, 74 (2003).

⁸⁴ See Diego A. Zambrano, *A Comity of Errors: The Rise, Fall, and Return of International Comity in Transnational Discovery*, 34 BERKELEY J. INT’L L. 101, 104 (forthcoming 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2564797.

⁸⁵ In common law countries like the U.S., evidence-collection responsibility always belonged to the lawyers, so U.S. judges are not as protective of this power.

profoundly related to U.S. systems of governance and regulation.

C. *The U.S. Judicial Solution: Sanctions*

The conflict-of-laws concerns and practical difficulties of getting discovery in China have risen to prominence relatively recently. Historically, with U.S. judgments not recognized in China, many Chinese defendants had the best of both worlds—they were free to sell into the U.S. market, but protected from after-the-fact regulation should the products prove defective. When sued in the US, they often responded by simply ignoring the litigation, including discovery requests under the FRCP. A default judgment would ultimately be entered, which would be unenforceable in China.⁸⁶

However, while it remains true that U.S. court judgments cannot be enforced in China, it does not follow that U.S. litigation has no importance to Chinese defendants. First, to the extent the Chinese defendant has assets in the United States, those assets are subject to attachment to satisfy the judgment or, given sufficient contacts, attachment to support a quasi in rem action. Secondly, even if the Chinese defendant has no assets in the United States, it might have assets in a country which does recognize United States judgments, and those assets become subject to seizure.⁸⁷

Finally, U.S. judges have asserted power over who is allowed to do business in America. U.S. judges have begun to enter expansive permanent injunctions and other innovative deterrents against Chinese defendants in such default cases, forbidding them to do further business in America.⁸⁸ This has broad consequences for

⁸⁶ See, e.g., *Herman Miller, Inc. v. Alphaville Design, Inc.*, No. C 08-03437 WHA, 2009 U.S. Dist. LEXIS 103384 (N.D. Cal. Oct. 22, 2009); *TracFone Wireless, Inc. v. Pak China Grp. Co.*, 843 F. Supp. 2d 1284 (S.D. Fla. 2012). In both cases (and others), the Chinese defendant did not respond after being served in accordance with the Hague Service Convention, and a default judgment and permanent injunction were entered. Note that this practice by Chinese firms is by no means entirely a thing of the past. See, e.g., Peter Dujardin, *Liebherr's President: Chinese Firm's Theft of Truck Designs is 'Just Wrong,'* DAILY PRESS (Dec. 17, 2015), <http://www.dailypress.com/news/crime/dp-nws-liebherr-hearing-20151216-story.html>.

⁸⁷ For an example of how such remedies might be applied, see Peter Dujardin, *Can Judgment Against Chinese Firms Be Enforced?*, DAILY PRESS (Dec. 21, 2015), <http://www.dailypress.com/news/crime/dp-nws-evg-liebherr-hearing-20151221-story.html>.

⁸⁸ See *Gucci Am., Inc. v. Huoqing*, No. C-09-05969 JCS, 2011 U.S. Dist.

Chinese businesses, where the United States is often their largest export market.⁸⁹ Once these Chinese defendants understood that failing to appear in court could lead to being cut off from U.S. markets, some began to litigate these issues in U.S. courts.⁹⁰ While a U.S. court judgment or settlement can be expensive, for some Chinese companies, participation and payment is yet cheaper than losing access to such a profitable market.

This solution has created a new problem, as actively participating Chinese defendants both take advantage of China's restrictions on permitted discovery to try to limit the amount of information they must turn over, and yet also must work around said restrictions in order to comply with U.S. court orders.

IV. THE SEMINAL CASE OF TAISHAN DRYWALL

The case of *Taishan Drywall* exemplifies the application of these tactics. In this case, to the shock of many observers, a Chinese defendant ultimately paid U.S. damages in a mass tort class action.⁹¹

A. *The Taishan Drywall Case*

The Taishan case arose from a major financial and public health crisis tied to the importation of defective products from

LEXIS 783, at 63 (N.D. Cal. Jan. 3, 2011). In this case, a Chinese defendant was selling counterfeit designer goods on a number of websites. In addition to a permanent injunction against using the plaintiff's trademark again in any way, the court transferred ownership of the websites to the plaintiffs, "in order to give practical effect to the permanent injunction."

⁸⁹ The U.S. is China's largest trading partner by volume. As of June 2016, 18% of Chinese exports went to the United States. See *China Exports*, TRADING ECONOMICS, <http://www.tradingeconomics.com/china/exports> (last accessed June 14, 2016).

⁹⁰ See, e.g., *Zamperla, Inc. v. Golden Horse Amusement Equip. Co.*, No. 6:10-cv-1718-Orl-37KRS, 2015 U.S. Dist. LEXIS 86567 (M.D. Fla. Apr. 29, 2015). In this unfair competition case, the Chinese defendants were served with process while at an annual trade show, and ultimately did not appear or respond to the complaint. A default judgment and permanent injunction were entered. The Chinese defendants discovered the consequences upon their return for the following year's trade show. Faced with losing access to the U.S. market or litigating, they filed a motion to set aside the default judgment and litigated the issue.

⁹¹ See, e.g., Aaron M. Kessler, *Chinese Drywall Firm to Pay Damages*, N.Y. TIMES, Mar. 18, 2015.

China. After Hurricane Katrina, there was a shortage of construction materials in the United States. Approximately 550 million pounds of drywall were imported from China to aid in rebuilding. However, after the installation of this drywall, “property owners began to complain of emissions of smelly gasses, the corrosion and blackening of metal wiring, surfaces, and objects, and the breaking down of appliances and electrical devices in their homes.”⁹²

The impact on home owners was substantial. As a practical matter their homes—typically the largest investment and asset held by a middle class U.S. homeowner—became unlivable. The toxic effects of the drywall mandated not just the replacement of the defective drywall, but also the replacement of high cost items such as air conditioning units and metal plumbing or fixtures, which were ruined by the corrosion caused by the drywall. The costs of remediation ran into the billions of dollars.

The Taishan defendants, Chinese drywall manufacturers and affiliates, had sold mass quantities (1,825,202 sheets) of contaminated drywall into the United States. Litigation started in the spring of 2009. In this mass tort class action, representative plaintiffs were often common homeowners across multiple states, with no contract with Taishan, no access to arbitration,⁹³ and no ability to litigate in China. They were middle-class U.S. citizens who had put their savings into rebuilding after Katrina, only to find that the installed

⁹² *Germano v. Taisham Gypsum Co., Ltd.* (In re Chinese-Manufactured Dry-wall Prods. Liab. Litig.), No. 2047, 2014 U.S. Dist. LEXIS 137807 (E.D. La. Sep. 26, 2014).

⁹³ Given China’s reservations to the New York Convention, even if arbitration worked for contract claimants, this would still leave tort victims without a legal remedy, even those whose personal injury claims arose out of some contract. While the text of the Convention states that it shall apply arbitral awards arising out of differences between persons, both physical and legal, and U.S. courts have willingly allowed personal injury claims based in contract to be forced into arbitration, China’s reservations to the Convention clarify that for China, the Convention will only apply decisions arising out of legal relationships (contractual or not) that are considered “commercial” under the PRC law. *See* Convention on the Recognition and Enforcement of Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38 [hereinafter cited as New York Convention]; *Marmet Health Care Ctr., Inc. v. Brown*, 132 S. Ct. 1201 (2012) (forcing negligence-based wrongful death claims against a nursing home into arbitration based on an ante-mortem signed contract); and *Contracting States*, NEW YORK ARBITRATION CONVENTION, <http://www.newyorkconvention.org/countries> (last visited Apr. 22, 2016).

drywall had destroyed their homes and in some cases made them sick as well.

Under the American regulatory and compensation system, litigation would normally produce the funds for remediation, which in turn would give manufacturers an ongoing incentive to not ship products known to be defective.

Given that the defendants were Chinese, under existing law the likelihood of any remedy for the 99%-class⁹⁴ American homeowners affected by the poisonous drywall seemed minimal. Taishan looked to be able to access the benefits of the U.S. markets, but avoid any accountability for causing harm to U.S. citizens. Given this reality, media reports of the time show extreme anger, frustration, and resentment directed at China and Chinese companies, who were viewed as immoral: willing to hurt regular people and dodge responsibility in order to make a profit.⁹⁵

Lawsuits were filed against U.S. importers and distributors, but this failed to provide relief. Many of these companies were small enterprises, and went bankrupt in the face of liability.⁹⁶ Having been deceived along with their customers, imposing costs on them did not provide the desired after the event regulation.

⁹⁴ With increasing income inequality in the U.S., this phrase has emerged as shorthand to delineate the elite from the masses. See, e.g., John Stoehr, *Hillary holds her own with the 99%*, USA TODAY (Apr. 4, 2016), <http://www.usatoday.com/story/opinion/2016/04/03/hillary-clinton-wall-street-blue-collar-vot-e-column/82536262/>.

⁹⁵ See, e.g., Katherine Sayre, *Maker of defective Chinese drywall Taishan skips out on court hearing, leaving homeowners waiting*, THE TIMES-PICAYUNE, Aug. 13, 2014 (“The question here in this case is whether the Chinese companies and their government, whether they will honor their moral and legal obligations under a commercial contract It’s bigger than just drywall.”); Dan Harris, *Chinese Drywall Cases Make U.S. Lawyers Angry. I Want My Lex Americana!*, CHINALAWBLOG, Oct. 3, 2009 (citing Erwin Gonzalez: “If the Chinese Companies are not willing to be accountable and responsible for their acts and omissions they should not do business in the United States.”); Jacqui Goddard, *Tainted drywall from China is driving owners from their homes*, The Christian Science Monitor, Apr. 4, 2009 (“[T]here is anger and frustration that this is just the latest in a series of health and safety scares relating to imported Chinese goods . . . [Victim Rene Galvin] owns a boutique in Atlantic City and has cleared out all items marked ‘Made in China’ from her inventory. New additions to her stock include T-shirts that she has had printed with the words: ‘No more toxins from China.’”).

⁹⁶ E.g., Aaron Kessler, *Builder WCI faces revolt over Chinese Drywall*, HERALD TRIBUNE, (Jan. 31, 2011), <http://www.heraldtribune.com/article/20110131/ARTICLE/101311009?p=1&tc=pg>.

CASES WHERE THE TAISHAN DEFENDANTS HAVE BEEN HELD IN DEFAULT⁹⁷

	Taishan	TTP	BNBM	BNBM Group	CNBM Group	CNBM
Germano (Virginia)	X					
Wiltz (Virginia)			X			
Gross (Virginia)			X	X	X	X
Amorin (Virginia)	X	X		X	X	X
Amorin (Louisiana)	X	X				X
Amorin (Florida)	X	X				

It is worth stressing that this was not a case where an item was put into the global “stream of commerce” and carried by chance to the U.S. Taishan’s international export model was predominantly aimed at the United States. They had gone so far as to recruit English-speaking staff with Americanized names to directly target U.S. customers. Their marketing web map depicted an arrow pointing directly from China to the United States.⁹⁸

Initially, the Taishan defendants and affiliates declined to show up in court. Based on preliminary findings that personal jurisdiction existed, and given the failure to defend, the Taishan defendants were held across the board in default, pursuant to Federal Rule of Civil Procedure (“FRCP”) 55.

Recognizing that default judgments would be unenforceable in China and that assets would be difficult to locate in the United States, presiding judge Eldon Fallon went beyond ordering Taishan to pay damages. The judge enjoined Taishan from doing further business in the United States, thereby closing off its target

⁹⁷ *Id.* at 7. As can be seen from this chart, this was an extremely messy class action across multiple states and involving multiple defendants.

⁹⁸ Kessler, *supra* note 96, at 13. While this was analyzed by the court to determine if there were sufficient minimum contacts for U.S. court to exercise personal jurisdiction, it underlines the degree to which Taishan’s business model depended on U.S. revenue.

market. The judge further alerted the executive branch to further enforce this judgment.⁹⁹

Once the injunctions and sanctions took effect, cutting off Taishan's revenue stream, Taishan showed up in U.S. court to try and vacate the default judgments.¹⁰⁰ Taishan initially argued that the default judgments should be vacated on the grounds that the U.S. courts did not have personal jurisdiction over them. Taishan also argued that it "did not understand the significance of [being served with the Complaint] and it was ignorant of the U.S. legal system."¹⁰¹

This defense required Taishan to submit to U.S. discovery requests in order to determine, as a matter of fact, whether Taishan had sufficient minimum contacts with the forum states to allow a U.S. court to exercise personal jurisdiction.¹⁰² This discovery process "degenerated into 'chaos and old night,'" as colorfully described by presiding Judge Fallon.¹⁰³ Twelve lawyers flew to Hong Kong to take three depositions that were ultimately ruled ineffective because of "disagreement between interpreters, counsel, and witnesses, translation difficulties, speaking objections, colloquy among counsel and interpreters, and in general ensuing chaos."¹⁰⁴ Taishan additionally pleaded it did not have control over some of the documents requested, which were in control of other Chinese

⁹⁹ *E.g.*, *Germano v. Taishan Gypsum Co. (In re Chinese Manufactured Drywall Prods. Liab. Litig.)*, No. 2047, 2014 U.S. Dist. LEXIS 183686 (E.D. La. July 17, 2014) ("IT IS FURTHER ORDERED that Taishan, and any of its affiliates or subsidiaries, is hereby ENJOINED from conducting any business in the United States until or unless it participates in this judicial process . . . IT IS FURTHER ORDERED that the clerk of court forward this contempt order to the U.S. Secretary of Commerce, the Chair of the U.S. Senate Committee on Commerce, Science, and Transportation, and the U.S. Attorney General, so that these officials are aware of the seriousness of the situation, and for any appropriate action they may see fit.").

¹⁰⁰ *E.g.*, *In re Chinese Manufactured Drywall Prods. Liab. Litig.*, 894 F. Supp. 2d 819 (E.D. La. 2012). While cases were filed in many jurisdictions, by this point most had transferred to the Eastern District of Louisiana for consolidation and coordination of trial proceedings.

¹⁰¹ *Id.* at 863.

¹⁰² *See* Taishan Discovery Order. Other parties also claimed immunity under the Foreign Sovereign Immunities Act, which will also require discovery. *E.g.*, *In re Chinese Manufactured Drywall Prods. Liab. Litig.*, No. 2047, 2015 U.S. Dist. LEXIS 95431 (E.D. La. July 22, 2015).

¹⁰³ Taishan Discovery Order at 5.

¹⁰⁴ *Id.*

entities (who perhaps would not understand a U.S. discovery request). The U.S. judge did not find this claim plausible.¹⁰⁵

In the end, with mounting evidence that the Taishan defendants had targeted not just the U.S. as a whole but specific state markets, the trial courts upheld personal jurisdiction, which in turn was upheld by the Fifth Circuit Court of Appeals.¹⁰⁶ The case, apparently, has proceeded toward settlement.

The exercise of jurisdiction over and the banning of the Taishan defendants made perfect sense in a regulatory system that depends on after-the-fact regulation to protect consumers. In other countries, sellers may be required to demonstrate that they comply with local safety and quality standards before goods are allowed in the country's market. In the U.S., entry to the market is much less restricted, but that openness depends on the effective use of after-the-fact regulation. Banning from the market those who opt out of participating in after-the-fact regulation vindicates that system of regulation, which is an important factor of U.S. governance.

That said, the Chinese drywall litigation was a source of significant friction between the U.S. and China. Given the massive impact of the defective drywall on thousands of homeowners, and given the well-publicized efforts of the Chinese defendants to enjoy the benefits of the U.S. market while not submitting to U.S. regulatory processes, it became a focal point for those critical of Chinese product quality as well as of Chinese trade practices.¹⁰⁷ The refusal to appear once served and to cooperate with discovery can appear as an arrogant refusal to submit to the regulatory processes of a market they sought to exploit.

At the same time, Taishan and similar cases give rise to reciprocal tensions within China. Chinese defendants were ordered by U.S. courts to take actions on Chinese soil that violated Chinese substantive law. Chinese deponents ultimately had to leave their homes and fly to Hong Kong to give their depositions in neutral territory, in order to comply with both Chinese and U.S. law. In other cases, U.S. law demands the provision of information that

¹⁰⁵ *Id.* at 23.

¹⁰⁶ *E.g.*, Baldwin v. Taishang Gypsum Co., Ltd. (In re Chinese-Manufactured Drywall Prods. Liab. Litig.), 742 F.3d 576 (5th Cir. 2014).

¹⁰⁷ See Kessler, *supra* note 96.

Chinese law prohibits providing. From a Chinese perspective—especially from the perspective of those who do not understand all that is at stake for the U.S. if its litigation system is disregarded—this also can seem like an arrogant disregard of national sovereignty.

B. *Beyond Taishan*

The story of Taishan shows how Chinese companies that wish to continue to do business in the United States will be haled, will they or won't they, into U.S. courts. The next part of this story is what happens there. Even when a Chinese defendant is willing to cooperate with FRCP imposed discovery,¹⁰⁸ Chinese law may pose hurdles. U.S. judges must determine if these hurdles are real, or if they are part of the defendant's litigation strategy.

U.S. discovery requests may in fact conflict with Chinese law. In the case of China, the Law of the People's Republic of China on Guarding State Secrets ("State Secrets Law") gives all citizens the duty of guarding certain "secrets" under Article 2 and requires State pre-approval before furnishing others under Article 30.¹⁰⁹ State secrets are broadly defined to include trade secrets, and

¹⁰⁸ Note they may not cooperate, and this bears consequences as well. *See, e.g.,* Herman Miller, Inc. v. Alphaville Design, Inc., No. C 08-03437 WHA, 2009 U.S. Dist. LEXIS 103384 (N.D. Cal. Oct. 22, 2009); TracFone Wireless, Inc. v. Pak China Grp. Co., 843 F. Supp. 2d 1284 (S.D. Fla. 2012). In both cases (and others), the Chinese defendant did not respond after being served in accordance with the Hague Service Convention, and a default judgment was entered against the Chinese defendant.

¹⁰⁹ 中华人民共和国保守国家秘密法（2010 修订）[State Secrets Law of the People's Republic of China (2010 version)] (promulgated by the Nat'l People's Cong., April. 29, 2000, effective Oct 1, 2010), CLI.1.129605 CHINALAWINFO, available at http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383925.htm (last visited) [hereinafter "State Secrets Law"]; Megan C. Chang & Terry E. Chang, *Brand Name Replicas and Bank Secrecy: Exploring Attitudes and Anxieties Towards Chinese Banks in the Tiffany and Gucci Cases*, 7 BROOK. J. CORP. FIN. & COM. L. 425, 430 (2013) (listing Chinese legal provisions that prohibit banks transferring data, starting with Article 6 of the Commercial Bank Law); Global Legal Monitor, *China: NPC Decision on Network Information Protection*, LIBRARY OF CONGRESS (Jan. 4. 2013), available at <http://www.loc.gov/law/foreign-news/article/china-npc-decision-on-network-information-protection/> (describing the Decision on Network Information Protection, which requires Internet service providers to not divulge citizens' personal data). *See* Abdollahi, *supra* note 77, at 102–03.

violation is strictly enforced.¹¹⁰ This is the most commonly cited when Chinese defendants argue they cannot legally transmit information demanded in U.S. discovery, but other Chinese regulations, decisions and laws also prohibit extraterritorial transfer of sensitive information.¹¹¹

When U.S. discovery requests might conflict with foreign law, the effect should theoretically be analyzed under principles of international comity.¹¹² There are good reasons to be cautious in such instances. Heavy-handed judicial imperialism can lead to undesired and unexpected reactions from foreign sovereigns.¹¹³ Over-broad discovery demands may even destabilize foreign relations.¹¹⁴

If the goal were merely to respect international comity, going through the Hague Convention would be the safest choice. While the second *Aerospatiale* factor does require consideration of sovereign interest, consideration in a three-factor balancing test is not

¹¹⁰ For example, in 2010, the Australian mining company Rio Tinto was subjected to Chinese criminal prosecution under the State Secrets Law for sending business information about iron ore mining and steel production to Australia. Kenneth Rashbaum, Vishal Oza, & Fred Chan, *A Discovery Road Block—Moving Data Out of China*, NAVIGANT INSIGHTS (Dec. 12, 2012), <http://www.navigant.com/insights/hot-topics/technology-solutions-experts-corner/a-discovery-road-block-moving/> (last visited June 10, 2016).

¹¹¹ See Megan C. Chang & Terry E. Chang, *Brand Name Replicas and Bank Secrecy: Exploring Attitudes and Anxieties Towards Chinese Banks in the Tiffany and Gucci Cases*, 7 BROOK. J. CORP. FIN. & COM. L. 425, 430 (2013) (listing Chinese legal provisions that prohibit banks transferring data, starting with Article 6 of the Commercial Bank Law); Global Legal Monitor, *supra* note 109.

¹¹² See Restatement of Foreign Relations Law of the United States (Revised) § 437(1)(c) (Tent. Draft No. 7, 1986) (approved May 14, 1986) (giving factors for comity analysis, such as “(1) the importance to the . . . litigation of the documents or other information requested; (2) the degree of specificity of the request; (3) whether the information originated in the United States; (4) the availability of alternative means of securing the information; and (5) the extent to which non-compliance with the request would undermine important interests of the United States, or compliance with the request would undermine important interests of the state where the information is located.”).

¹¹³ Historically, nations have responded by enacting strict criminal statutes to force U.S. courts to back down, or by intervening directly in the action to protect their judicial sovereignty. Bernard H. Oxman, *The Choice Between Direct Discovery and Other Means of Obtaining Evidence Abroad: The Impact of the Hague Evidence Convention*, 37 U. MIAMI L. REV. 733, 742–43 (1983).

¹¹⁴ See Zambrano, *supra* note 84, at 103 (explaining how Chinese regulators recently threatened the stability of bilateral relations with the United States because of discovery requests for Gucci Am., Inc. v. Weixing Li).

nearly as respectful of comity as a treaty. Under Hague Convention procedure, the right to interpret Chinese law to determine whether discovery is allowed or prohibited rests with Chinese courts,¹¹⁵ while if going through the FRCP, U.S. courts will themselves interpret the relevant Chinese law to decide if the defendant's concerns are valid.¹¹⁶ If the U.S. interpretation does not match the ultimate Chinese judicial interpretation, this violates international comity and leaves defendants "between a rock and hard place."

As aforementioned, though, U.S. judges find themselves in a similar sticky position. U.S. judges are not merely tasked with concern for international comity; they are tasked with defending the U.S. after-the-fact regulatory system. If the Hague Convention does not produce results, some judges may feel forced to carry out their duties in other ways. In such cases, with the Hague Convention a perceived nullity, the judge weighs the importance of the document to the litigation (and correspondingly, the ability to maintain an after-the-fact regulatory system) directly against the need to respect another sovereign's interests.

¹¹⁵ See Abdollahi, *supra* note 77, at 23–25; see also Hague Evidence Convention, at art. 9 & art. 11.

¹¹⁶ For an example, see *Wultz v. Bank of China*, in which a bank was required to produce documents located in China, including documents the bank argued were subject to attorney-client privilege. Judge Scheindlin of the S.D.N.Y. held that because China does not recognize attorney-client privilege, and the documents and alleged "attorneys" were in China, the bank could not plead attorney-client privilege. The judge ruled additionally that the definition of attorney, in China and without, did not include un-licensed employees who are the "functional equivalent of a lawyer," even though Chinese law does not require in-house counsel to be licensed. *Wultz v. Bank of China*, 979 F. Supp. 2d 479, 493, 495 (S.D.N.Y. 2013) (survivors of a suicide bombing in Israel alleged Bank of China provided material support and resources to an international terrorist organization, and requested discovery to prove this point). Note that as of 2011, China only had 200,000 licensed lawyers. *Number of China's Licensed Lawyers Reaches 200,000*, XINHUA, Oct. 19, 2011. Much of China's legal work is carried out by unlicensed legal workers. William P. Alford, *Tasselled Loafers for Barefoot Lawyers: Transformation and Tension in the World of Chinese Legal Workers*, 141 CHINA Q. 22, Mar. 1995. However, many countries do not accord attorney-client privilege to in-house counsel, even when licensed. *E.g.*, Sam Widdoes, *Privilege in a Global Landscape Part II: International In-House Counsel*, ASSOCIATION OF CORPORATE COUNSEL: LEGAL RESOURCES, May 10, 2013, (explaining how the European Court of Justice has repeatedly held that privilege only adheres to independent, not in-house, lawyers).

1. Gamesmanship v. Good Faith

Often, the judge's decision is colored by their sense that the Chinese defendant in the case is not operating in good faith, and thus, regardless of the defendant's claims, demanding the pertinent documents would not truly violate international comity. Defendants that plead, seemingly as litigation strategy, that discovery would violate Chinese law may reduce the credibility of other Chinese defendants in the eyes of U.S. judges. Take the case of *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, in which a Chinese company facing a show cause order argued it could not turn over the requested documents because, upon questioning, PRC authorities had advised such production would violate PRC law. Ultimately, however, after the SEC requested assistance from the relevant Chinese agency, the China Securities Regulatory Commission ("CSRC"), the CSRC obtained the required documents from the plaintiff and produced them to the SEC. The SEC then dismissed the subpoena enforcement without prejudice.¹¹⁷ In this case, the Chinese regulatory agency did not think the production of the documents requested violated Chinese law, although the Chinese defendant claimed that it would. While it is possible that the Chinese company believed in good faith that production of the documents would violate Chinese law, it is also possible that claiming such violation was part of their litigation strategy.

Because of limited understanding of Chinese law, Chinese defendants pleading requirements of Chinese law are vulnerable to accusations of gamesmanship in U.S. courts.¹¹⁸ Chinese defendants may also be viewed as unwilling to play by the rules, if the

¹¹⁷ Press Release, SEC, *Joined by Deloitte China, Files a Motion to Dismiss Without Prejudice the Subpoena Enforcement Action*, U.S. SECURITIES AND EXCHANGE COMMISSION (Litigation Release No. 22911/ Accounting and Auditing Enforcement Release No. 3531) (Jan. 27, 2014), in relation to *Securities and Exchange Commission v. Deloitte Touche Tohmatsu CPA Ltd.*, Civil Action No. 1:11-MC-00512 (D.D.C. filed September 8, 2011), available at <https://www.sec.gov/litigation/litreleases/2014/lr22911.htm>.

¹¹⁸ In a case where information bound by a U.S. non-disclosure agreement was used by the Chinese company ZTE to later bring an antitrust suit in China, ZTE initially argued that it was required to disclose the confidential information at issue in its Chinese complaint under Chinese law, specifically, Article 121 of the PRC Civil Procedure Law. The judge analyzed PRC disclosure law in order to dismiss this claim as "nothing more than gamesmanship," before deciding the argument was irrelevant because the original non-disclosure agreement was governed

rules are unfavorable to them. This can lead to suspicion on the part of judges, and unfavorable rulings. One case, *Vringo v. ZTE*,¹¹⁹ shows many examples of this interplay between a U.S. judge and a Chinese plaintiff. Judge Kaplan of the Southern District of New York (“S.D.N.Y.”)¹²⁰ presided.

ZTE argued that the Chief Counsel of ZTE could not be deposed in the United States because he may be wanted in the U.S. in connection with alleged sales of embargoed equipment to Iran, and cannot appear here without risking arrest.¹²¹ This had not been revealed in prior motions demanding this deposition, and as aforementioned, deposition cannot be taken in China due to China’s reservations to the Hague Evidence Convention. ZTE additionally stated it had no intention to comply regardless of the outcome of the motion, and thus the Court should consider what sanction to impose if ZTE’s motion were not granted.¹²² The judge did not lie

by New York law. *Vringo, Inc. v. ZTE Corp.*, No. 14-cv-4988 (LAK), 2015 U.S. Dist. LEXIS 71919, at *19-20 (S.D.N.Y. June 3, 2015). Compare this to Judge Fallon’s sidestepping—see *In re Chinese Manufactured Drywall*, *supra* note 100 (“Both parties agree that Chinese law applies to the analysis of whether TTP’s contacts may be imputed to TG for purposes of personal jurisdiction, but they disagree on the interpretation and application of Chinese law and have presented competing expert opinions on this law. The Court finds no reason to address the parties’ arguments on imputing the contacts of TTP to TG for purposes of personal jurisdiction in *Germano*, because the present evidence demonstrates that TTP had no contacts with Virginia during the relevant time period, leaving no forum contacts to impute to TG.” and “TG and most Respondents agree that Chinese law on piercing the corporate veil applies to the analysis of whether TTP’s contacts may be imputed to TG for purposes of personal jurisdiction, but they disagree on the interpretation and application of this law and have presented competing expert opinions on this law. However, the Court finds it need not at this juncture of the litigation determine whether TTP’s corporate veil can be pierced to determine whether TG is liable for TTP’s forum-related actions.”).

¹¹⁹ In December 2013, Vringo Inc. (a licensor of telecommunications patents) and ZTE Corporation (a Chinese telecommunication company), met to discuss patent disputes between the companies. Before entering the meeting, they signed a non-disclosure agreement (“NDA”). However, the two could not reach an agreement. Ultimately ZTE filed an antitrust action against Vringo in China, based on the information revealed during this confidential meeting, using the proposal produced in the meeting as an exhibit. *Vringo, Inc.*, 2015 U.S. Dist. LEXIS 65260.

¹²⁰ The S.D.N.Y. serves as battleground for many cases in which the question of discovery ordered on Chinese defendants is raised.

¹²¹ This Chief Counsel’s emails indicated he knew and approved ZTE’s plan to “forc[e] Vringo” to settle at a reasonable price by “making war.” *Vringo, Inc. v. ZTE Corp.*, No. 14-cv-4988 (LAK) (FM), 2015 U.S. Dist. LEXIS 105140, at *16 (S.D.N.Y. Aug. 11, 2015).

¹²² *Id.* at *36.

down before this challenge. The Court ultimately did not concede that possible criminal prosecution was a reason to excuse compliance with discovery procedure, on the grounds that a contrary ruling would put the court in the position of aiding a putative criminal in avoiding apprehension while allowing such person full access to the benefits of the U.S. civil legal system.¹²³

Suspicious U.S. judges might feel that Chinese defendants, as in *Deloitte Touche Tohmatsu* and *ZTE*, were not willing to engage in good faith with the U.S. judicial system. While U.S. defendants might also use such tactics, the judge in such cases more likely has the knowledge to accurately judge whether or not the claim is fair. Overwhelmed by Chinese defendants pleading Chinese law as defense, multiple “boy-who-cried-wolf” claims may have led to a cynicism among the U.S. judiciary when it comes to the comity claims of Chinese defendants. The judge’s perception that a defendant was using “boy-who-cried-wolf” tactics might adversely affect the willingness of a judge to believe a defendant’s claims that they could not comply with U.S. discovery without violating Chinese law. While some comity claims are no doubt merely litigation strategy, some are not. In the event the comity concern is real, the situation is extremely difficult for the Chinese defendant. This is an area in which cooperation between the U.S. and Chinese judiciary or regulators, as in *Deloitte Touche Tohmatsu*, could lead to a more nuanced understanding of which claims are legitimate and which claims are gamesmanship.

Given this suspicion, at least one U.S. judge has explicitly added an analysis of the defendant’s good faith to the comity balancing test. In *Tiffany v. Forbse*, Judge Buchwald of the S.D.N.Y. required plaintiffs’ discovery requests against the Industrial and Commercial Bank of China (“ICBC”) to go through the Hague Evidence Convention, whereas discovery requests against the S.D.N.Y.’s perennial counterparty, the Bank of China, were compelled under the FRCP.¹²⁴ This was because Bank of China had continued to act as the acquiring bank for the offending website after being notified of the preliminary injunction, which indicated

¹²³ *Id.* at *34.

¹²⁴ *Tiffany (NJ) LLC*, 2012 U.S. Dist. LEXIS 72148, at *30

bad faith to the court, while ICBC immediately ceased, which indicated a welcome willingness to comply with U.S. law.¹²⁵ By adding a “good faith” factor to the traditional comity analysis,¹²⁶ the S.D.N.Y. turned discovery rulings into both punishment for undesirable behavior and reward for willingness to comply with the requirements of the U.S. system.

2. Comity v. Efficiency

The sense that the Chinese are not willing to engage fully with the U.S. system applies not only to defendants but also to the Chinese judiciary. As aforementioned, District Court judges are overwhelmingly likely to apply the FRCP due to a belief that the Hague Evidence Convention will not result in timely discovery, which is necessary for effective after-the-fact regulation.

However, the preference for efficiency over comity is perhaps more pronounced in the trenches of the district courts, as opposed to at the circuit court level. Other concerns prevail at the circuit court level. For example, in *Gucci America v. Weixing Li*, the Second Circuit ultimately overruled much of Judge Sullivan’s original decision,¹²⁷ applying a detailed analysis emphasizing the importance of international comity concerns.¹²⁸ The court considered a declaration from a Chinese law expert attesting to direct conflict of law, Chinese official concerns on the effect the case could have on U.S.-China relations, a conflicting order from the High People’s Court of Beijing Municipality, and an amicus brief from the U.S. government arguing for vacatur so the lower court could perform a “thorough international comity” analysis.¹²⁹

Upon remand, however, District Judge Sullivan assessed specific personal jurisdiction in light of the Second Circuit decision, and upon finding specific personal jurisdiction, went through his own comity analysis.¹³⁰ He determined that personal jurisdiction could be asserted over BOC without considering “the fact that granting Gucci’s motion would force BOC to violate Chinese law.”

¹²⁵ *Id.* at 30–31.

¹²⁶ *Id.* at 13. See also Restatement, *supra* note 112.

¹²⁷ *Gucci Am., Inc.*, 2012 U.S. Dist. LEXIS 171520 (2012).

¹²⁸ *Gucci Am.*, 768 F.3d 122 (2014).

¹²⁹ See Zambrano, *supra* note 84, at 33–38.

¹³⁰ *Gucci Am., Inc. v. Weixing Li*, 2015 U.S. Dist. LEXIS 131567.

As regards the fair play and substantial justice arm of personal jurisdiction analysis, he argued that “burden,” in discovery, refers merely to logistical difficulties such as excessive cost or travel, and not to burden inflicted by conflict of laws.¹³¹ In the comity analysis, the court considered a recent decision from the Beijing High Court ordering BOC to lift the asset freeze imposed by the S.D.N.Y., creating a direct conflict of laws. Judge Sullivan argued that these decisions showed instead that even Chinese courts felt that Bank of China had broad contractual rights over its customers, such as the right to freeze accounts. Ultimately he disagreed with Judge Pitman’s assessment in *Tiffany v. Andrew* of the possibility of relief through the Hague Evidence Convention, and determined that given the balance of comity, discovery must go forward.¹³²

If Bank of China’s claim that it could not allow discovery without breaking Chinese law were true, this decision left Bank of China with no choice but to violate either U.S. or Chinese law. In face of Bank of China’s continued unwillingness to comply with the court order, the court ordered a coercive sanction—a \$50,000 daily fine for each day of non-compliance.¹³³ Pragmatically, this method could make it more expensive to comply with Chinese law than U.S. law, and thereby coerce compliance with U.S. law over Chinese law.

While the case could be appealed to the circuit court again, this case demonstrates that efficiency-focused district judges hold significant power even in the face of a comity-concerned circuit court. In order to improve a defendant’s chances of getting Hague discovery, district court judges seemingly must be convinced that A) Chinese defendants act in good faith when requesting reprieve on grounds of international comity and B) that discovery sufficient

¹³¹ *Id.* at 25–26 (“Although BOC asks the Court to consider the fact that granting Gucci’s motion would force BOC to violate Chinese law . . . , BOC cites to no other courts that have considered such arguments in the context of assessing the reasonableness of an exercise of personal jurisdiction, as opposed to a separate and subsequent comity analysis, and the Court declines to be the first With respect to the forum’s interest in adjudicating the dispute, courts do not ‘compare the interests of the sovereigns’ but rather ‘determine whether the forum state *has* an interest.’”)

¹³² *Id.* at 34 (“Hague Convention requests . . . are not an available alternative method of securing the information [the plaintiff] requests.”).

¹³³ *Gucci Am., Inc. v. Weixing Li*, No. 10-cv-4974 (RJS), 2015 U.S. Dist. LEXIS 160842 (S.D.N.Y. Nov. 30, 2015).

to permit the U.S. to operate under a regulation-after-the-fact model can be had in timely enough fashion to be effective through the Hague Evidence Convention. As aforementioned, rarely is that last standard met.

Some judges, however, are willing to take a chance in order to respect international comity. In *Tiffany v. Andrew*, Judge Pitman, magistrate judge of the S.D.N.Y. found that the PRC's interests in defending confidential bank records and defending state secrecy trumped the plaintiff's need for data on Chinese soil.¹³⁴ The Bank cited cases in which a commercial bank had been held liable in China under Chinese law after turning over similar information, although the circumstances were quite different. While copious evidence indicated that a request sent through the Hague Evidence Convention was likely to be futile, some evidence suggested that matters had changed, and the method was not deemed *certainly* futile.¹³⁵ This hope, plus the interest of the Chinese government, here outweighed plaintiffs' interests, and plaintiffs were told to go through the Hague Evidence Convention to get the desired discovery. However, if such attempt proved futile, they were welcome to return to the S.D.N.Y. to get discovery through the FRCP.

Decisions like *Tiffany v. Andrew* give comity a chance. If China then provided the necessary discovery through treaty-sanctioned methods, other judges would more willingly send plaintiffs through the Hague Evidence Convention in the future. If the Hague Evidence Convention worked as well as the FRCP, or even slightly worse, then the balancing test of *Aerospatiale* would always fall towards the side of international comity. However, if the Hague Evidence Convention continues to work as it always has (which is, not at all), the judges willing to take these chances will not take them again. The choice as to whether U.S. judges will respect Chinese judicial sovereignty and send plaintiffs through the Hague Convention in the future thus rests with Chinese judges. If Chinese judges responsible for implementing Hague Convention requests will not recognize and reciprocate such olive branches, little hope for a solution can be seen. If these Chinese judges alternatively send a strong signal to U.S. judges that reasonable Hague Evidence Convention requests will be honored by China in timely fashion, they strengthen that arm of the *Aerospatiale* balancing test, and

¹³⁴ *Tiffany (NJ) LLC v. Qi Andrew*, 276 F.R.D. 143 (S.D.N.Y. 2011).

¹³⁵ *Id.* at 156.

push U.S. judges to send U.S. plaintiffs through the Hague Convention to get their discovery.

V. MOVING FORWARD

At present, the need for discovery in U.S. based cases involving Chinese defendants creates a dilemma. Given the U.S. “after-the-fact” regulatory system, U.S. courts cannot yield on getting the discovery necessary to push litigation forward without yielding important elements of national sovereignty. The Chinese, who for various reasons have opted to restrict the disclosure of information held internally by businesses, have their own reasons for asserting their system and their sovereignty.

The first step forward is to recognize the costs of the dilemma. The relationship between China and the U.S. matters, in no small part because they represent the two largest economies on the planet and two of the most deadly military forces. Ongoing situations that erode good will might in the best of cases impede economic cooperation, and in the worse of cases erode relationships past a tipping point.

On the U.S. side of the Pacific, resentment of China is growing, some with some foundation, but much more with no basis in fact. Political candidates build followings by promising to “get tough with China.”¹³⁶ In this environment, settings like the Taishan Drywall case—which is by no means unique—only fan the flames by giving critics of China something specific to point to. In the Taishan case the Chinese wall of privacy looked likely to help tortfeasors who had profited while bankrupting American homeowners. In cases such as Gucci and other IP cases, repeat intellectual property violators are shielded by vigorous refusals to provide financial information, driven—so claim those opposing cooperation—by the requirements of the Chinese government.

On the U.S. side, a basic question arises for U.S. judges—when is this a fight worth having? Put differently, judges, before provoking conflict with orders that conflict with Chinese law, should at least ask themselves whether the ultimate justification for asserting U.S. sovereignty exists in the case. In the case at bar, do

¹³⁶ *E.g.*, *Trump: We need to get tough with China*, MORNING JOE, May 20, 2016, available at <http://www.msnbc.com/morning-joe/watch/trump-we-need-to-get-tough-with-china-689521219810>.

important issues of after-the-fact regulation arise? That was clearly the case in Taishan drywall, a large multidistrict case involving a significant event and plaintiffs who could not feasibly bring suit in China. It might not be so in other matters, and if not, judges should avoid orders that burden Chinese and U.S. relations. U.S. judges are taking some steps in this direction. As aforementioned, today, the only way a Chinese defendant ends up in litigation in the U.S. is if they previously purposely availed themselves of the U.S. market in connection with the matter at issue.

On the same terms, legislators—who undoubtedly could create responses beyond the scope of what can be ordered by an individual judge—should carefully weigh the costs of such solutions on the relationship.¹³⁷ Subject to compliance with international treaties, the U.S. could, for example, potentially subject manufacturers not subject to the U.S. system of after-the-fact regulation to a different system of regulation,¹³⁸ requiring goods to pass inspection and approval before being imported to the U.S., or perhaps require foreign manufacturers to consent to U.S. jurisdiction and processes for actions related to the imported goods. Even under free trade agreements, the U.S. seems likely to have a right to some system of regulation that effectively protects its citizens. Either expanded ex ante or ex post systems would burden the economies affected, and U.S. lawmakers should not take such a step without

¹³⁷ Legislative responses were proposed in light of the drywall situation. *See, e.g.*, the Foreign Manufacturers Accountability Act of 2010. This statute would have required foreign manufacturers exporting product into the U.S. to register a U.S. agent to accept service of process for all civil and regulatory actions, and to accept personal jurisdiction where the agent is located. While this statute was widely expected to pass into law—despite concerns that it might conflict with GATT—in the end Congress instead passed a more limited law setting forth requirements on drywall manufacture and labelling, and directing the executive branch to seek the cooperation of the Chinese government in getting cooperation from the drywall defendants. *See* the Drywall Safety Act of 2012, Pub. L. No. 112–266, 15 U.S.C. 2051. The possibility very much remains for legislation similar to the Foreign Manufacturer’s Accountability Act to be resurrected in future Congresses.

¹³⁸ One could argue that seemingly stricter CFIUS requirements for Chinese businesses are already a soft manifestation of this option. *See* Minxin Pei, *Washington is Giving the Cold Shoulder to Chinese Investment*, FORTUNE, Feb. 23, 2016, available at <http://fortune.com/2016/02/23/chinese-company-acquisitions-us-companies/> (“Of all the countries in the world, the U.S. is undoubtedly among the most friendly to foreign investors. But a series of recent events suggest that Uncle Sam is becoming less tolerant of Chinese companies. . . .”).

reflecting on the importance of the relationships involved.

On the Chinese side, similar issues arise. Only China can decide which assertions of national sovereignty are in its long term best interest.

In the long run, a new negotiated solution that works better than the Hague Convention would be desirable. In considering the value and terms of a new agreement, both sides should recognize that the other side operates within a system, and that features that appear comparable may in fact serve quite different functions.

While treaties exist for reciprocal recognition of judgments, neither the U.S. nor China are signatories.¹³⁹ There is little hope for mutual recognition of substantive judgments between China and the United States in the immediate future.¹⁴⁰

In this context, the problem will not be easily solved. The U.S. cannot afford to walk away from its system of after-the-fact regulation. Yet China will not lightly allow U.S. lawyers to engage in intrusive discovery on Chinese soil. Neither U.S. nor Chinese judges have the time or resources to take on direct management of a U.S. style discovery program in China.

Reaching a solution requires a deep and nuanced understanding of the interests at stake on both sides. As this article suggests, when parties come from vastly different cultures with vastly different systems, such understanding is hard to come by. What people think they know about the other system can often stand in the way of actual understanding.

One approach might be for the two governments to recognize this as a problem worth solving, but one that will require more study and more cross-system understanding. In this regard, one small first step might be to create a transnational study group or

¹³⁹ See, e.g., Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters (Feb. 1, 1971), online at <https://www.hcch.net/en/instruments/conventions/full-text/?cid=78>.

¹⁴⁰ With rare exceptions (e.g. *Sanlian v. Robinson*), U.S. courts do not enforce Chinese judgments. With no exceptions, Chinese courts do not enforce U.S. judgments. Under Article 265 of the PRC Law of Civil Procedure, foreign court/parties to a judgment may apply for recognition/enforcement of that judgment. However, this will only be granted if there is reciprocity or a treaty. In spite of great strides being made by the Chinese court system to modernize, U.S. courts are unlikely to grant full reciprocity to Chinese courts in the near future.

commission, involving lawyers, judges and scholars from both systems, to dig into the problem. Each side can educate the other about what is stake for their system, look into how the issues have been resolved in other transnational settings, and explore whether there is a way to address the issue that respects the sovereign interests of both China and the U.S. One way such a group could help would be in identifying true conflicts of law between the U.S. and China, so U.S. judges would have more information on whether a comity claim was valid in deciding whether or not to impose sanctions for noncompliance with FRCP discovery. The mere existence of such a body would highlight both the importance of the issue and the sincere desire of each side to find a resolution, and would reduce the perceptions that either side is arrogant and unconcerned. It would also provide a vehicle for developing and testing complete or partial solutions that meet the needs of both countries.

VI. CONCLUSION

The current impasse involving U.S. discovery from Chinese defendants carries higher costs than perhaps either side recognizes. The failure of Chinese defendants to participate in litigation plays into negative perceptions of China and frustrates the way the U.S. regulates its markets. Intrusive requests for information from the U.S. play into correlative negative narratives and impose burdens on Chinese officials. For the good of an important relationship each side should work to understand the problem in light of the other side's systems of litigation and governance, and work toward a constructive solution.

DRAFTING AN OPTIMAL DISPUTE RESOLUTION CLAUSE IN INVESTMENT TREATIES

*Jayoung Jeon**

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I. INTRODUCTION

Dispute resolution provisions in investment treaties play an important role in the broader framework of investment protection as they provide mechanisms to resolve disputes between foreign investors and host states.¹ Evidencing their importance, more than 3,000 bilateral investment treaties (BITs) and free trade agreements (FTAs),² which account for 93% of the existing investment treaties, contain some form of investor-state dispute settlement (ISDS).³ However, despite the significance of dispute resolution mechanisms, they have been provided differently by different investment treaties,⁴ often without any policy explanation.⁵

The current landscape of dispute resolution provisions renders it crucial to provide a mechanism that prescribes an appropriate role to the domestic courts of host states in resolving investment disputes and that serves the virtues of dispute resolution. Surprisingly, the existing literature fails to address this important issue,⁶ with a few exceptions. Even these exceptions address only part of the issue, rather than engaging in an extensive analysis. I

¹ *TTIP: What Exactly Is the ISDS Mechanism for Resolving Investor Disputes?*, EUR. PARLIAMENT NEWS (Sept. 6, 2015, 6:24 PM), <http://www.euro.parl.europa.eu/news/en/news-room/20150605STO63242/TTIP-what-exactly-is-the-ISDS-mechanism-for-resolving-investor-disputes> [hereinafter *TTIP: What Exactly?*].

² *Investor-to-State Dispute Settlement (ISDS): Some Facts and Figures*, EUR. COMM'N 3, http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153046.pdf (last updated Mar. 12, 2015) [hereinafter *Some Facts and Figures*].

³ Joachim Pohl, Kekeletso Mashigo & Alexis Nohen, *Dispute Settlement Provisions in International Investment Agreements: A Large Sample Survey 7* (OECD, Working Papers on International Investment, Paper No. 2012/02, 2012), available at http://www.oecd.org/investment/investment-policy/WP-2012_2.pdf.

⁴ *Id.* at 3 (“The study also found little evidence of general convergence of approaches towards regulating ISDS in BITs.”).

⁵ *Id.* (“The survey also highlights the diversity that characterizes the design of ISDS: over a thousand different combinations of rules regulating ISDS can be found in only 1,660 bilateral treaties, with variation found both at editorial and substantial level. Differences in policy approaches between countries are the source of some of this variance, but it appears that much of it may not reflect differences in policy.”)

⁶ Professor Guillermo Aguilar-Alvarez of Yale Law School was puzzled by the dearth of discussions on this issue in the scholarly circle. His inspirations, in large part, motivated this Paper.

discuss these exceptions below in the order of increasing relevance.

Interaction of International Tribunals and Domestic Courts in Investment Law by Schreuer, most notably, recognizes that domestic courts have a role to play in resolving investment disputes, even in the presence of an agreement to arbitrate.⁷ Then, it offers “a broad overview of the interplay between international tribunals and domestic courts,” but, as the article itself admits, does “no more.”⁸ Relevantly, though, it discusses competing jurisdiction between international arbitration and domestic courts, and, in particular, examines the fork-in-the-road provisions that “offer the investor a choice between the host state’s domestic courts and international arbitration.”⁹

Application of International Investment Agreements by Domestic Courts by Yimer et al. similarly provides an overview of the current role that local courts play in investment arbitration. It discusses different types of dispute resolutions clauses, including those providing for waiting periods, fork-in-the-road provisions, and those consisted of three options. However, this discussion remains descriptive at most. The article limits its analytical discussion to examining the pros and cons of domestic courts’ involvement in investment dispute settlement, and those of international arbitration.¹⁰

Dispute Settlement Provisions in International Investment Agreements by Pohl et al. surveys a sample of 1,660 BITs.¹¹ Based on the survey results, this paper highlights the diversity of the ISDS designs, categorizing them into seven options: domestic court only; investment arbitration only; choice between judicial review in the host state and international arbitration final and exclusive; choice not final or exclusive; chronological sequence;

⁷ Christoph Schreuer, *Interaction of International Tribunals and Domestic Courts in Investment Law*, in CONTEMPORARY ISSUES IN INTERNATIONAL ARBITRATION AND MEDIATION: THE FORDHAM PAPERS (2010) 71, 72 (Arthur W. Rovine ed., 2011).

⁸ *Id.*

⁹ *Id.* at 78.

¹⁰ Bahakal Yimer et al., *Application of International Investment Agreements by Domestic Courts*, GRADUATE INST. OF INT’L & DEV. STUDIES (June 10, 2011), http://graduateinstitute.ch/files/live/sites/iheid/files/sites/ctei/shared/CTEI/Law%20Clinic/Memoranda%202011/UNCTAD_Memo.pdf (last visited Oct. 7 2016).

¹¹ Mashigo & Nohen, *supra* note 3.

subject matter; and miscellaneous criteria. However, it fails to discuss the policy implications of each option.

Dispute Settlement: Investor-State produced by a team led by Sauvant and Roffe, as part of the United Nations Conference on Trade and Development Series on issues in international investment agreements,¹² seems to advance the literature the most. It recognizes that states have various options when drafting investment dispute settlement provisions and categorizes them into six options: exclusivity of national dispute-settlement methods in a host country; international dispute settlement is subject to a requirement of prior exhaustion of local remedies in a host country; non-binding preference for national dispute settlement; choice of national or international dispute settlement; compulsory international dispute settlement; and establishment of a specialized dispute settlement body under the investment agreement itself. Then, it considers the fairness implications of each option to the investor and to the host country. This discussion, although commendable, fails to present a complete picture because fairness to the parties is not the only virtue that an ISDS provision should serve, as will be discussed in Part II.

This Paper fills in the gap in the literature by making a two-fold contribution. Descriptively, this Paper categorizes different investment dispute settlement options by building on the existing literature and by considering their practical implications. Normatively, it identifies the primary virtues of investment dispute resolution provisions and the proper role of domestic courts in resolving investment disputes, and, based on these considerations, proposes the optimal way to draft dispute resolution clauses in investment treaties.

The remainder of the Paper proceeds as follows. Part I categorizes different dispute resolution clauses in investment treaties into five options. Part II identifies the four primary virtues of investment dispute resolution provisions. Part III prescribes a proper role to local courts in resolving investor-state disputes. Based on the discussions in Parts II and III, Part IV provides the optimal design of dispute resolution clauses. Then, this Paper concludes

¹² U.N. CONF. ON TRADE AND DEV., *DISPUTE SETTLEMENT: INVESTOR-STATE*, UNCTAD/ITE/IIT/30, U.N. Sales No. E.03.II.D.5 (2003), available at http://unctad.org/en/Docs/iteiit30_en.pdf [hereinafter *Dispute Settlement*].

by summarizing the discussions in previous Parts and suggesting areas of further research.

II. DIVERGENT ROLES OF DOMESTIC COURTS IN RESOLVING INVESTMENT DISPUTES AS PRESCRIBED BY BITs

BITs assign divergent roles to the domestic courts of host states in resolving investment disputes. This divergence is striking because it contrasts with remarkable convergence of substantive investment protection standards.¹³ BITs commonly guarantee fair and equitable treatment, full protection and security, national treatment, and most-favored-nation treatment, and protect investors against arbitrary and discriminatory treatment, expropriation, and war and civil unrest.¹⁴

This Part updates and refines the categorization of ISDS clauses previously conducted by scholars as follows: domestic court only; international arbitration only; choice between domestic court adjudication and international arbitration final and exclusive; choice not final or exclusive; and domestic court, waiting period, then international arbitration. In addition to advancing the descriptive literature, this categorization will prove useful when discussing the optimal ISDS design in Part IV, as I will refer back to these categories of ISDS clauses.

Note that this categorization leaves out ISDS clauses that restrict access to arbitration of “claims concerning alleged breaches of specific treaty provisions, such as the amount of compensation for expropriation, provisions on compensation for losses, or free transfers.”¹⁵ This Paper makes a conscious choice

¹³ Ignacio Suarez Anzorena & William K. Perry, *The Rise of Bilateral Treaties: Protecting Foreign Investments and Arbitration*, 58 IN-HOUSE DEF. Q. 59 (2010) (“The degree of protection provided to foreign investors varies among BITs and depends on the specific terms of each treaty. However, BITs generally provide the following standard protections.”).

¹⁴ Christoph Schreuer, *Investments, International Protection*, in MAX PLANCK ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW, para. 8, available at <http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e1533?rskey=LAQbeO&result=1&prd=EPIL> (last updated June 2013); Neil Sorensen, *Bilateral Investment Treaties and Disputes*, INST. FOR AGRIC. & TRADE POLICY (2001), http://www.bilaterals.org/IMG/pdf/Bilateral_Investment_Treaties_and_Disputes.pdf.

¹⁵ Mashigo & Nohen, *supra* note 3, at 14; see, e.g., Agreement between the Government of Australia and the Government of the People’s Republic of China

not to discuss this type of ISDS clauses because: first, they are very few in number;¹⁶ and, second, they have gradually been abandoned for use, with the last such provision appearing in 2003.¹⁷

A. Option 1: Domestic court only

Some ISDS clauses allow only domestic courts to hear the disputes. The Korea-Bangladesh BIT is an example. It provides in Article 5.1:

The national or company affected shall have a right, under the law of the Contracting Party making the expropriation, to prompt review, by a judicial or other independent authority of that Contracting Party, of his or its case and of the valuation of his or its investment in accordance with the principles set out in this paragraph.¹⁸

This Paper argues that there is a type of ISDS provisions that should belong to Option 1, although they had previously been classified as a separate category by scholars:¹⁹ provisions that allow recourse to international arbitration in case the decision rendered by domestic courts turns out to be “manifestly unjust” or to have violated the provisions of an international agreement.²⁰

on the Reciprocal Encouragement and Protection of Investments, Austl.-China, art. XII, July 11, 1988, 1514 U.N.T.S. 81.

¹⁶ Only forty-four out of a sample of 1,660 treaties contained ISDS provisions that limit access to arbitration based on subject matter. Mashigo & Nohen, *supra* note 3, at 14.

¹⁷ *Id.* at 15.

¹⁸ Agreement between the Government of the Republic of Korea and the Government of the People’s Republic of Bangladesh for the Promotion and Protection of Investments, S. Kor.-Bangl., art. 5.1, June 18, 1986, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/270> (last visited Oct. 7 2016).

¹⁹ *See, e.g.*, Mashigo & Nohen, *supra* note 3, at 14.

²⁰ Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Oriental Republic of Uruguay for the Promotion and Protection of Investments, U.K.-Uru., art. 8(2)(ii), Oct. 21, 1991, T.S. No.69; *see also* Agreement between the Government of the Italian Republic and the Government of the Oriental Republic of Uruguay for the Promotion and Protection of Investments, It.-Uru., art. 9(3), Feb. 21, 1990, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/1717> (providing that an investor may proceed to international arbitration if the court decision is “in contrast to norms of international law, with the contents of the

This argument is based on the practical implication of such provisions. In practice, these provisions are likely to function just like Option 1 because the modern interpretation of the “manifestly unjust” language sets a very high bar to allowing international arbitration. For example, in *Loewen v. USA*,²¹ the arbitral tribunal limited the application of the language to *procedural* denial of justice, excluding *substantive* denial of justice: although the tribunal found that the verdict in the previous domestic litigation was “clearly improper and discreditable,”²² it did not conclude that the minimum standards of international law and fair and equitable treatment have been violated because the claimant, Loewen, was granted all the *procedural* safeguards of a trial.²³ Thus, the *Loewen* precedent interprets the “manifestly unjust” language to be, by and large, powerless, rendering provisions with this language essentially equivalent to the domestic court-only provisions. The *Loewen* tribunal’s view has subsequently been supported by *Paulsson*²⁴ and *Montt*.²⁵

B. Option 2: International arbitration only

In contrast to Option 1 (domestic court-only), some international agreements provide that disputes be resolved only by international arbitration. Such agreements include: Egypt-Netherlands BIT; Austria-Bolivia BIT; Belgium/Luxembourg-Cyprus BIT; Belgium/Luxembourg-Estonia BIT; Belgium/Luxembourg-Georgia BIT; Belgium/Luxembourg-Mongolia BIT; Belgium/Luxembourg-Vietnam BIT; France-Haiti BIT; Hungary-Croatia BIT; and South Africa-Iran BIT. The Egypt-Netherlands BIT provides:

Each Contracting Party hereby consents to submit any legal dispute arising between that Con-

present agreement, or if it is manifestly unjust or constitutes a denial of justice.”).

²¹ *Loewen Group, Inc. and Raymond L. Loewen v. U.S.*, ICSID Case No. ARB(AF)/98/3, Award (June 26, 2003).

²² JAN PAULSSON, DENIAL OF JUSTICE IN INTERNATIONAL LAW 192 (2005).

²³ *Loewen*, ICSID Case No. ARB(AF)/98/3 at paras. 142–157, 165–171, 207–217.

²⁴ PAULSSON, *supra* note 22, at 192.

²⁵ SANTIAGO MONTT, STATE LIABILITY IN INVESTMENT TREATY ARBITRATION: GLOBAL CONSTITUTIONAL AND ADMINISTRATIVE LAW IN THE BIT GENERATION 334 (2009) (“‘Manifestly unjust’ is an extremely deferential standard used in reviewing judicial decisions.”).

tracting Party and a national of the other Contracting Party concerning an investment of that national in the territory of the former Contracting Party, at the choice of the national concerned, to

–the International Centre for Settlement of Investment Disputes for settlement by conciliation or arbitration under the Convention on the Settlement of Investment Disputes between States and Nationals of other States opened for signature at Washington on 18 March 1965

–a sole arbitrator or *ad hoc* arbitration tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law,

–the Regional Centre for International Commercial Arbitration in Cairo,

–the Court of Arbitration of the Paris International Chamber of Commerce²⁶

This Paper points out, however, that Option 2 is unlikely to achieve its literal purpose: to limit the mechanism of investment dispute resolution to international arbitration. Investors will probably have recourse to domestic courts, even when bound by an agreement with an international arbitration-only provision, for the following reasons.

First, from a textualist perspective, an investment treaty that does not explicitly exclude domestic remedies would not necessarily deny access to domestic courts. Analogize Option 2 to investment treaties that do not contain any reference to ISDS. There are more than a handful of such treaties.²⁷ However, scholars and practitioners have not necessarily interpreted the absence of an ISDS provision in BITs as denying the contracting parties access to justice, whether it be in front of domestic courts or arbitral tribunals.²⁸

²⁶ Agreement on Encouragement and Reciprocal Protection of Investments between the Arab Republic of Egypt and the Kingdom of the Netherlands, Egypt-Neth., art. 9.1, Jan. 17, 1996, T.S. No. 66.

²⁷ Mashigo & Nohen, *supra* note 3, at 10 n.2 (finding that 4% of the 1,660 bilateral treaties in the sample do not mention any ISDS mechanism).

²⁸ *See id.* at 10.

Second, even if the international agreement does exclude the option of domestic remedies, investors can bring claims to domestic courts based on domestic law for the same measure being complained of.²⁹ Investors may even bring a lawsuit complaining a breach of an investment treaty if the host state is a monist country that treats “international law, including treaties, as domestic law.”³⁰ In other words, at least in monist states, a treaty violation that gives rise to arbitral jurisdiction automatically grants domestic courts the jurisdiction to rule on the treaty violation.

C. Option 3: Choice between domestic court adjudication and international arbitration final and exclusive (fork-in-the-road)

Rather than providing one option of either domestic courts or international arbitration to the exclusion of the other, international agreements can provide for a choice between the two, making the choice final and exclusive. Such provisions are commonly known as the “fork-in-the-road.”³¹ The South Africa-Zimbabwe BIT, for example, provides:

If the dispute has not been settled within six (6) months from the date at which it was raised in writing, the dispute may at the choice of the investor, after notifying the party concerned of its intention to do so in writing, be submitted—(a) to the competent courts of the Party in whose territory the investment is made; (b) to arbitration by the International Centre for the Settlement of Investment Disputes (ICSID) established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, opened for signature at Washington DC on 18 March 1965; or (c) an *ad hoc* arbitration tribunal, which unless otherwise agreed upon by the parties to the dispute, is to be established under the Arbi-

²⁹ U.N. CONF. ON TRADE AND DEV., *INVESTOR-STATE DISPUTE SETTLEMENT: UNCTAD SERIES ON ISSUES IN INTERNATIONAL INVESTMENT AGREEMENTS II*, at 81, UNCTAD/DIAE/IA/2013/2 (2014), available at http://unctad.org/en/PublicationsLibrary/diaeia2013d2_en.pdf (“[A] right to claim a violation of the host State’s domestic law is self-evident.”) [hereinafter *UNCTAD Series*].

³⁰ *Id.*

³¹ Mashigo & Nohen, *supra* note 3, at 12.

tration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

If the investor submits the dispute to the competent court of the host Party or to international arbitration mentioned in sub-Article (2), the choice shall be final.³²

D. Option 4: Choice between domestic court and international arbitration not final or exclusive

International agreements, such as the China-Netherlands BIT and Austria-Mexico BIT, provide for a choice between domestic court and international arbitration, making the choice neither final nor exclusive. The China-Netherlands BIT, for example, provides:

An investor may decide to submit a dispute to a competent domestic court. In case a legal dispute concerning an investment in the territory of the People's Republic of China has been submitted to a competent domestic court, this dispute may be submitted to international dispute settlement, on the condition that the investor concerned has withdrawn its case from the domestic court. If a dispute concerns an investment in the territory of the Kingdom of the Netherlands an investor may choose to submit a dispute to international dispute settlement at any time.³³

A few treaties that fall under Option 4 explicitly allow investors to simultaneously pursue a claim in both arbitration and

³² Agreement between the Government of the Republic of South Africa and the Government of the Republic of Zimbabwe for the Promotion and Reciprocal Protection of Investments, S. Afr.-Zim., arts. 7(2), 7(3), Nov. 27, 2009, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/2281> (last visited Oct. 7 2016); *see also* Agreement between the Government of the French Republic and the Government of the Argentine Republic on the Reciprocal Promotion and Protection of Investments, July 3, 1991, 1728 U.N.T.S. 297; Agreement between the Government of the Republic of Chile the Government of the Republic of Indonesia on the Reciprocal Promotion and Promotion of Investments, Chile-Indon., art. XIII.3, July 4, 1999, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/686> (last visited Oct. 7 2016).

³³ Agreement on Encouragement and Reciprocal Protection of Investments between the Government of the People's Republic of China and the Government of the Kingdom of the Netherlands, China-Neth., art. 10(2), Nov. 26, 2001, T.S. No. 24.

domestic court.³⁴ However, more often, international agreements within the scope of Option 4 have a waiver requirement, according to which investors are obliged to waive their right to other proceedings before they can refer the matter to international arbitration.³⁵

The waiver requirement is intended to bring the following benefits: it prevents the risk of double jeopardy and recovery; it eliminates the possibility of inconsistent decisions by arbitral tribunals and domestic courts; and it reduces the burden on states by forbidding parallel proceedings.³⁶

E. Option 5: Domestic court, waiting period, then international arbitration

Some dispute resolution provisions require that investors first present their dispute to domestic courts, then, after a certain period of time, give the option to arbitrate. The Argentina-Netherlands BIT is an example, which states:

If within a period of eighteen months from submissions of the dispute to the competent organs mentioned in paragraph (2) above, these organs have not given a final decision or if the decision of the aforementioned organs has been given but the parties are still in dispute, then the investor concerned may resort to international arbitration or conciliation.³⁷

³⁴ *E.g.*, Agreement between the Federal Republic of Germany and the Republic of Madagascar on the Encouragement of Investment, Ger.-Madag., art. 10, Sept. 21, 1962, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/2980> (last visited Oct. 7, 2016).

³⁵ *E.g.*, North American Free Trade Agreement art. 1121, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289; Central America Free Trade Agreement art. 10.18, Aug. 5, 2004, 43 I.L.M. 514.

³⁶ Wolfgang Alschner, *Regionalism and Overlap in Investment Treaty Law: Towards Consolidation or Contradiction?*, 17 J. INT'L ECON. L. 271, 290-91 (2014).

³⁷ Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Argentine Republic, Neth.-Arg., art. 10(3), Oct. 20, 1992, T.S. No. 192.

III. PRIMARY VIRTUES OF INVESTMENT DISPUTE RESOLUTION PROVISIONS

This Part identifies four primary virtues that should be served by ISDS provisions: fairness to the parties; decisional accuracy; efficient resolution of disputes; and procedural integrity.

A. Fairness to the parties

ISDS provisions should be fair to all contracting parties. Dispute resolution provisions that are fair will generally have the following characteristics: they prevent forum shopping by claimants, eliminate excessive cost burden on one party, disallow double recovery, etc. However, there are some considerations more specific to “investment” dispute resolution. First, a fair ISDS provision would be sensitive to both the investors’ commercial interests and the host states’ public interests, including the right to regulate.³⁸

An investor-state disputes arises between a private commercial party and a state administration or agency and as such includes a public interest and policy element. This cannot be wholly disregarded against the commercial interests of the private party, nor, indeed, can the legitimate interests and expectations of the commercial party always take second place to the public interest.³⁹

Second, an ISDS provision should also take into account the parties’ preferred forum. Host states would like to be given the opportunity to correct the alleged violations themselves through their domestic court system.⁴⁰ On the other hand, investors would prefer to bring the claims in their home countries. However, the courts of the investors’ home countries are not a viable option because

[I]n most cases they lack territorial jurisdiction over investments taking place in another State. An addi-

³⁸ Markus Krajewski, *Investment Law and Public Services: Clashes of Interests or Peaceful Coexistence?*, INVESTMENT TREATY NEWS (July 19, 2012), <https://www.iisd.org/itn/2012/07/19/investment-law-and-public-services-clashes-of-interests-or-peaceful-coexistence/> (last visited Oct. 23, 2016).

³⁹ *Dispute Settlement*, *supra* note 12, at 80.

⁴⁰ See STEPHAN W. SCHILL ET AL., INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP 163 (2015).

tional obstacle to using domestic courts outside the host State would be State immunity. Host States dealing with foreign investors will frequently act in the exercise of sovereign powers (*jure imperii*) rather than in a commercial capacity (*jure gestionis*).⁴¹

The investors' second choice would, then, be international arbitration, which they consider to be "independent and neutral," at least more so than local courts in host states, and where they can bring their claims under treaty standards.⁴²

Note the significance of fairness in drafting ISDS provisions. An unfair provision would fail to preserve the relationship and good will of the parties and "make it more difficult to resolve the dispute without litigation."⁴³ More fundamentally, an unfair provision may cause one or more parties to the investment treaty to withdraw from it. For example, South Africa⁴⁴ and Indonesia⁴⁵ have recently begun to withdraw from BITs, which they viewed as unfairly focused on the investors' interests, ignoring the concerns for developing countries. Thus, the repercussions of unfair provisions are not limited to specific disputes but may pose a threat to the workings of the overall system.

B. Decisional Accuracy

An ISDS provision should enable the decision-makers to resolve the disputes fairly. Many disputants highly value decisional accuracy, even when compared to other virtues of dispute

⁴¹ Schreuer, *supra* note 7, at 72.

⁴² *Some Facts and Figures*, *supra* note 2, at 3; see also *TTIP: What Exactly*, *supra* note 1, at 1 ("[I]nternational obligations may not automatically be applied in domestic courts.").

⁴³ Anne Bihancov, *What Is an Example of a Good Dispute Resolution Clause and Why?*, CIVIL JUSTICE RESEARCH ONLINE 9 (2014), <http://www.civiljustice.info/cgi/viewcontent.cgi?article=1002&context=adreal> (last visited Oct. 7, 2016).

⁴⁴ *South Africa Begins Withdrawing from EU-Member BITs*, INVESTMENT TREATY NEWS (Oct. 30, 2012), <https://www.iisd.org/itn/2012/10/30/news-in-brief-9/> (last visited Oct. 7, 2016).

⁴⁵ Ben Bland & Shawn Donnan, *Indonesia to Terminate more than 60 Bilateral Investment Treaties*, FINANCIAL TIMES (Mar. 26, 2014), <http://www.ft.com/intl/cms/s/0/3755c1b2-b4e2-11e3-af92-00144feabdco.html#axzz449fKWqzT> (last visited Oct. 7, 2016).

resolution processes.⁴⁶ One can enhance decisional accuracy by ensuring that the legal system hearing the disputes has the requisite expertise and experience.⁴⁷ Alternatively, one can institute redundancy in the resolution mechanism—by allowing appeals or multiple proceedings—and correct any errors and inconsistencies in decisions.

C. *Efficient resolution of disputes in terms of time and cost*

A good ISDS provision should encourage early and effective resolution, and lower the costs of managing disputes.⁴⁸ However, “speed is not an unqualified virtue,”⁴⁹ as no one would think that flipping a coin is more than a capricious decisional method. Accordingly, although a speedy resolution has benefits, it should not compromise fairness to the parties and decisional accuracy.

D. *Procedural integrity*

A good ISDS clause should promote procedural integrity. This means several things in practice. First, it should be written in a way that clearly directs the procedures to be followed. In the same vein, the U.S. National Alternative Dispute Resolution Advisory Council has noted that “[d]isputes relating to the interpretation of . . . [dispute resolution] clauses [that lack clarity] may result in litigation, and such clauses may be found to be void for uncertainty.”⁵⁰ Second, it should promote transparency in proceedings by, for example, publishing arbitral awards, holding public hearings, etc. Third, it should provide a resolution mecha-

⁴⁶ John Lande, *Judging Judges and Dispute Resolution Processes*, 7 NEV. L.J. 457, 466 (2007).

⁴⁷ See *International Dispute Resolution, LL.M.*, DONAU-UNIVERSITÄT KREMS, http://www.donau-uni.ac.at/en/studium/international_dispute_resolution/20424/index.php (last visited Mar. 22, 2016) (“[T]he quality of the tribunal has a significant impact on maintaining the confidence of the parties involved in arbitration as a system that works.”).

⁴⁸ *What Makes a Good Dispute Resolution Clause?*, KHENG HOE ADVOCATES (2015), available at <http://www.slideshare.net/ChanHoe/what-makes-a-good-dispute-resolution-clause> (last visited Mar. 22, 2016).

⁴⁹ John Fellas, *A Fair and Efficient International Arbitration Process*, 59 DISP. RES. J. 2, 2 (2004), available at http://www.hugheshubbard.com/Article Documents/a_fair_efficient_dispute_resolution_fellas.pdf.

⁵⁰ Bihancov, *supra* note 43, at 5 (quoting NADRAC, *ADR in the Civil Justice System—Issues Paper* (Mar. 2009, Commonwealth of Australia)).

nism that leads to enforceable results.⁵¹ Lack of clear enforcement mechanisms would render the resolution process less certain for investors. Fourth, it should lead to results that are reasonably predictable and consistent. Predictable results are of significant importance to investors because “[o]nce the investor has sunk in its resources, it becomes vulnerable to changes in the position of the host [s]tate.”⁵² In order to counter these uncertainties, investors would want to examine, prior to their investment, how investment disputes are settled, and predict the associated risks. Perhaps not to the same extent as foreign investors, but consistency is also appreciated by states. They surely would not want to be subject to the whims of some decision-maker.

As much as clarity is important, however, where possible and appropriate, “disputes should be resolved in a confidential context,”⁵³ even if such resolution comes at the expense of transparency.

IV. THE OPTIMAL ROLE OF DOMESTIC COURTS IN INVESTMENT DISPUTE RESOLUTION

This Part makes a normative argument for what the role of domestic courts should be in resolving investment disputes, after considering the pros and cons of their involvement against the four virtues identified in Part II.

A. Domestic Courts Should Play Some Role

First, where parties feel comfortable,⁵⁴ domestic courts should play at least some role in resolving investment disputes. This is not an unprecedented view. Scholars have recognized that “[n]ational courts are an important complement to the resolution of investment disputes.”⁵⁵ Susan D. Franck, for one, argued that,

⁵¹ Timothy Stostad, *Trappings of Legality: Judicialization of Dispute Settlement in the WTO, and Its Impact on Developing Countries*, 39 CORNELL INT’L L.J. 811, 812 (2006).

⁵² Schreuer, *supra* note 14, para. 1.

⁵³ *Effective Dispute Resolution*, FAIR WORK OMBUDSMAN, <https://www.fairwork.gov.au/how-we-will-help/templates-and-guides/best-practice-guides/effective-dispute-resolution> (last visited Dec. 21, 2016).

⁵⁴ Part IV explains the reason for inserting this qualifying phrase, by rejecting mandatory adjudication by domestic courts.

⁵⁵ Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 GLOBAL BUS. & DEV. L.J. 337, 368 (2007).

“as many BITs permit investors to bring their claims in national courts, under appropriate circumstances, investors may elect to litigate treaty violations,” and encouraged governments to move away from a model of mandatory arbitration.⁵⁶ Reviewing the domestic courts’ involvement under the primary virtues of dispute resolution gives additional reasons why domestic courts should play a role.

Fairness to the parties. It is fair to give local courts an opportunity to correct the alleged violations themselves. Denial of this opportunity would unsettle the balance between the rights of the investors and the right of the host country to regulate the investment that takes place within its territory.⁵⁷ The host country’s right to self-regulate becomes even more important when foreign investment intertwines with the important interests of the local population, which often is the case.⁵⁸

Decisional accuracy. Domestic courts can increase the chances of accurately resolving disputes by correcting errors through the appeal system.⁵⁹ This is so “because more people, judges and attorneys alike, will have had a chance to evaluate the issue, and make different and better arguments.”⁶⁰

Prospectively, by hearing more investment disputes, domestic courts can develop the rule of law and hone their decision-making in this area.⁶¹ Excluding local courts from investment dispute resolution would deny them such learning process and a chance to boost the accuracy of their decision-making.

Procedural integrity. Domestic courts make trials open to public except “in the most exceptional circumstances (e.g. Official Secrets),”⁶² and publish judgments.⁶³ This creates precedent

⁵⁶ *Id.*

⁵⁷ Prateek Mishra, *The Role of Domestic Courts in International Investment Arbitration: Have Local Remedies Reemerged?*, ACADEMIA.EDU, http://www.adeia.edu/5532695/The_Role_of_Domestic_Courts_in_International_Investment_Arbitration_Have_Local_Remedies_Re-emerged (last visited Mar. 22, 2016).

⁵⁸ Schreuer, *supra* note 14, para. 2.

⁵⁹ *Dispute Resolution Clauses: An Overview*, ASHURST LLP 2, https://www.ashurst.com/doc.aspx?id_Resource=4722 (last visited Mar. 22, 2016) [hereinafter *An Overview*].

⁶⁰ Mishra, *supra* note 57.

⁶¹ Franck, *supra* note 55, at 368.

⁶² *An Overview*, *supra* note 59, at 2.

⁶³ *Id.*

for later cases⁶⁴ and puts prospective or current investors on notice of the courts' treatment of investment disputes.⁶⁵ In contrast, arbitration hearings can be held in private, and the awards and other documents produced kept confidential.⁶⁶ Moreover, arbitral awards "do not give rise to any binding precedent or *res judicata* vis-a-vis other parties."⁶⁷ Admittedly, however, this comparative advantage of domestic court adjudication is minimal in the investor-state arbitration context because "virtually all ICSID, NAFTA, and Energy Charter awards are made public, as well as many . . . rendered under UNCITRAL and IAC rules."⁶⁸

B. Domestic Courts' Jurisdiction Should Not Be Exclusive

Second, although domestic courts could play some role, they should not be given the exclusive authority to resolve investment disputes. Investors should also have the option of international arbitration because of the limitations of domestic court adjudication and comparative advantages of arbitration discussed below.

Fairness to the parties. International agreements, including investment agreements, do not form a part of the domestic legal system, with the exception of a few monist countries.⁶⁹ Thus, domestic courts of most countries cannot apply domestic laws to the settlement of investment disputes, which unfairly denies investors the opportunity to bring their claims under treaty stand-

⁶⁴ *Id.*

⁶⁵ Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 Cornell L. Rev. 1, 34 (2008).

⁶⁶ *An Overview*, *supra* note 59.

⁶⁷ *Id.* at 3.

⁶⁸ ALEC STONE SWEET, *THE EVOLUTION OF INTERNATIONAL ARBITRATION* (forthcoming 2016); *see also* Marney Cheek & Catherine Gibson, *Maximising Investment Treaty Protection*, COVINGTON & BURLING LLP 75 (2015), https://www.cov.com/~media/files/corporate/publications/2015/10/maximising_investment_treaty_protection.pdf ("Decisions of investor-state arbitral tribunals have long been publicly available for free, and in recent years, there has been a significant trend towards promotion of transparency in investor-state arbitration."); Comm. On Int'l Com. Disp., *Publication of International Arbitration Awards and Decisions*, N.Y. CITY BAR ASS'N 1 (2014), <http://www2.nycbar.org/pdf/report/uploads/20072645-PublicationofInternationalArbitrationAwardsandDecisions.pdf> ("Publication of arbitral awards and other decisions (most importantly, challenges to arbitrators) has become more common . . .").

⁶⁹ *Some Facts and Figures*, *supra* note 2, at 3.

ards.⁷⁰ As the tribunal in *Maffezini v. Spain* recognized, “[t]raders and investors . . . have traditionally felt that their rights and interests are better protected by recourse to international arbitration than by submission of disputes to domestic courts.”⁷¹

In addition, many investors worry that domestic courts may be vulnerable to political influences and biases against them.⁷² This concern is aggravated when the counterparty is a state entity, as in investment disputes.⁷³ Further compounding the fairness concern are the “distance and the disadvantages . . . [that investors] face[] (foreign court system, language, and culture unfamiliar to them).”⁷⁴ Thus, fairness concerns counsel against providing domestic court adjudication as the exclusive dispute resolution option.

Moreover, such non-exclusivity not only benefits investors but also may promote foreign investment in host states. It signals to potential investors that the country harbors a safe environment to invest, and may attract foreign investment, by creating “the appearance and reality of fairness in the dispute-settlement process.”⁷⁵ Anecdotally, for example, American investors, such as Ronald Lauder, have testified that they based their investment decisions in the Czech Republic largely on the knowledge that the investment was protected under the standards of BITs.⁷⁶ Empirically, some scholars, called “treaty protagonists,” analyzed data on foreign investment and argued that investment treaties tend to attract foreign investment.⁷⁷ For example, in the context of U.S.

⁷⁰ Alschner, *supra* note 36, at 289.

⁷¹ Emilio Agustín Maffezini v. The Kingdom of Spain, ICSID Case No. ARB/97/7, Decision on objections to jurisdiction, para. 55 (Jan. 25, 2000).

⁷² Steffen Hindelang, *Study of Investor-State Dispute Settlement (ISDS) and Alternatives of Dispute Resolution in International Investment Law*, EUROPÄISCHER SALON, https://publixphere.net/i/salon/page/STUDY_ON_INVESTORSTATE_DISPUTE_SETTLEMENT_ISDS_AND_ALTERNATIVES_OF_DISPUTE_RESOLUTION_IN_INTERNATIONAL_INVESTMENT_LAW_BY_PROF_DR_STEFFEN_HINDELANG_LLM_1 (last visited Mar. 22, 2016).

⁷³ *An Overview*, *supra* note 59, at 3.

⁷⁴ Thomas H. Oehmke, *Arbitrating International Claims—At Home and Abroad*, 81 AM. JUR. TRIALS 1, § 6 (last updated Feb. 2016).

⁷⁵ *Dispute Settlement*, *supra* note 12, at 2.

⁷⁶ *Treatment of U.S. Business in Eastern and Central Europe: Hearing Before the Subcomm. on European Affairs of the Senate Comm. on Foreign Relations*, 106th Cong., 2nd. Sess., 18 (2000) (Testimony of Ronald Lauder, Chairman, Central European Media Enterprises).

⁷⁷ Franck, *supra* note 55, at 352.

BITs, Salacuse and Sullivan found strong evidence for BITs' positive impact on foreign direct investment.⁷⁸ Neumayer and Spess, Swensen, and Egger and Pfaffermayr⁷⁹ reached similar conclusions about other BITs.

Decisional accuracy. As mentioned above, domestic courts most often apply their own laws, rather than treaty standards, in resolving investment disputes.⁸⁰ Accordingly, they may fail to properly resolve the disputes that may be best described as treaty violations.

Moreover, domestic court judges are more likely to be general practitioners than arbitrators who are appointed to specific cases because of their "more focused skills, applicable knowledge, and expertise."⁸¹ Thus, where a dispute raises technical or scientific issues of fact, it would require substantial efforts and resources for domestic court judges to understand the issues and

⁷⁸ *Id.* at 352 n.80 (citing Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L.J. 67, 109, 111 (2005)) ("They conclude the following: (1) a 'U.S. BIT is more likely than not to exert a strong and positive role in promoting U.S. investment'; (2) a 'U.S. BIT is more likely than not to exert a strong and positive role in promoting overall investment'; and (3) a 'U.S. BIT is likely to exert more of an impact than other OECD BITs in promoting overall investment.'").

⁷⁹ *Id.* at 352 n.81 (citing Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment in Developing Countries?*, 3 WORLD DEV. 31 (2005)); *Id.* at 352 n.82 (citing Deborah L. Swenson, *Why Do Developing Countries Sign BITs?*, 12 U.C. DAVIS J. INT'L L. & POL'Y 131, 152–55 (2005)) (finding BITs, particularly those with the United States, were positively correlated with larger investment flows but acknowledging that these results may be influenced by other variables such as alternative investment promotion measures); Peter Egger & Michael Pfaffermayr, *The Impact of Bilateral Investment Treaties on Foreign Direct Investment*, 32 J. COMP. ECON. 788 (2004) (reviewing OECD data and finding investment treaties exert a significant positive effect on FDI, particularly if they are implemented and noting that simply signing a treaty has positive—although less significant—effects on FDI). However, note also the existence of contrary views. *See, e.g.*, Jennifer Tobin & Susan Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties*, Center for Law, Economics and Public Policy Research Paper No. 293 (May 2, 2015) ("We find a very weak relationship between BITs and FDI. Further, we find that rather than encouraging greater FDI in riskier environments, BITs only have a positive effect on FDI flows in countries with an already stable business environment. Overall, BITs seem to have little positive effect either on foreign investment or on outside investors' perception of the investment environment in low- and middle-income countries.").

⁸⁰ *See Some Facts and Figure*, *supra* note 2.

⁸¹ Oehmke, *supra* note 74, § 5.

render an informed decision. In the absence of such efforts, domestic court judges would be “ill prepared” to hear complex cases⁸² and may fail to resolve them fairly.

Efficient resolution. At least in theory, adjudication by domestic courts is not expected to be as efficient as its alternative, arbitration, for the following reasons. First, domestic courts may draw out proceedings by allowing appeals, whereas arbitration typically disallows appeals.⁸³ Second, parties can more easily “adapt procedures to the needs of a particular dispute in arbitration than in court,”⁸⁴ thereby saving time and money. Third, parties can avoid extensive document production in arbitration, whereas litigation in the United States, for example, may subject them to aggressive American style discovery—an idea foreign to those from the Continental legal system.⁸⁵

However, arbitration’s expected advantage in efficiency has been challenged by many international arbitration practitioners⁸⁶ and in-house counsels.⁸⁷ Along the same lines, arbitral tribunals have drawn attention to the fact that arbitration often incurs substantial costs.⁸⁸ Statistics support their view: arbitration costs in

⁸² STONE SWEET, *supra* note 68, at 3.

⁸³ Becky L. Jacobs, *A Perplexing Paradox: “De-Statification” of “Investor-State” Dispute Settlement?*, 30 EMORY INT’L L. REV. 17, 25 (2015) (“This is particularly poignant in this context given that ISDS arbitral awards have only limited review mechanisms, either statutorily or judicially, within the affected state or as provided by the relevant arbitral institution’s governing documents.”).

⁸⁴ *An Overview*, *supra* note 59, at 2.

⁸⁵ William W. Park, *Arbitrator Integrity*, in THE BACKLASH AGAINST INVESTMENT ARBITRATION: PERCEPTIONS AND REALITY 189, 203 (Michael Waibel et al. eds., 2010) (“For instance, a party hoping to avoid extensive document production may prefer a French professor over an American litigator, given that American style ‘discovery’ has traditionally been foreign to the Continental legal system.”).

⁸⁶ Christian Bühring-Uhle, *Advantages of Arbitration*, in TOWARDS A SCIENCE OF INTERNATIONAL ARBITRATION: COLLECTED EMPIRICAL RESEARCH 25, 38–41 (2005).

⁸⁷ Gaukrodger, D. & K. Gordon, *Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community* 19–22 (OECD, Working Papers on International Investment 2012/03, 2012), <http://dx.doi.org/10.1787/5k46b1r85j6f-en>.

⁸⁸ *Abaclat and Others v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (Aug. 4, 2011). The arbitral tribunal in *Abaclat and Others v. Argentine Republic* also drew attention to the fact that the parties to the dispute had incurred arbitration costs of at least \$39 million. David Gaukrodger, *Inter-Governmental Consideration of Investor-State Dis-*

recent cases have averaged over \$8 million, with costs exceeding \$30 million in some cases.⁸⁹

Moreover, domestic courts may be able to resolve investment disputes more quickly than arbitral tribunals. This possibility has already been realized in *GAMI investments, Inc. v. Mexico*,⁹⁰ where Mexican courts reversed the expropriation of the sugar mills before the arbitrators reached the adjudication of the NAFTA dispute. Admittedly, *Gami* may be an outlier. At the same time, however, it may not be, if we consider the fact that domestic court judges can impose sanctions on parties delaying matters and use their coercive powers to induce timely resolution of disputes, unlike arbitrators.⁹¹ Because of these arguments to the contrary, the efficiency argument does not present the best argument against the domestic courts' exclusive authority.

Procedural integrity. Unlike arbitral tribunals, domestic courts lack an international regime for enforcement of their judgments, and are subject to "local laws governing enforcement and execution."⁹² This exposes investors to the risk that their hard-earned judgments remain merely symbolic.⁹³ Although some countries have reciprocal arrangements for the recognition and enforcement of judgments, many do not.⁹⁴ In contrast, it is relatively clear that arbitral awards will be enforced. An extensive enforcement regime for arbitration awards exists under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention)⁹⁵ and the ICSID Convention.⁹⁶ These conventions also limit the grounds for re-

pute Settlement at the OECD-Hosted Freedom of Investment (FOI) Roundtable, in THE ROLE OF THE STATE IN INVESTOR-STATE ARBITRATION 220, 225 (2014).

⁸⁹ Cecilia Olivet & Pia Eberhardt, *Challenging the Investment Arbitration Industry*, TNI (Feb. 12, 2013), <https://www.tni.org/es/node/12278>.

⁹⁰ *GAMI Investments, Inc v. Mexico*, Final Award (NAFTA Ch. 11 Arb. Trib. Nov. 15, 2004), http://www.italaw.com/sites/default/files/case-documents/ita0353_0.pdf; see also SEAN D. MURPHY, UNITED STATES PRACTICE IN INTERNATIONAL LAW: 2002–2004 174 (2005).

⁹¹ *An Overview*, *supra* note 59, at 3.

⁹² Natalie Reid & David Rivkin, Lecture at Yale Law School (Mar. 28, 2016).

⁹³ Dammann & Hansmann, *supra* note 65, at 33 ("[T]he Hague Convention on Choice of Court Agreements, which would guarantee similar advantages with respect to foreign court decisions, has still not entered into force.")

⁹⁴ *An Overview*, *supra* note 59, at 2.

⁹⁵ *Id.* at 1.

⁹⁶ STONE SWEET, *supra* note 68, at 32 ("The ICSID Convention establishes its own autonomous enforcement regime: there is no 'seat,' and the courts of 'each

fusal to recognize and enforce the awards to limited exceptions. The New York Convention limits them to seven grounds: incapacity of a party; failure to give proper notice to a party, or the inability of a party to present his/her case; the award fell outside the scope of the arbitration agreement; the selection of the arbitrators violated the agreement; if the agreement did not address selection, the selection process violated the law; the law of the country in which enforcement is sought prohibits arbitration on the subject matter of the issue in dispute; or the recognition or enforcement of the award would be contrary to the public policy of that country.⁹⁷ Similarly, under the ICSID Convention, there are only five grounds for authorizing an *ad hoc* committee to annul an ICSID award: the tribunal was not properly constituted; the tribunal “manifestly exceeded its powers”; one of the arbitrators was corrupt; there was a serious departure from a fundamental rule of procedure; or the award has failed to state the reasons on which it is based.⁹⁸

To summarize, with consent of the parties, domestic courts should play a role in resolving investment disputes, but they should not be the exclusive option to investors. The option of investment arbitration should also be made available.

V. THE APPROPRIATE DESIGN OF INVESTOR-STATE DISPUTE SETTLEMENT PROVISIONS

Based on the primary virtues of investment dispute resolution provisions in Part II and the assessment of the optimal role of domestic courts in Part III, this Part proposes the appropriate design of ISDS clauses.

contracting state’ are to enforce the centre’s awards ‘as if [they] were a final judgment in that State.’ Thus, with respect to transnational coordination and enforcement, the ICSID Convention exhibits even stronger, quasi-constitutional features than does the New York Convention.”) (quoting Article 54(1), the ICSID Convention).

⁹⁷ New York Convention arts. V(1)(a)-(e), V(2)(a)-(b); see also Kathryn Helne Nickerson, *International Arbitration* (revised Mar. 2005), <http://www.osec.doc.gov/ogc/occic/arb-98.html>.

⁹⁸ ICSID Convention art. 52(1); see also Clement Erohubie Oseoamen, *Problems of Enforcement of Awards in International Investment* (Sept. 15 2014) (unpublished LLM thesis, University of Liverpool) (on file with author), available at http://www.academia.edu/8447303/Problems_of_enforcement_of_awards_in_International_Investment_law.

Before discussing the details, however, let us ensure that we have the discretion to modify ISDS provisions. Recent trends demonstrate that we can. In the last few years, contracting parties have become more creative in writing ISDS provisions by adapting forums to their needs and choosing more cost-effective ways of dealing with their disputes.⁹⁹ Some scholars have even encouraged creativity in writing ISDS provisions because they believe that it better serves the interests of contracting parties and avoids protracted proceedings in an unfavorable forum.¹⁰⁰

What form should an optimal ISDS provision take? First of all, consideration of the role of domestic courts rules out Option 1 and Option 2 because domestic courts should play at least some role in resolving disputes, with parties' consent, but not an exclusive role.¹⁰¹ Accordingly, an optimal ISDS design should allocate the role of domestic courts to somewhere on the continuum between Option 1 and Option 2.

If domestic courts should play some role, should we mandate domestic court adjudication? The answer is no, because the mandate undermines procedural integrity.

Procedural integrity. Such mandate translates to adopting the local remedies rule, which is “a standard of customary international law that requires parties who have been injured in a foreign nation to exhaust all other available remedies prior to seeking international redress.”¹⁰² In contrast, most BITs do not mention exhaustion of local remedies, except regarding the denial of justice claims, and many scholars have interpreted this silence as waiving the local remedies rule.¹⁰³ Some BITs even explicitly include an obligation not to apply the local remedies rule if claimants submit the dispute to investment arbitration.¹⁰⁴ For ex-

⁹⁹ *An Overview*, *supra* note 59, at 2.

¹⁰⁰ *Id.* at 5.

¹⁰¹ See discussions in Part III.

¹⁰² Bradford K. Gathright, Comment, *Step in the Wrong Direction: The Loewen Finality Requirement and the Local Remedies Rule in NAFTA Chapter Eleven*, 54 EMORY L.J. 1093, 1124 (2005) (“The local remedies rule is a standard of customary international law that requires parties who have been injured in a foreign nation to exhaust all other available remedies prior to seeking international redress.”).

¹⁰³ CHRISTOPHER F. DUGAN ET AL., INVESTOR-STATE ARBITRATION 347 (2008).

¹⁰⁴ UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD), BILATERAL INVESTMENT TREATIES 1995–2006: TRENDS IN INVESTMENT RULEMAKING,

ample, the Austria-United Arab Emirates BIT provides, “If the investor chooses to file for arbitration, the host Contracting Party agrees not to request the exhaustion of local settlement procedures”¹⁰⁵ Thus, mandating adjudication by domestic court would create inconsistencies within the BITs, causing confusions in the process.

How about slightly deviating from the local remedies rule and adopting Option 5 instead, which mandates domestic court adjudication but only for a certain period of time? Unfortunately, Option 5 also fails to provide an optimal design for the following reasons.

Fairness to the parties. By setting the waiting period too short, Option 5 denies states a *realistic* chance to resolve the disputes in their domestic courts. Let us consider, for example, the Belgium/Luxembourg-Botswana BIT, which sets a waiting period of only six months.¹⁰⁶ In most circumstances, six months would not be sufficient for domestic courts to fully deliberate on an investment dispute. It would merely “give an investor ‘a feel’ for whether the judges are independent and impartial, and whether it is worth continuing the domestic proceedings,” giving an unfair advantage to investors.¹⁰⁷ It is also hard to remedy this problem because a single waiting period is unlikely to account for the particularities of each dispute. For instance, the tribunal in *Abaclat v. Argentina* found that the eighteen-month waiting period in the Argentina-Italy BIT was not long enough to effectively resolve the claims brought by the claimants.¹⁰⁸ On the other hand, the same eighteen-month period was suggested to be sufficient by the tribunal in *BG Group v. Argentina* “under normal circum-

at 108 *et seq.*, U.N. Doc. UNCTAD/ITE/IIA/2006/5, U.N. Sales No. E.06.II.D.16 (2007).

¹⁰⁵ Agreement between the Republic of Austria and the United Arab Emirates for the Promotion and Protection of Investments, Austria-U.A.E., art. 10(5), June 18, 2001, <http://investmentpolicyhub.unctad.org/IIA/country/12/treaty/283>.

¹⁰⁶ Agreement Between the Belgium-Luxemburg Economic Union and the Republic of Botswana on the Reciprocal Promotion and Protection Of Investments, art. 12, June 7, 2006, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/331>.

¹⁰⁷ *UNCTAD Series*, *supra* note 29, at 83.

¹⁰⁸ *Abaclat and Others v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, paras. 585–590 (Aug. 4, 2011), <http://www.italaw.com/documents/AbaclatDecisiononJurisdiction.pdf>.

stances.”¹⁰⁹ Such conflicting views would invite further thorny issues, such as the normality versus abnormality of circumstances. Moreover, Option 5 is not budget neutral: by requiring investors to first seek recourse in domestic courts, Option 5 unfairly imposes additional costs on investors who eventually want to arbitrate the dispute.

Procedural integrity. The waiting period under Option 5 often raises interpretive questions, such as “whether the claimant must pursue local remedies diligently or can sit on its hands for the stipulated period.”¹¹⁰ Many arbitrators have also refused to give effect to waiting periods by allowing arbitration to proceed before the claimant had waited the required period on various grounds, including that the treaty was not sufficiently clear and precise, that the issue of the wait period was insignificant because the tribunal would have allowed the claim to be re-submitted in due course, that imposing the wait period would have little effect other than to increase any damages owed by the state, that the respondent state’s obligation to provide most-favored-nation treatment extended to dispute settlement processes such that wait periods were removed or shortened for all claimants, or that giving effect to a wait period would nullify the treaty’s role to provide access to international arbitration regardless of whether an investor resorted to other remedies.¹¹¹

Thus, fairness and clarity concerns advise against mandating domestic court adjudication. I argue, instead, that it should be offered as one of the resolution options to investors, along with international arbitration. I argue so because it better serves at least two of the virtues of dispute resolution: fairness to the parties and decisional accuracy.

¹⁰⁹ *BG Group Plc. v. The Republic of Argentina*, UNCITRAL Arbitration, Final Award, para. 155 (Dec. 24, 2007), <http://www.italaw.com/sites/default/files/case-documents/ita0081.pdf>; see also Daniel E. González et al., *U.S. Supreme Court Decides First Case Related to International Investment Treaty Arbitration*, HOGAN LOVELLS (Mar. 13, 2014), <http://www.lexology.com/library/detail.aspx?g=5bf8ae15-fead-4f53-a07f-16afe58119ef> (“Comparing the BIT’s 18-month waiting period to similar U.S. regimes mandated by Congress, the Chief Justice [Roberts] stated [in *BG Group PLC. v. The Republic of Argentina*] that the waiting period could have had an impact on the outcome of the arbitration.”).

¹¹⁰ GUS VAN HARTEN, *SOVEREIGN CHOICES AND SOVEREIGN CONSTRAINTS* 147–48 (2013).

¹¹¹ *Id.*

Fairness to the parties. Giving the option of domestic court adjudication avoids the unfairness associated with mandatory adjudication. At the same time, it leaves open the opportunity for domestic courts to resolve the disputes. Moreover, by allowing investors to freely choose between the two options—investment arbitration and domestic court adjudication—it respects party autonomy, which is the fundamental principle of international arbitration.¹¹²

Decisional accuracy. Redundancy in recourse, made possible by the options of arbitration and domestic court adjudication, is likely to lead to more accurate results. Analogously, in the domestic context, Robert Cover argued in favor of concurrent jurisdiction at both the state and federal levels because he believed: first, concurrent forum fights the corrupt interest of judges;¹¹³ second, to the extent that the jurisdictional alternatives differ with respect to the supposed salient social determinants of ideology, complex concurrency constitutes a strategy for coping with ideological impasse among different parties;¹¹⁴ and, third, multiplicity of forums “means an innovation is more likely to be tried,”¹¹⁵ which confirms the norm if several authorities articulate the same norm or reveals “different social conditions and/or ideologies” if different authorities articulate different norms.¹¹⁶ The third consideration seems most applicable to the context of investment disputes. Just as concurrent jurisdiction in state and federal courts would either confirm their decisions or reveal areas of inconsistencies, which, in turn, contributes to higher decisional accuracy through communication and experimentation by decision-

¹¹² Olena S. Perepelynska, *Party Autonomy v. Mandatory Rules in International Arbitration*, THE UKRAINE J. OF BUS. L., Jan.–Feb. 2012, at 38 (2012) (“This basic principle of arbitration is known as party autonomy. According to one of the classical books in international arbitration—‘Party autonomy’ is the guiding principle in determining the procedure to be followed in an international commercial arbitration. It is a principle that has been endorsed not only in national laws, but by international arbitration institutions and organizations. The legislative history of the Model Law shows that the principle was adopted without opposition”) (quoting A. REDFERN ET AL., LAW AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION 265 (2004)).

¹¹³ Robert Cover, *The Uses of Jurisdictional Redundancy: Interest, Ideology, & Innovation*, 22 WM. & MARY L. REV. 639, 658–62 (1981).

¹¹⁴ *Id.* at 665.

¹¹⁵ *Id.* at 674.

¹¹⁶ *Id.* at 674–75.

makers,¹¹⁷ concurrent jurisdiction in arbitral tribunals and local courts is likely to increase their decisional accuracy.

The idea of giving investors two options narrows down the best ISDS design to either Option 3 or Option 4. However, Option 3 fails to make the best design because it may be unfair to host states.

Fairness to the parties. As mentioned above, local courts do not apply treaty standards when deciding investment disputes; they apply their own laws. This poses a serious fairness problem for host states. Under Option 3, investors are forced to give up the right to bring their claims under the treaty standards, by litigating in local courts. Accordingly, investors would always elect to arbitrate the claims and never litigate in local courts. Thus, in practice, Option 3 is likely to deny local courts a real opportunity to hear investment disputes.

Neither is Option 4 perfect for the following reasons.

Fairness to the parties. Option 4 unfairly benefits investors by allowing them to forum shop between domestic courts and arbitration.¹¹⁸ Forum shopping becomes an even more serious problem if we consider the possibility of parallel *commercial* arbitration on contract claims, in addition to the *options* of investment arbitration and domestic court adjudication.¹¹⁹ Moreover, the possibility of parallel proceedings under Option 4 subjects host states to the risk of double jeopardy.¹²⁰

Efficient resolution. Final resolution of investment disputes, and thus *justice*, will be delayed under Option 4 if investors exhaust remedies at both local courts and arbitral tribunals. In addition, Option 4 makes parallel proceedings possible, forcing host states to respond to lawsuits in multiple forums and unfairly subjecting them to excessive legal costs.

¹¹⁷ *Id.* at 676–80.

¹¹⁸ Richard H. Kreindler, *Arbitral Forum Shopping*, in PARALLEL STATE AND ARBITRAL PROCEDURES IN INTERNATIONAL ARBITRATION 153, 158 (Lew & Cremades Román eds. 2005), available at <http://www.shearman.com/~media/Files/NewsInsights/Publications/2005/07/Arbitral-Forum-Shopping/Files/Publikation/FileAttachment/Arbitral-Forum-Shopping--263.pdf>.

¹¹⁹ Reid & Rivkin, *supra* note 92.

¹²⁰ *Id.* at 191.

Procedural integrity. There is much ambiguity surrounding the non-exclusivity of the investors' choice under Option 4. This ambiguity arises, in part, because the fork-in-the-road clauses often make only one of the two *choices*—domestic courts and arbitration—explicitly final. For example, the Peru-Singapore FTA makes only the choice of domestic courts, but not of international arbitration, final by providing: “unless . . . the investor concerned has already submitted the dispute for resolution before the courts or administrative tribunals of the disputing Party . . . , the investor concerned may submit the dispute for settlement to arbitration.”¹²¹ Complicating the issue, in some cases, tribunals have interpreted the investor's choice between domestic court and international arbitration to be final without any explicit language. For example, the tribunal in *Pantechniki v. Albania*¹²² interpreted the dispute resolution clause in the Greece-Albania BIT to make the investor's choice final and exclusive, although the treaty did not explicitly indicate so.¹²³ *Pantechniki* is not unprecedented; the tribunal in *Middle East Cement v. Egypt* has similarly read a forum-selection clause as a fork-in-the-road provision, despite the absence of language to that effect.

Fortunately, however, these problems with Option 4 can be remedied by obliging investors to waive their right to other proceedings before initiating arbitration. Indeed, as discussed in Part I, many investment agreements that can be classified as Option 4 include a waiver requirement. The waiver requirement can stop

¹²¹ Peru-Singapore Free Trade Agreement, Peru-Sing., art. 10.17, May 29, 2008, http://www.sice.oas.org/TPD/PER_SGP/Final_Texts_PER_SGP_e/10-%20investment.pdf; *see also*

Agreement Between Japan and Brunei Darussala for an Economic Partnership, Japan-Brunei, art. 67.4, June 15, 2007, *available at* <http://www.mofa.go.jp/region/asia-paci/brunei/epa0706/agreement.pdf> (“[I]f the disputing investor has not submitted the investment dispute for resolution under courts of justice or administrative tribunals or agencies, the disputing investor may submit the investment dispute to one of the following international conciliations or arbitrations.”).

¹²² *Pantechniki S.A. Contractors & Engineers v. Republic of Albania*, ICSID Case No. ARB/07/21, Award (July 30, 2009).

¹²³ The applicable clause states that “the investor or Contracting Party concerned may submit the dispute either to the competent court of the Contracting Party or to an international arbitration tribunal.” Fiona Marshall, *Commentary: Pantechniki v. Albania Decision Offers Pragmatic Approach to Interpreting Fork-in-the-Road Clauses*, INVESTMENT TREATY NEWS, Sept. 2, 2009, <https://www.iisd.org/itn/2009/09/02/commentary-pantechniki-v-albania-decision-of-fers-pragmatic-approach-to-interpreting-fork-in-the-road-clauses/>.

investors from forum shopping and eliminate the risk of double jeopardy. By disabling parallel proceedings,¹²⁴ it also prevents delays in the final resolution of disputes.

One may question how the waiver requirement is preferable to the exclusivity inherent in Option 3, given that both purport to prevent parallel proceedings once the investors have made a choice between international arbitration and domestic court adjudication. In addition to the fairness concern that Option 3 may deny states a realistic chance to hear the disputes, there are at least two other considerations that advise in favor of the waiver requirement and against Option 3.

Fairness to the parties. If one adopts *Loewen* as a true statement of international law (that claims of denial of justice require domestic remedies be exhausted first), a fork-in-the-road provision may render denial of justice claims impossible.¹²⁵ This is so because, once the investor brings a claim to domestic courts in order to satisfy the *Loewen* requirement, his choice will be made final, denying him the option to arbitrate later. No tribunal has squarely addressed this issue to this day, leaving this possibility a lurking concern.

Procedural integrity. It is well-established in principle and has been confirmed in a number of decisions¹²⁶ that a fork-in-the-road clause serves as a bar to international arbitration only if the same dispute, same parties, and the same cause of action had been brought before domestic courts.¹²⁷ Due to these cumulative requirements, arbitral tribunals rarely bar arbitral proceedings based on fork-in-the-road clauses.¹²⁸ In fact, according to Yimer et al., *Pantechniki v. Albania* is the only public case in which “the previous domestic court proceedings of the claimant barred it from having access to international arbitration.”¹²⁹ Thus, Option 3 is

¹²⁴ Alschner, *supra* note 36.

¹²⁵ JORGE E. VIÑUALES, FOREIGN INVESTMENT AND THE ENVIRONMENT IN INTERNATIONAL LAW 365 (2012).

¹²⁶ Schreuer, *supra* note 7, at 79 n.28.

¹²⁷ *Id.* at 79.

¹²⁸ Yimer et al., *supra* note 10, at 11.

¹²⁹ *Id.*; see also Marshall, *supra* note 123.

unlikely to achieve its purported goal as effectively as a waiver requirement.¹³⁰

The waiver requirement, however, can be inefficient at times: upon finding a waiver defective, the arbitral tribunal dismisses the case in its entirety, rather than allowing the party to amend the waiver and then bring it back to the same tribunal. Since a newly formed tribunal should examine the amended waiver, proceedings get delayed and protracted. This was the case in *Waste Management, Inc. v. Mexico*.¹³¹ When the claimant failed to submit a requisite waiver under the North American Free Trade Agreement (NAFTA) Article 1121, the *Waste Management* tribunal ruled that it lacked jurisdiction to hear the claims. Such waivers rejected as defective are re-evaluated by a different tribunal, which delays proceedings.

Parties to investment agreements can counter this problem by tweaking the language of investment treaties. Tweaks can take various forms. Parties can expressly stipulate that tribunals treat the waiver requirement as an admissibility issue. Alternatively, it can eliminate the ambiguity in the existing provisions. For illustration, let us take the example of Article 1121 of the NAFTA, which provides the waiver requirement as one of the “Conditions Precedent to Submission of a Claim to Arbitration.” On its face, the phrase “Submission of a Claim to Arbitration” could be interpreted to relate to either the admissibility or jurisdictional issue, leaving uncertain which way it should be interpreted. Thus, by clarifying that the phrase relates to the admissibility issue, parties can produce a more efficient waiver.

Such modifications have been proposed already. For example, Keith Highet, in his dissenting opinion in *Waste Management*, wrote that the majority “transformed what should . . . have been a

¹³⁰ See Doak Bishop, *A Practical Guide for Drafting International Arbitration Clauses*, KING & SPALDING 44, http://www.kslaw.com/library/pdf/bishop_9.pdf (last visited Mar. 22, 2016) (“[T]he U.S. position appears to be that the inclusion of ‘final and binding’ language and the adoption of arbitral rules deeming a waiver of the right to appeal are not sufficient to preclude court review of an award under the limited, but fundamental, defenses provided by the New York Convention. To waive the right to review under these defenses, the arbitral clause must clearly and expressly provide for such a waiver.”).

¹³¹ *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/98/2, Arbitral Award (June 2, 2000), <http://www.italaw.com/sites/default/files/case-documents/ita0892.pdf>.

question of admissibility into a question of jurisdiction” by treating the waiver requirement as a jurisdictional issue.¹³² Defining jurisdiction as “the power of the tribunal to hear the case” and admissibility as “whether the case itself is defective,”¹³³ Highet concluded that the waiver requirement is a matter of admissibility because he believed that insufficiency of the claimant’s waiver was “the only element that could legally affect jurisdiction under Article 1121” of the NAFTA.¹³⁴

Analogously, the tribunal in *Abaclat v. Argentina* interpreted an analogous phrase in Argentina-Italy BIT¹³⁵ as relating to the admissibility issue. Article 8 of the BIT provides for the “conditions for implementation of Argentina’s consent to ICSID jurisdiction and arbitration,” like Article 1121 of the NAFTA. Although the requirement at issue was not a waiver but the negotiation and eighteen-month litigation requirements, the *Abaclat* tribunal’s interpretation of the phrase as an admissibility issue despite the inclusion of the term “jurisdiction” shows that arguments can be made in favor of viewing waiver requirements as an admissibility issue.¹³⁶

Thus, consideration of the virtues of investment dispute resolution and the proper role of domestic courts in resolving disputes suggests that Option 4 with a waiver requirement and modifications to view it as an admissibility issue would provide the best model for ISDS clauses.

VI. CONCLUSION

This Paper categorizes different forms of ISDS clauses into five options: domestic court only; international arbitration only; choice between domestic court adjudication and international ar-

¹³² *Id.* at para. 56.

¹³³ *Id.* at para. 58.

¹³⁴ *Id.* at para. 59.

¹³⁵ Agreement between Italy and Argentine Republic for the Promotion and Protection of Investment, Arg.-It., art. 8.3, May 22, 1990, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/99>.

¹³⁶ *Abaclat and Others v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, para. 496 (Aug. 4, 2011) (“The Tribunal is of the opinion that the negotiation and 18 months’ litigation requirements relate to the conditions for implementation for Argentina’s consent to ICSID jurisdiction and arbitration, and not the fundamental question of whether Argentina consented to ICSID jurisdiction and arbitration.”).

bitration final and exclusive; choice not final or exclusive; and domestic court, waiting period, then international arbitration. It then identifies the four primary virtues of ISDS clauses: fairness to the parties; decisional accuracy; efficient resolution in terms of time and cost; and procedural integrity. Based on the consideration of these virtues, this Paper prescribes that, with consent of the parties, domestic courts should play a role in resolving investment disputes, but not to the exclusion of the option of international arbitration. It wraps up the discussion by proposing Option 4 (choice between domestic court adjudication and international arbitration not final or exclusive) with a waiver requirement and some modifications to render the requirement an admissibility issue to be the optimal design of ISDS clauses that takes into account the optimal role of domestic courts and the primary virtues of dispute resolution.

Future scholarship should critically evaluate and expand on this Paper. Specifically, it should identify any additional virtues of dispute resolution and analyze the proposed ISDS design against these virtues. If possible and appropriate, it should also introduce more creativity to designing ISDS provisions.

A Look into Protection of Preferred Stockholders' Rights Under the Context of State-owned Enterprise Reform

*Ling Tong**

ABSTRACT

In wake of severe financial distress and other troubles (such as the long-criticized monopoly dilemma) haunting many state-owned enterprises, Chinese government is now vigorously pushing forward the second round of state-owned enterprises reform, in which preferred stocks are encouraged to be used for achieving the "retreat" of state-owned capital.

Because of its hybrid features, preferred stocks are expected to play an active role in such so-called "hybrid-ownership" reform of state-owned enterprise. Under the first model where state-owned capital will retreat by gradually transferring controlling power to private capital, preferred stocks can be used to generate stable income for state-owned capital, achieving the objective of preserving and increasing the value of state-owned assets. Under the second model where state-owned capital retains absolute control, preferred stocks can be used to attract private capital to invest and thus maintain the hybrid-ownership of the enterprise.

However, under both models, horizontal conflicts of interest between common shareholders and preferred stockholders still exist or even intensify. How to protect the legitimate interests of preferred stockholders becomes a critical question relating to the success of the state-owned enterprise reform.

In the United States, under Delaware laws, the protection of preferred stockholders' rights comes from both contract law and corporate laws. Under contract laws, preference rights of the preferred stocks are contractual in nature and should be respected. However, remedies granted by contract laws are not sufficient because preferred stock transactions are inevitably incomplete transactions due to its additional equity-like features. Under corporate laws, Delaware courts recognized

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that the preferred shareholders can protect themselves against opportunism by the common shareholders through breach of fiduciary claims. Besides, as the last straw, preferred stockholders can seek appraisal right protection despite that Delaware courts are reluctant to second-guess the board's business judgment on determination of "fair value."

Under Chinese laws, although the spirit of freedom of contract is generally respected, too many mandatory regulatory requirements deter parties from taking advantage of the flexibility of preferred stocks through contractual arrangements. Besides, it is still controversial whether preferred stockholders are entitled to appraisal right. Arguably, protection of preferred stockholders' rights under Chinese laws can be strengthened through advancing ex post protection mechanism such as breach of fiduciary claims and appraisal right action.

Key words: State-Owned Enterprise Reform, Preferred Stock, Protection of Shareholder's Right

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I. INTRODUCTION

According to a series of regulations, rules and policies promulgated by the central government and all levels of local governments, preferred stocks are expected to play an active role in the second round of state-owned enterprises undergoing through China. However, because of the rooted horizontal conflict of interest between common shareholders and preferred stocks, protection of preferred stockholders' legitimate rights becomes critical to the success of using preferred stocks to achieving the "retreat" of state-owned capital.

This paper first tries to introduce various legal remedies preferred stockholders are entitled to under U.S. laws to protect themselves against opportunism by common shareholders. In the end, this paper also reviews legal remedies currently available under Chinese laws and tries to make some suggestions.

This paper contains six parts as below:

In Part I, this paper gives a brief introduction to basic concepts and features of preferred stocks, informing readers with basic know-how on this topic.

In Part II, a brief development history of preferred stocks in China will be introduced. For decades, *de facto* preferred stocks are used by venture capitals to mitigate risks associated with pre-IPO investments through complicated contract terms, enforceability of which are in doubt. The launch of preferred stocks pilot program in China represents the first steps towards a more pervasive concept of preferred rights similar to those in other jurisdictions.

Part III of this paper analyzes the expected role of preferred stocks under the context of Chinese state-owned enterprise reform. This paper argues that either under Model I where private capital takes control or under Model II where state-owned capital retains absolute control, horizontal conflicts between common shareholders and preferred stockholders remain or even intensify. The protection of preferred stockholders' legitimate rights became a critical question.

In Part IV, this paper introduces the ongoing dispute over the nature of preferred stocks and the protection of preferred stockholders' interest under overlapping regimes span over contract

laws and corporate laws in the United States. Arguably, several important legal mechanisms worked closely to protect the preferred stockholders' rights, contributing to the active preferred stocks market in the United States.

Part V of this paper analyzes legal remedies currently available for protection of preferred stockholders' right under Chinese laws. This paper argues that Chinese laws should refrain from imposing unnecessary *ex ante* restrictions on the issuance of preferred stocks. On the other hand, Chinese lawmakers should focus on strengthening *ex parte* protections such as breach of fiduciary claim and appraisal right claims.

Part VI gives a brief conclusion of this paper.

II. BASIC CONCEPTS AND FEATURES OF PREFERRED STOCKS

Preferred stocks are described as “hybrid between debt and equity,”¹ giving its holder constant payment stream similar to bonds promised as a contract right while simultaneously allowing issuer the flexibility to create a bundle of different rights concerning voting, periodic returns preference payment in event of liquidation.

A. Preferred Stocks Have Many Debt-Like Features

Preferred stocks have many debt-like features:

1. Both are the product of mutual bargaining. The dividend payments (either at a fixed rate or a floating rate) and other rights preferred stockholders are entitled to are determined through mutual bargaining between the issuer and the holders *ex ante* and are usually stipulated in an instrument called the certificate of designation.²

Consequently, both preferred stockholders and creditors have limited upside, meaning that their maximum return on investment is determined *ex ante*, normally as the interest or dividend to be paid.³ In contrast, common shareholders who are residual

¹ STEPHEN J. LUBBEN, *CORPORATE FINANCE* 161 (5th rev. ed. 2013) [hereinafter *Corporate Finance II*].

² *Id.*, at 162.

³ See Ben Walther, *Peril and Promise of Preferred Stock*, 39 *DEL. J. CORP. L.* 161, 168 (2014) [hereinafter *Walther Article*].

claimants on company assets have unlimited upside while have no guarantee of any constant payments.

2. Both are senior securities. Preferred stocks have seniority over common shareholders in a company's capital structure, meaning that preferred stockholders are paid before the common over the distribution of company earnings such as dividends or claims on liquidation proceeds in the event that the company is liquidated.

3. Both have no voting rights under normal circumstances. Similar to creditor, preferred stockholders usually do not bargain for voting rights except for extraordinary circumstances such as merger, or upon default of dividend payments by the issuer for a specific period of time as provided in the contract. This may be explained by the fact that as a fixed income earner like a bondholder, preferred stockholder's interest in management affairs of the company is not significant as a result of its limited claim on the earning of the going concern.⁴

4. Preferred stocks may be redeemed in some circumstances. Once preferred stocks are redeemed, payments similar to "principal" are paid by issuer to the holder, turning the preferred stocks investment into a fixed term with fixed yields resembling a debt investment.

B. Preferred Stocks Have Many Equity-Like Features

Preferred stockholders are considered as "owners" of "equity"⁵ because preferred stocks have many equity-like features:

1. Both preferred stockholders and common shareholders rank "next in line after creditors." In the event that the company is liquidated for bankruptcy, preferred stockholders may together with common shareholders participate in distribution of liquidation proceeds after and only after creditors are satisfied.

2. Both get no absolute promise on dividend payments. Unlike debt securities which have absolutely enforceable contract right to interest payments unless the company is in severe financial distress like bankruptcy, dividend payments to preferred stocks and common stocks are contingent and not a "fixed income security at

⁴ See WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 611 (7th ed. 2012) [hereinafter *Corporate Finance I*].

⁵ *Id.*

all.”⁶

3. Preferred stockholders may have voting right as common shareholders. Although modern preferred stockholders usually give up voting right in exchange for priority over constant dividend payments, in some extraordinary circumstances they are entitled to vote. For example, preferred stockholders as a class may regain voting rights when several consecutive or nonconsecutive dividend payments are in default,⁷ e.g. some corporations may provide preferred stockholders with a class vote for electing a certain number of directors in the event of default on paying three consecutive dividend payments.

4. Preferred stockholders enjoy favorable tax treatment similar to common shareholders with respect to dividend payments. In the United States, venture capitalists as preferred stockholders have historically enjoyed favorable tax treatment when they receive dividends from portfolio corporations.⁸ Normally, U.S. companies that are subject to corporate income tax are allowed to deduct certain percentage of their dividend income from taxable income.⁹

C. Different Categories of Preferred Stocks

By combining different rights and privileges characteristics together, a corporation may issue different preferred stocks which could be categorized mainly as following:

1. Cumulative vs. Noncumulative. The cumulative feature requires that if dividends have been skipped or omitted in the past, the skipped or omitted dividends will be accumulated and should be paid in priority before other subordinate preferred stockholders or common shareholders get paid any dividends. The cumulative feature of preferred stocks provides holders with additional protection because no dividends could be paid to common shareholders until all accumulative dividends not paid in the past have been paid

⁶ Corporate Finance I, *supra* note 4, at 607.

⁷ See Richard M. Buxbaum, *Preferred Stock: Law and Draftsmanship*, 42 CAL. L. REV. 243, 291 (1954).

⁸ See Piper Jaffray, *Preferred Stock: Stocks That Act Like Bonds* (2005), http://www.piperjaffray.com/pdf/preferred_stocks.pdf (last visited Dec. 29, 2016).

⁹ *Id.*

to the preferred.

2. Participating vs. Non-Participating. The participating feature entitles preferred stockholders to recoup their initial investment plus accrued dividends (if any) and proportionally the “common upside” value of the firm. However, holders of non-participating preferred stocks are only entitled to the greater of its initial investment amount plus accrued dividends (if any) OR proportionally the “common upside” value of the firm.¹⁰ In downside circumstances where the firm is liquidated with remaining assets amount less than the preferred stockholder’s initial investment value, the difference between participating and non-participating is not meaningful because both types could provide its holders with “downside protection,” meaning no liquidation proceeds are paid to common shareholders. In a normal or upside circumstance, the participating feature can have great impact on liquidation proceeds between preferred stockholders and common shareholders.

3. Convertible vs. Non-Convertible. The convertible feature entitles holder to convert preferred stock to a pre-determined number of common stock upon occurrence of a pre-determined event or after a pre-determined period of time. Normally, holders can decide whether to make the conversion upon satisfaction of pre-determined conditions. However, some convertible preferred stocks give the issuer the right to compel the conversion.¹¹ A substantial percentage of modern preferred stocks are convertible.

4. Redeemable v. Non-Redeemable. Redeemable preferred stock is also called callable preferred stock. The redeemable feature allows the issuer to call or redeem the preferred stocks at a pre-determined price which is normally higher than the market value and then retire it, meaning the issuer can cancel the securities if its costs become too high.¹² Issuers favor the redeemable feature because it allows the issuer to substitute preferred stocks with lower-cost ones if market interest rate becomes lower. However, the issuer is not obliged to redeem the preferred stocks if market

¹⁰ *The Different Types of Preferred Stock*, FINANCIALWEB, <http://www.finweb.com/investing/the-different-types-of-preferred-stock.html#axzz41HhjNpvG> (last visited Feb. 29, 2016).

¹¹ *Id.*

¹² See Accounting Dictionary, *Redeemable Preferred Stock*, <http://www.accountingtools.com/redeemable-preferred-stock> (last visited Feb. 29, 2016).

interest rates remain steady or become higher. Apparently, redeemable feature favors the issuer.¹³

III. A BRIEF INTRODUCTION OF THE DEVELOPMENT HISTORY OF PREFERRED STOCKS IN CHINA

A. Early Preferred Stocks Issued Without Legislative Authority

China's first modern shareholding company was established in 1980, after which shareholding companies spread out throughout China. In this early stage, shares issued by these shareholding companies have hybrid features of equity and debt because to-be-enlightened Chinese investors strongly favored a promise on fixed amount of return similar to interest payments promised by banks. Although these early stage shares contained some similar features, strictly speaking, they may not be called preferred stocks because relevant shareholding companies did not even realize the distinction between common shares and preferred stocks.¹⁴ Lacking clear definition and legislative authority, preference features are incorporated into common shares to accommodate risk-averse investors.

B. Early Preferred Stocks Issued with Vague Legislative Authority

In 1992, China National Committee for Economic System Reform issued the *Opinions on Standards for the Companies Limited by Shares* (the "Opinions on Standard"), clearly allowing companies limited by shares to issue both common stocks and preferred stocks that can have preference over the company's dividend (at a fixed rate) and liquidation proceeds before common shareholders.¹⁵ Hangzhou Tianmu Pharmaceutical Limited once issued preferred stock according to the authority under the Opinions on Standard.¹⁶

¹³ See Foundersworkbench, *Participating vs. Non-Participating Preferred Stock*, <http://www.foundersworkbench.com/participating-vs-non-participating-preferred-stock> (last visited Feb. 29, 2016).

¹⁴ See 优先股在中国：发展历程及操作方法探讨 [*Preferred Stocks in China: Discussion on History of Development and Practice Guide*], 经管之家 [FIN. HOME] (Sept. 11, 2013, 09:04:42 AM), <http://bbs.pinggu.org/thread-2624782-1-1.html> (last visited Feb. 29, 2016).

¹⁵ See 股份有限公司规范意见 [Opinions on Standards for the Companies Limited by Shares] (promulgated by the China Nat'l Comm. for Econ. Sys. Reform, May 15, 1992, effective May 15, 1992) art. 23, CLI.4.5738 CHINALAWINFO.

¹⁶ *Preferred Stocks in China: Discussion on History of Development and*

However, before long, in 1993, the Opinions on Standard was abolished and replaced by *Company Law of the People's Republic of China (1993)* (the "Chinese Company Law 1993"). Article 135 of the Chinese Company Law 1993 provides a controversial authority on the issuance of class shares such as preferred stocks: "State Council of China may otherwise promulgate rules with respect to the issuance of other classes of shares other than [common] shares prescribed under this Company Law."¹⁷ Zhou Xiaochuan, governor of the People's Bank of China, once explained that Chinese legislators did not usher in the concept of preferred stocks in the Chinese Company law 1993 due to concern that such new concept was too forward-looking for Chinese capital market.¹⁸ Nonetheless, some Chinese scholars insist that Article 135 carves out a niche for the issuance of preferred stocks in China.¹⁹

In the following twenty years after the controversial authority carved out by Chinese Company Law 1993, State Council of China promulgated no further detailed rules regarding issuance of other classes of shares. Although the mechanism of preferred stocks was widely used in venture capital investments in China through complicated contractual terms in order to circumvent restrictions under Chinese Company Law,²⁰ preferred stocks, as an important financing tool, has not been officially adopted by Chinese companies (particularly large listed companies whose issuance of shares are subject to strict regulations) for financing due to the lack of clear legislative authority. This period is called the quiet era of preferred stocks.

Practice Guide, *supra* note 14.

¹⁷ See 中华人民共和国公司法(1993) [Company Law of the People's Republic of China (1993)] (promulgated by the Nat'l People's Cong., Dec. 29, 1993, effective Dec. 29, 1993) art. 135, CLI.1.218774 CHINALAWINFO [hereinafter PRC Company Law].

¹⁸ See 周小川 (Zhou Xiaochuan), 优先股能在处理危机中发挥独特作用 [Special Role of Preferred Stocks in Dealing with Financial Crisis], 中国金属通报 [CHINA METAL BULL.], issue 34, at 23 (2013).

¹⁹ See 汪青松 (Wang Qingsong), 优先股的市场实践与制度建构 [Market Practice and Rule Construction in Relation to Preferred Stocks], 证券市场导报 [SEC. MKT. REP.], at 14 (Mar. 2014).

²⁰ See Jing Li, *Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations*, 1 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 60, 13 (2012).

C. Preferred Stocks Issued with Clear Legislative Authority Since 2013

In November 2013, State Council of China issued the *Guiding Opinions on the Pilot Launch of Preferred Stocks* (the “Guiding Opinions”), on a trial basis, allowing public (both listed and unlisted) companies to issue, either through private placement or public offering, preferred stocks.²¹

Several months later in March 2014, the long-awaited *Administrative Measures of the Preferred Stocks Pilot Program* (“Administrative Measures”) promulgated by China Regulatory Securities Commission (“CSRC”) came into effect, providing more practical rules for implementing the trial preferred stocks program in China.²²

Under the Guiding Opinions and Draft Administrative Measures, preference stocks are defined as a class of shares prescribed under the Chinese Company Law other than ordinary shares whose holders shall have priority rights over common shareholders in relation to distribution of profits and residual assets which are essentially preferred dividend and liquidation rights.

Immediately after the Administrative Measures came into effect, Guanghai Energy (Stock Code: 600256) released its preliminary plan to issue preferred stocks for raising up to RMB 5 billion through private placements. Chinese companies finally entered into a new era when preferred stocks could be issued with clear legislative authority.

²¹ See 国务院关于开展优先股试点的指导意见 [Guiding Opinions on the Pilot Launch of Preferred Stocks] (promulgated by the St. Council, Nov. 30, 2013, effective Nov. 30, 2013) art. 2, CLI.2.213719 CHINALAWINFO [hereinafter Guiding Opinions].

²² See 优先股试点管理办法 [Administrative Measures of the Preferred stocks Pilot Program] (promulgated by the China Reg. Sec. Comm., Mar. 21, 2014, effective Mar. 21, 2014), CLI.4.221521 CHINALAWINFO [hereinafter Administrative Measures].

IV. PREFERRED STOCKS' ACTIVE ROLE IN THE CONTEXT OF STATE-OWNED ENTERPRISE REFORM

A. The Role of Preferred Stocks is Officially Recognized Under the Context of State-Owned Enterprise Reform

From early 1990s, many Chinese scholars started urging that China should usher in preferred stocks to facilitate reform state-owned enterprise. For example, in an early article published in 1994, one professor discussed the feasibility of converting state-owned shares into preferred stocks in China.²³

Similar discussions are re-ignited as the second round state-owned enterprises reform was gradually launched in recent years. Professor Liu Junhai of Renmin University pointed out in 2012 that preferred stocks could be good remedy for troubles haunting state-owned enterprises.²⁴ Another scholar also mentioned that preferred stocks should be a “important financing tool” in China’s second round state-owned enterprise reform.²⁵

Particularly, after several concrete new policies announced by the Communist Party of China, preferred stocks are expected to play an active role in the state-owned enterprise reform currently undergoing throughout China. According to *Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform*, China will vigorously promote hybrid-ownership economic, encouraging more non-state-owned capital to invested in state-owned enterprises.²⁶

According to *Guiding Opinions of the CCCPC and State*

²³ See 王佐强 (Wang Zuoqiang), 国有股设为优先股如何 [How About to Converting State-Owned Stocks into Preferred Stocks], 经济论坛 [ECON. F.], issue 23, at 37 (1995).

²⁴ See generally 刘俊海 (Liu Junhai), 优先股将根治国企、VIE 难题 [Preferred Stocks Will Solve State-Owned Enterprise and VIE Troubles], 董事会 [Dir. & Boards], issue 88, at 43–44 (May 2012) [hereinafter Liu Junhai Article].

²⁵ See 冯威 (Feng Wei), 优先股市场实践与理论定位的背离及其制度完善 [Preferred Stock: Market Practice’s Deviation from Theory and System Improvement on Rules], 清华法律评论 [TSINGHUA L. REV.], issue 8, at 195 (2015).

²⁶ State-owned enterprise is a broad concept which may be misunderstood as including all enterprises in which the central or local government directly or indirectly holds any equity interest. Therefore, state-controlled enterprise may be a more accurate concept. See generally 中共中央关于全面深化改革若干重大问题的决定 [Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform] (promulgated by the CCCPC, Nov. 12, 2013, effective Nov. 12, 2013), art. 6, CLI.5.213067 CHINALAWINFO.

Council on Comprehensively Deepening State-owned Enterprise Reform 2015,²⁷ for the purpose of diversifying the ownership structure of state-owned enterprise, the state will explore the solution of allowing partial state-owned capital to be converted into preferred stocks and establish special state-owned shares management system in a few particular areas.

In its later-promulgated *Opinions on Development of Hybrid-Ownership Economic in State-Owned Enterprise* (the “Opinions on Hybrid Ownership”),²⁸ State Council of China further emphasized that “state-owned shares are allowed to be converted into preferred stocks when state-owned capital is to hold interest in non-state-owned enterprise or non-state-owned capital is to hold interest in state-owned enterprise.”

Legally, the role of preferred stocks is officially recognized under the context of state-owned enterprise reform.

B. Two Different Roles of Preferred Stocks in State-Owned Enterprise Reform

Before long after the issuance of the above-mentioned state-level policies, almost all provincial governments announced their own proposals on state-owned enterprise reform, many of which mentioned preferred stocks. However, up to date, there is no uniform reform plan announced by the central government due to the extreme complexity of this task.

Based on these proposals from provincial governments,²⁹ the development of hybrid-ownership requires that state-owned

²⁷ See 中共中央、国务院关于深化国有企业改革的指导意见 [Guiding Opinions of the CCCPC and State Council on Comprehensively Deepening State-owned Enterprise Reform] (promulgated by the CCCPC and St. Council, Aug. 24, 2015, effective Aug. 24, 2015), art. 7, CLI.5.256926 CHINALAWINFO.

²⁸ See 国务院关于国有企业发展混合所有制经济的意见 [Opinions on Development of Hybrid-Ownership Economic in State-Owned Enterprise] (promulgated by the St. Council, Sept. 23, 2015, effective Sept. 23, 2015), art. 3, CLI.2.257547 CHINALAWINFO [hereinafter *Opinions on Hybrid Ownership*].

²⁹ *E.g.*, 河北省人民政府关于地方国有企业发展混合所有制经济的实施意见 [Implementing Opinions of Hebei Provincial Government on Development of Hybrid-Ownership Economics in Local State-Owned Enterprises] (promulgated by the Hebei Provincial Gov., Dec. 9, 2015, effective Dec. 9, 2015), art. 3, available at https://www.baidu.com/link?url=n6ms-R1mhXAJinWkHrVM8CADWjQfHGn3B6BdC5QDgkXs_HkzPCdMC6c7sRyagz3fx3LYgjXWR6UidRtfsjZRZy7KDagxnyaJIIOsdGcabYm&wd=&eqid=a36code600102689000000656d48262 [hereinafter *Hebei Implementing Opinions*].

capital move in both directions, retreating from commercial industries while strengthening its absolute controlling position in “key industries.” Generally speaking, preferred stocks could be used to diversify the shareholding of state-owned enterprises mainly in the following two ways.

1. Model I: State-Owned Capital Gradually Transfer Controlling Power

For commercial enterprises which engage in fully competitive industries,³⁰ state-owned capital can gradually retreat by converting state-owned common shares into state-owned preferred stocks to the extent that non-state-owned common stockholders can hold controlling power in the enterprise after such conversion (“Model I”).

State-owned enterprises to be reformed under Model I will be thrown into a highly competitive market. Under Model I, preferred stocks may cause positive effects on such reform arguably in the following aspects:

a) Preferred stocks system can help return management power to private capital. As discussed above, under normal circumstances, preferred stockholders give up voting rights in exchange for preference, creating an opportunity to allocate the voting power among different class of shareholders. By converting state-owned common shares into state-owned preferred stocks, private capital, particularly long-term strategic investors, could be attracted to participate in managing the former state-owned enterprise.³¹

Before the conversion, essential management powers are exercised indirectly by all levels of State-Owned Assets Supervision and Administration Commission (“SASAC”) that is under direct supervision of all levels of central or local governments, ranging from appointment of directors and supervisors, executive compensation scheme, to even the training and entertainment activities for

³⁰ Such as financing, information technology, transportation and logistics industries. See 河北关于深化地方国有企业改革的实施意见 [Implementing Opinions of Hebei Provincial Government on Deepening Local State-Owned Enterprise Reform] (promulgated by the Hebei Provincial Gov., Nov. 15, 2015, effective Nov. 15, 2015), art. 9, available at <http://he.people.com.cn/n/2015/1119/c192235-227130485-6.html>.

³¹ See generally Liu Junhai Article, *supra* note 24.

employees.³²

After the conversion, management power could be separated from state-ownership. The management can independently operate the enterprise, in consistent with state-owned enterprises' plan to gradually retreat from competitive industries.

b) Preferred stocks system can to some extent help minimize agency costs problems haunting state-owned enterprises in competitive industries. After nearly thirty years of the first round reform, Chinese state-owned enterprises still dominate the whole economy. By the end of January 2015, there are totally 2,635 companies listed on the main board in Shanghai Stock Exchange, 38% of which are state-controlled. These state-owned enterprises are reported to remain low-efficient and beset with serious financial troubles.³³ Many scholars attribute this phenomenon to the so-called "double-agency" problem.

Double agency problem refers to two layers of delegation in state-owned enterprises which may increase agency costs. The first layer of delegation is between the state and SASAC, which is an institute agent delegated by the state to supervise state-owned assets. The second layer of delegation is between SASAC who functions the role as shareholder and the management of the enterprise.

Because of its nature as an organ of the government, SASAC is widely criticized for pursuing many political objectives while failing to fulfil its responsibilities as a shareholder.³⁴ On the one hand, SASAC inclines to overly interfere with the enterprises' daily management through regulatory-oriented rules to achieve many political objectives it carries;³⁵ on the other hand, SASAC

³² See generally 邓峰 (Deng Feng), 国企改革理论困局和道路展望 [The-ory Dilemma and Prospect of State-Owned Enterprise Reform] (Dec. 2015), <http://www.aisixiang.com/data/94860.html> [hereinafter Deng Feng Speech].

³³ See 王晶 (Wang Jing), 天则所认为国有企业真实利润为负 [Tianze Research Institute Opines That Actual Profits of State-owned Enterprise is Below Zero], 财新网 [CAIXIN.COM], (March 3, 2011, 09:30 AM), <http://economy.caixin.com/2011-03-03/100231363.html>.

³⁴ See 余世宽 (She Shikuan), 中国优先股制度研究 [Research on China's Preferred Stocks System] (Apr. 17, 2014) (unpublished master's dissertation, S. China Univ. of Tech.), available at http://xueshu.baidu.com/s?wd=paperuri%3A%288c5356f8582cd2a370502c4055c99380%29&filter=sc_long_sign&tn=SE_xueshusource_2kduw22v&sc_vurl=http%3A%2F%2Fcdm.cnki.com.cn%2FArticle%2FCDMD-10561-1014065335.htm&ie=utf-8&sc_us=1238345614094740150, at 27 (2014) [hereinafter She Shikuan Article].

³⁵ See Deng Feng Speech, *supra* note 32. See also 郑志刚 (Zheng Zhigang),

is arguably not in a good position to make reasonable business decisions to pursue maximize economic interest for the enterprise because economic profit is merely one of its many objectives. Consequently, double-agency problem is exacerbated in Chinese state-owned enterprises because of SASAC's role a "shadow" shareholder from corporate governance perspective.³⁶

By returning management powers to private capital, double agency costs could be reduced to some extent.

c) Stable dividends generated by preferred stocks can help preserve and increase the value of state-owned capital. According to article 8 of *Law of the People's Republic of China on the State-Owned Assets of Enterprises*, SASAC should establish effective evaluation and accountability system to ensure the preservation and increase of state-owned assets value. Some scholars observed that this "political" requirement puts pressures on SASAC to pursue short-term financial performance by closely monitoring the enterprise's financing and investment activities, consequently restricting state-owned enterprises' capability to compete with non-state-owned enterprise in the long run.³⁷

Because of its preference feature, preferred stocks have priority over the enterprise's dividends. It can generate long-term stable returns and is therefore favored by risk-averse investors, such as large insurance companies and pension funds.³⁸ For example, Industrial and Commercial Bank of China's recent issuance of preferred stocks, which promise an annual rate of return at six percent, are over-subscribed by foreign investors.³⁹ Compared to Chinese

国企公司治理与混合所有制改革的逻辑和路径 [Governance of State-owned Enterprise and the Logic and Path for State-owned Enterprise Reform], 证券市场导报 [SEC. MKT. REP.], at 6 (June 2015).

³⁶ See She Shikuan Article, *supra* note 34, at 125.

³⁷ See Deng Feng Speech, *supra* note 32.

³⁸ See 叶檀 (Ye Tan), 优先股可能变成“优先陷阱” [Preferred Stocks May Be a Priority Trap], 卓越理财 [WISE MONEY], at issue 1, 15 (2014). See also 优先股: 发展历程及与股票、债券的比较分析 [The Development of Preferred Stocks and A Comparative Study of Preferred Stocks With Stocks and Bonds], SINA BLOG (Mar. 24, 2014, 10:42:36 AM), http://blog.sina.com.cn/s/blog_5dde75a80102e kyg.html.

³⁹ See 工行完成 346 亿多币种境外优先股发行获 4.9 倍认购 [ICBC Completes 34.6 Billion Issuance of Preferred Stocks], 网易财经 [MONEY.163.COM], Dec. 4, 2014, <http://money.163.com/14/1204/10/ACK6777400254TFQ.html>.

listed companies' tradition of being reluctant to pay little or extremely low dividends,⁴⁰ the stable return expected from preferred stocks are more likely to satisfy SASAC's objective to preserve and increase the value of state-owned assets.⁴¹

d) Preferred stock can arguably motivate the management to achieve better financial performance. Because of preferred stock's preference over dividends, common shareholders are residual claimant who won't get paid until promised dividends to preferred stockholders are paid.

Besides, the management usually "comes to view the preferred issue much as it would a bond, establishing the policy that the full preferred dividend must be paid as a matter of course . . . comes to view the preferred issue much as it would."⁴²

Arguably, the management who are usually selected by common shareholders, has motivation to achieve better financial performance to pay the preferred stockholders and then create additional value for common shareholders.

In sum, under Model I, preferred stocks could be used to return controlling power from state-owned enterprise to private capital in competitive industries where state-owned capital is about to retreat.

2. Model II: State-Owned Capital Retains Absolute Control

For commercial or non-commercial enterprises which engage in key industries that have close relationship with national security or are vital to national interest, and public welfare enterprises which are focusing on providing public goods or services or undertaking special tasks, state-owned capital should maintain absolute or full control while allowing private capital to participate in equity-holding through hybrid-ownerships, such preferred stocks ("Model II").

According to the Opinions on Hybrid Ownership, private capital is encouraged to participate in equity-holding in enterprises

⁴⁰ See A 股观察: 近 15 年 58 家上市公司从未分红 [Observation on Listing Companies in Mainland China: 58 Listed Companies Never Pay out a Penny of Dividends for Nearly 15 Years], 东北网 [DBW.CN], Aug. 3, 2015, <http://finance.dbw.cn/system/2015/08/03/056722870.shtml>.

⁴¹ See generally Hebei Implementing Opinions, *supra* note 29.

⁴² See Corporate Finance I, *supra* note 4, at 618.

under Model II for the purpose of providing financing and/or supporting services (such as repair service) to these state-owned enterprises.⁴³

For private capital, participation in these state-owned enterprises under model II looks attractive for at least two reasons:

i) to share stable profits earned by state-owned enterprises under model II which usually engage in monopoly business. Some risk-averse private investors favor preferred stocks “that have an investment grade rating as opposed to speculative grade” because such preferred stocks with investment grade rating arguably carry a lower investment risk than preferred stocks that have no such characteristics.⁴⁴ Given grade rating on Chinese enterprises is not as popular and reliable as in the United States, a label of state-owned enterprise engaged in monopoly business is to some extent a reliable guarantee on the enterprise’s stable operation and profit-generating capability.

ii) to establish cooperation relationship with state-owned enterprises hoping to get business opportunities providing supporting services for these enterprises through outsourcing. This kind of cooperation chemistry between private capital and state-owned capital is also mentioned by the Opinions on Hybrid Ownership.

However, under model II, state-owned capital must hold absolute or full control over the enterprise. To achieve these goals, preferred stocks may contribute to reform state-owned enterprises at least in two particular ways:

a) The Issuance of Preferred Stocks Can Avoid Diluting State-Owned Capital’s Absolute Control

As discussed above, preferred stockholders can give up voting rights through contractual arrangements. This special feature of preferred stocks perfectly matches state-owned capital’s special desire to retain absolute control over enterprises under Model II.

⁴³ See generally Opinions on Hybrid Ownership, *supra* note 28.

⁴⁴ See Doug K. Le Du, *Tax-Advantaged Preferred Stocks: Does It Really Matter?*, SEEKING ALPHA (Feb. 20, 2012, 7:00 AM), available at <http://Seekingalpha.com/article/376681-tax-advantaged-preferred-stocks-does-it-really-matter>.

b) Preferred Stocks Financing Can Help State-Owned Enterprises Optimize Their Debt-Equity Ratio

In the United States, large corporations such as financial institutions and public utilities favor the issuance of publicly listed preferred stock because of the tax advantages associated with dividend payments.⁴⁵ Although the issuer cannot deduct dividend payments before tax as interest expenses on bonds, corporate receivers pay tax on only thirty percent of preferred dividends received, offering a more attractive investment opportunity than bonds to institutional investors like insurance companies that are subject to federal corporate income tax. Such a corporate preferred issue could sell at a lower yield than the same company's bonds.⁴⁶ Therefore, large corporations such as financial institutions and public utilities which are in need of large-scale financing favor the issuance of preferred stocks.

Chinese corporate taxpayers enjoy more favorable tax advantages on dividend payments. According to *Provisions on Accounting Treatment and Distinction Between Debt Financing Instrument and Equity Financing Instrument* promulgated by the Ministry of Finance in wake of state authorization to issue preferred stocks under the Guiding Opinions, once preferred stocks are recognized as equity financing instrument in light of its contractual arrangement, corporate taxpayers who receive relevant dividend payments can enjoy ZERO corporate income tax.⁴⁷

Many state-owned enterprises such as public utilities need large-scale of funds for preliminary construction and operation. Traditionally, these state-owned enterprises heavily rely on low-cost financing through bank loans by taking advantage of its high credibility.⁴⁸ However, many state-owned enterprises nowadays

⁴⁵ See Patrick Gleeson, *Tax Advantages of a Company to Finance with Preferred Stock*, CHRON, <http://smallbusiness.chron.com/tax-advantages-company-finance-preferred-stock-71307.html> (last visited Feb. 29, 2016).

⁴⁶ See Corporate Finance I, *supra* note 4, at 620.

⁴⁷ See 金融负债与权益工具的区分及相关会计处理规定 [Notice of the Ministry of Finance on Issuing the Provisions on Differentiating Financial Debt and Equity Instruments and Related Accounting Treatment] (promulgated by the Fin. Ministry, Mar. 7, 2014, effective Mar. 7, 2014) art. 3, CLI.4.221424 CHINALAWINFO.

⁴⁸ See 中小企业融资难原因何在? 银行经理: 傍国企只因安全可靠 [Why It Is So Difficult for Small and Medium-size Enterprises to Get financing? Bank's Manager Said State-owned Enterprise Is More Safe and Reliable], 凤凰财经 [FINANCE.IFENG.COM], Aug. 25, 2014, <http://finance.ifeng.com/a/20140825/129>

are trapped with high debt-equity ratio and are under pressure to deleverage to avoid financial risks associated with huge bank loans.⁴⁹ Preferred stocks, which could be designed as equity financing tools that,⁵⁰ can effectively help indebted state-owned enterprises to manage debt-equity ratio while allowing their corporate investors to enjoy tax advantages.⁵¹

In sum, under Model II, preferred stocks could be used to attract private capital's participation in state-owned enterprises that engage in key industries while allowing state-owned capital to retain absolute control.

C. Horizontal Conflict of Interest Between Common Shareholders and Preferred Stockholders Remain Severe in the Context of State-Owned Enterprise Reform

Despite its hybrid features, preferred stocks are traditionally regarded as stocks and preferred stockholders are traditionally regarded as "owner" with "equity interest," like a common shareholder. By virtue of this ownership interest, preferred stockholders are also corporate constituency who has a bite on the pie of company wealth, involving in a zero-sum game playing.⁵² Consequently, preferred stockholders may have direct conflicts with other corporate constituents and director/officers of the company who actually operate the business.

87018_0.shtml.

⁴⁹ See 人行专家建议将部分银行贷款转化为优先股 [*Experts from The People's Bank of China Suggest to Partially Convert Bank Loans Into Preferred Stocks*], 新浪财经 [FINANCE.SINA.COM.CN], June 11, 2015, <http://finance.sina.com.cn/stock/usstock/c/20150611/114222407278.shtml>.

⁵⁰ See 陈金祥(Chen Jinxiang), 优先股发行转换、回购等财务处理详解 [The Issuance, Conversion And Repurchase of Preferred Stocks: A Detailed Financial Analysis], 财会信报 [ACCT. MESSENGER], June 23, 2014, at B03.

⁵¹ See generally 甘德龙 (Gan Delong), 基于优先股改善国有上市公司治理 [Use Preferred Stocks to Improve the Governance of State-owned Enterprises], 现代企业 [MOD. ENTER.], issue 2, at 40-41 (2015).

⁵² See Lawrence E. Mitchel, *Puzzling Paradox of Preferred Stock and Why We Should Care about It*, 51 BUS. LAW. 443, 446 (1996) [hereinafter Lawrence Article].

1. There are Generally Two Types of Conflict of Interest Involving Preferred Stockholders⁵³

a) Vertical conflicts. Vertical conflicts exist between the enterprise's directors/officers and preferred stockholders, where the latter's interests are subject to the former's exercise of management powers. Vertical conflicts generally occur between director/officers and any corporate constituents group, which are the root of duties of care and duties of loyalty.

Vertical conflicts are not the focus of this paper because preferred stocks generally have the same rights as common shareholders to bring derivative actions against directors/officers in cases of such vertical conflicts. Preferred stockholders have the same right as common shareholders to sue directors if directors/officers enriched themselves at the expenses of preferred stockholders.⁵⁴

However, because vertical conflicts may sometimes overlap with horizontal conflicts (as discussed below) in the same cases, particularly when a board member holds substantial amount of common shares under employee stock ownership plans that are designed to align directors' interest with that of common shareholders, the vertical conflicts may also be taken into account when this paper discusses horizontal conflicts.

b) Horizontal conflicts. Horizontal conflicts exist between common shareholders and preferred stockholders, the two classes of corporate constituents who have direct conflict of interest with each other because as a result of its preferential rights, such as preference over declared dividends, preferences proceeds, and under particular circumstances the right to redemption at a premium price. Preferred stockholders get the first bite on the pie until promised privileges are satisfied, which come at the expense of common shareholders.

Horizontal conflicts root in its feature of preference. Theoretically speaking, common shareholders who are entitled to only

⁵³ *Id.*, at 449.

⁵⁴ According to Article 151 of PRC Company Law (2013 Amended), shareholder has the right bring derivative actions against directors/officers of the company who are in breach of his/her duty of care and duty of loyalty owe to the company. However, whether preferred stockholders can bring derivative actions against directors/officers under Chinese laws is still a pending question, to be clarified by further legislative rules or judicial cases.

residual assets tend to bet on the unlimited upside, but preferred stockholders who tend to be risk-averse rarely allow the enterprise to take excessive risks to pursue the unlimited upside.⁵⁵

The question of whether to declare dividends is a good window for looking into horizontal conflicts. When the enterprise is on the upside with sufficient earnings to pay dividends, horizontal conflicts may not be severe but still exist. As to preferred stockholders, declaration of dividends matches their desires to secure fixed and stable return. In stark contrast, common shareholders who pursue long-term interest tend to reserve earnings in the enterprise for operation expanding. Declaration of dividends will constrain their bet on the unlimited upside unless.⁵⁶

When the enterprise is on the downside lacking sufficient earnings to pay dividends, horizontal conflicts will escalate, particularly when the dividends are not even sufficient to satisfy preferred stockholders' fixed amount. If to declare dividends, all earnings go to preferred stocks, common shareholders, who get no benefit from declaration of dividends, would instead prefer to reserve the earnings in the enterprise to whether to financial distress.⁵⁷

2. Horizontal Conflicts Remain Severe or Even Intensify When State-Owned Interests Are Involved in The Context of State-Owned Enterprise Reform

a) Under Model I, preferred stockholders represent state-owned interests, which still carry on at least in near future both economic and political functions.⁵⁸ “To preserve and increase the

⁵⁵ See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U.L. REV. 967, 982 (2006).

⁵⁶ However, this incentive may be weakened if the enterprise has excessive working capital, either as a result of increasing intrinsic value of equity or from outside financing, for business operation. Like Alibaba. See Walther Article, *supra* note 3, at 169.

⁵⁷ See 周鹏 (Zhou Peng), 优先股制度中的利益冲突研究 [Studies on Conflict of Interest in Preferred Stocks Systems], 上海师范大学 [Shanghai Normal Univ.], at 17 (2015).

⁵⁸ For example, state-owned capital carries on the task to make up the shortfall of social pension funds. It is reported that a consensus is reached among ministers under the leadership of the central government and rules are being promulgated to implement a plan to gradually transfer ownership of state-owned shares to social security funds. By 2030, at maximum 40% of state-owned shares will be transferred. See 国有资本划拨社保正制定细则, 万亿国资划社保 [Implementing Rules Are Under Promulgation Related to Transfer of State-

value of state-owned assets” is not only an economic objective but also an objective related to the stability of the whole society. State-owned preferred stockholders are somehow under political pressure to make sure the preferred investment can generate state return.

Another concern is about how to prevent the loss and erosion of state-owned assets. It is widely reported that in the first round state-enterprise reform, state-owned assets were disposed to private parties at under-value price, causing significant losses to state-owned assets. Although the risk of under-value disposal no longer exists, there might be other tricky ways to erode state-owned assets, say the board which is controlled by private common shareholders keep declaring no dividends despite the enterprise has sufficient legally available funds. State Council of China keeps emphasizing that the bottom line of reform is to prevent loss of state-owned assets and has recently issued the *Opinion on Strengthen and Improve Supervision on State-Owned Enterprise to Prevent the Loss of State-Owned Assets*.⁵⁹

Given its special identity, state-owned preferred stockholders, who are directly or indirectly under supervision of the central government or all levels of local governments, have more political power to set the rules to guarantee its claims on stable dividend streams. However, political interference will go against the goal to return controlling power to private capital, which of course includes to discretion to declare dividends.

b) Under Model II, preferred stockholders represent private capital, giving up controlling powers in exchange for stable dividend streams. Because the enterprise is under the controlling shareholder's absolute control, preferred stockholders are arguably under threat of abuses by the controlling shareholder through “tunneling,”⁶⁰ which are not uncommon among state-controlled listed

owned Capital into Pension Funds], 华夏时报网 [CHINA TIMES] (Nov. 20, 2015), available at http://www.cnstock.com/v_news/sns_yw/201511/3629897.htm.

⁵⁹ See 不让国有资产流失是改革底线 [The Bottom Line Is No Loss of State-Owned Asset], 人民日报 [PEOPLE'S DAILY], Jan. 12, 2016, available at <http://finance.sina.com.cn/stock/t/2016-01-12/doc-ifxnkuy7927111.shtml>.

⁶⁰ “Tunneling” is a technical term broadly describing the controlling shareholder's extracting of corporate value from a corporation that he exercises control over to himself, at the sacrifice of minority shareholders. See Sang Yop Kang, *Taking Voting Leverage and Anti-Director Rights More Seriously: A Critical Analysis of Law and Finance* (Oct. 5, 2015), Peking University School of Transnational Law Research Paper No. 15-3, available at SSRN: <https://ssrn.com/abstract=2669420>.

companies.⁶¹

It is said that the biggest obstacle deterring private capital's participation in state-enterprise reform is the threat of tunneling by the controlling shareholders through related-party transactions, fund misappropriation, inter-enterprises loans or guarantee and the likes.⁶² In state-owned enterprises, tunneling is reported to be conducted by directors/officers (particular the ones who are founders of the enterprise) for personal benefits, such as the famous Yunnan Copper case, in which the listed company was once trapped with serious financial troubles.⁶³ Consequently, such tunneling may have undesirable effect on the state-owned enterprise's financial capability to pay constant dividends to preferred stockholders.

Therefore, under both Model I and Model II, horizontal conflicts such as different opinions on declaration of dividends become evident, particularly when the enterprise is on the downside. Whether preferred stocks can play its role as expected in the state-owned enterprise reform to a large extent depends on the protection of preferred stockholders' legitimate interests.

V. LEGAL THEORIES FOR PROTECTION OF PREFERRED STOCKHOLDERS' RIGHTS IN THE UNITED STATES

Under contractual arrangements, preferred stockholders are normally entitled to fixed amount of constant dividend payments and preference over liquidation proceeds. However, such preferences are vulnerable to exploitation by the common shareholders. By virtue of their natures, preferred stockholder's claims on pre-determined dividend payments lose value if they are subject to high variance risks while common shareholder's claims on residual assets benefit from taking high variance risks. Therefore, if common shareholders bet on the unlimited upside by pushing the firm to invest in high variance projects, their equity investments will ben-

⁶¹ State-owned enterprises are not less tunneled by controlling shareholders compared to non-stated-owned firms. See Kun Wang & Xing Xiao, *Controlling Shareholders' Tunneling and Executive Compensation: Evidence from China*, 17 J. ACCT. & PUB. POL'Y 89, 90 (2011).

⁶² See Zheng Zhigang, *supra* note 35, at 3.

⁶³ See generally 许淑贤 (Xu Shuxian), 公司治理、关联交易与“掏空”行为——基于云南铜业的案例研究 [*Corporate Governance, Related Transactions, and Tunneling—A Case Study Based on Yunnan Copper*], 中山大学 [Sun Yat-sen Univ.] (2010).

efit because all the upside goes to common shareholders at the expense of the other corporate constituents such as preferred stockholders who only make fixed claim but share the increased risk with common shareholders.

Therefore, both bondholders and preferred stockholders “seek to protect their fixed claims on the firm’s assets against opportunism by common shareholders.” However, bondholders and preferred stockholders’ ability to protect themselves against opportunism differs greatly.⁶⁴

In the United States, creditors such as bondholders can rely on remedies granted by contract laws. “A contract is a contract is a contract,” meaning that creditor’s legal remedies are limited to what they have bargained-for in the contract.

What kind of remedies preferred stockholders are entitled to, however, is still a controversial question even in the United States. Because of its hybrid characters, it has been long recognized that “legal treatment of preferred stockholders straddled the dividing line between corporate laws and contract laws.”⁶⁵ So the protection of preferred stockholders’ rights come from both contract laws and corporate laws.

A. Preferred Stockholders Are Entitled to Protection Under Contract Laws Which is Not Sufficient

In *Jedwab v MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986), Delaware Chancery court lay down the general rule concerning protection of preferred stockholders’ rights, which held that preference rights enjoyed by preferred stockholders are contractual in nature unless it is a right shared equally with common shareholders.⁶⁶ It is worth citing the classic reasoning here again:

With respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropri-

⁶⁴ See Walther Article, *supra* note 3, at 169.

⁶⁵ See Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1165 (2013).

⁶⁶ See *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

ately defined by reference to the specific words evidencing that contract.

Compared to common shareholders, preferred stockholders obtain their preference rights through explicitly negotiated contract terms.⁶⁷ The law of Delaware governing contracts is less controversial than the law governing shares. Under the concept of freedom of contract, a valid contract term mutually agreed by parties will be enforced unless the contract violates public policy or positive law, or unless a party's non-performance is excused.⁶⁸

Generally, preferred rights articulated in the contract will be respected in a similar way as debt-like rights. However, it is difficult, if not impossible, to specify every preferred right beforehand, preferred stock transactions are inevitably incomplete transactions.⁶⁹ Additionally, the good faith doctrine, which is supposed to protect parties' legitimate expectations from the contract, is narrowly applied to only limited situations where the substance should also be drawn from explicit contract terms.⁷⁰ Therefore, lacking a specific contract term regarding rights asserted by preferred stockholders, contractual protection became limited and protections under corporate laws are necessary.

B. Preferred Stockholders Are Also Entitled to Limited Protection Under Corporate Laws

No matter how similar preferred stocks and debts could be in terms of economic similarities, preferred stocks are stocks and could be distinguished from junior debts securities like a subordinated debenture because of its distinct characteristics of stocks.⁷¹ Thus, as illustrated by Judge Allen in his opinion in *Jedwab v. MGM Grand Hotels* above, with respect to rights asserted by preferred stockholders that are "shared equally with the common," the existence and the scope of such right should also be examined under general corporate law standards.

Under corporate laws, Delaware courts traditionally respect

⁶⁷ See William W. Brattont & Michael L. Wachtert, *A Theory of Preferred Stocks*, 161 U. PA. L. REV. 1815, 1839 (2013).

⁶⁸ See Marilyn B. Cane et al., *Recent Developments Concerning Preferred Stockholder Rights under Delaware Law*, 5 VA. L. & BUS. REV. 379, 424 (2011).

⁶⁹ Brattont & Wachtert, *supra* note 67, at 1839.

⁷⁰ See Cane et al., *supra* note 68, at 403.

⁷¹ See Corporate Finance I, *supra* note 4, at 608.

board of directors' business judgments, including discretion to declare or not payment of dividends unless mandatory dividends are contractually specified.⁷² The corporate laws' role as gap-filler seems to be limited due to courts' reluctance to interfere with the board's decision, unless special circumstances such as conflict of interest arise.⁷³

1. Corporate Laws Can Protect Preferred Stockholders Through Fiduciary Duty Theory

Delaware courts have long agreed that majority shareholders owe fiduciary duties to minority shareholders and the entire or intrinsic fairness test is appropriate for determining whether the majority shareholders elect to take advantage of their controlling powers to further their own interest at the costs of minority groups.⁷⁴ Similarly, preferred stockholders' interest may be exploited by majority common shareholders who control the board. Board members, most of whom owe their directorships to majority common shareholders, tend to maximize the value of majority common shareholders at the expense of minority groups including preferred stockholders.⁷⁵ Arguably, majority shareholders who control the board owe fiduciary to preferred stockholders.

Admittedly, it is still an ongoing argument whether and how directors owe fiduciary duty to preferred stockholder in the context of horizontal conflicts. However, in cases where directors themselves own common shares, courts are more willing to grant fiduciary duty protection to preferred stockholders.⁷⁶ In *HB Korenvaes Investments, LP v. Marriott Cwp.*, the court recognized that directors may owe fiduciary duties to preferred stockholders where preferred stockholders are placed in a weak position due to the lack of specific contractual provisions.⁷⁷ In *Re FLS Holdings, Inc. Shareholders Litigation* (1993 WL 104562 (Del.Ch.Apr. 2, 1993)), the court further noted that directors who were selected by common shareholders owed fiduciary duties to common shareholders as

⁷² *Id.*, at 621.

⁷³ See Cane et al., *supra* note 68, at 388.

⁷⁴ See Corporate Finance I, *supra* note 4, at 667.

⁷⁵ See Brattont & Wachtert, *supra* note 67, at 1835.

⁷⁶ See Lawrence Article, *supra* note 52, at 468–69.

⁷⁷ See Cane et al., *supra* note 68, at 396.

well as preferred stockholders and should treat preferred stockholders fairly in distributing the consideration in a merger.⁷⁸

If fiduciary duties are confirmed and the fairness test is applied, the court will examine both the substance and procedures. However, the court of *In Re Trados Inc. Shareholders Litigation*⁷⁹ noted “the entire fairness standard is not a bifurcated test as between fair price and fair process, the two components of an entire fairness analysis.”⁸⁰ But the court did reassure preferred stockholders that on matters for which preferred stockholders failed to negotiate for preference rights, the board owes preferred stockholders fiduciary duties in relation to allocation of merger consideration between common shareholders and preferred stockholders, a matter not specifically addressed by contract in the case.

2. Corporate Laws Can Protect Preferred Stockholders Through Appraisal Rights Actions

Appraisal right refers to the statutory right of a corporation’s dissenting minority shareholders to have a fair stock price be determined by a judicial proceeding or independent valuator, and the obligation for the corporation to pay minority shareholders at that price.⁸¹ Such an appraisal right is to protect the interest of minority shareholders who raise objection to a fundamental corporate action which the majority shareholders approve.⁸²

Under Delaware laws, preferred stockholders who are normally in the minority groups, can make appraisal right claim equally as common shareholders. In *In Re Appraisal of Metromedia International Group, Inc.*, dissenting preferred stockholders sought a judicial determination of the fair value of their cumulative convertible preferred stocks after a merger vote even though what the preferred stockholders claimed exceeded what the certificate of

⁷⁸ See *In re FLS Holdings, Inc. Shareholders Litigation*, No. 12623, 1993 WL 104562, at 4 (Del. Ch. 1993).

⁷⁹ *In re Trados Inc. S’holder Litig.*, 73 A.3d 17 (Del. Ch. 2013).

⁸⁰ See Lisa R. Stark, *Side-Stepping Fiduciary Issues in Negotiating Exit Strategies for Preferred Stock Investments after Trados*, A.B.A., (Sept. 2, 2013), http://www.americanbar.org/publications/blt/2013/09/02_stark.html.

⁸¹ See DENG FENG, COMMON COMPANY LAW 380 (2009) [hereinafter *Deng Feng Book*].

⁸² See Byron F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN ST. L. REV. 913, 923 (2012).

designation determines as their right upon occurrence of a merger.

However, the Chancery court recognized that due to the contractual nature of preferred stocks, in determining the fair value of preferred stocks, the court must look to the contract upon which the preferred stock's value is based, meaning the valuation of preferred stock must be viewed through the contract unless the contract is ambiguous or conflicts with positive law.⁸³ Therefore, when a contract fixes the precise value to be paid to the preferred stockholders upon a merger event, dissenting preferred stockholders can initiate appraisal right action against majority common shareholders/preferred stockholders for a fair price that is set *ex ante*. Under such appraisal right actions, preferred stockholders are entitled to what they have bargained for, rather than an uncertain amount determined by the court traditionally using a liberal approach by considering "all relevant factors involving the value of a company."⁸⁴ In *LC Capital Master Fund, Ltd. v. James*, the Chancery court also implied that in absence of a contractual arrangement, preferred stockholders have no right to demand additional value (if to deem a merger as a liquidation event which could qualify preferred stockholders for liquidation preference) from merger even though the board owes duty to make a "fair" allocation of merger consideration between the common and preferred stockholders.⁸⁵

In sum, under Delaware corporate laws, appraisal right action can function as the last straw for the protection of preferred stockholders' legitimate rights provided that the court is reluctant to second-guess the board's business judgment in absence of extraordinary circumstances such as conflict of interest.

VI. REFLECTION ON PROTECTION OF PREFERRED STOCKHOLDERS' RIGHTS UNDER CHINESE LAWS

A. *Chinese Laws Generally Respect the Spirit of Freedom of Contract Involving Preferred Stocks*

Generally, Chinese laws allow the parties to set the terms of

⁸³ See Corporate Finance II, *supra* note 1, at 174.

⁸⁴ *Id.*, at 173.

⁸⁵ *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 436-8 (Del. Ch. 2010).

preferred stocks contract through bargaining.

However, as shown in the table below, Chinese laws do not grant as much freedom to the parties as Delaware laws, particularly in public offering (compared to private placement⁸⁶) of preferred stocks.

Items	Delaware Laws	Chinese Laws
Scope of issuers	No restriction	Must be joint stock limited companies, ⁸⁷ either listed or unlisted. Private companies ⁸⁸ are not allowed to issue preferred stocks.
Dividend preference	Allowed	Allowed
Liquidation preference	Allowed	Allowed
Condition to declare dividends	Has “legally available funds”	As long as there are after-tax profits.
Price	Free to negotiate	Free to negotiate
Rate of dividend	Free to negotiate; floating rates are allowed	In private placements, the rate of dividend should not exceed weighted average rate of return on equity in the preceding two accounting years. In public offering, the rate of dividend must be fixed amount.
Conversion right	Allowed	In public offerings, listed companies are not allowed to issue preferred stocks that carry conversion rights, either for the issuer or the investor.
Redemption right	Free to negotiate	Free to negotiate
Voting right	Not compulsory, free to negotiate	Generally, no voting right. However, preferred

⁸⁶ Private placement refers to offering to no more than 200 specific subscribers. See 中华人民共和国证券法 [Securities Law of the People’s Republic of China] (promulgated by the Nat’l People’s Cong., amended Aug. 31, 2014, effective Jan. 1, 2006) art. 10, CLI.1.233280 CHINALAWINFO.

⁸⁷ There are merely two types of company forms under Chinese Company Law, limited liability company (whose total number of shareholders should not exceed fifty) and joint stock limited company (established by more than two but not more than two hundred shareholders. After its establishment, a joint stock limited company can become a public company through public or private offer if the total number of its shareholders exceeds two hundred). Joint stock limited company is the form normally adopted by large companies which raise funds through capital market. Limited liability company is the form normally adopted by closed company.

⁸⁸ Including domestic private companies in the form of limited liability companies, as well as foreign invested enterprises such as wholly foreign-owned enterprises, equity joint ventures and cooperative joint ventures.

Items	Delaware Laws	Chinese Laws
		stockholder can have voting right under some particular circumstances. ⁸⁹

For the purpose of protecting public investors, the Guiding Opinions requires all preferred stocks issued through public offering must be at fixed rate of dividend, cumulative, non-participating and mandatory payment of dividend as long as the issuer has after-tax profits. However, these mandatory regulatory requirements seem unwelcomed by market players.

By March 21, 2015, there are 21 companies in total that circulated their proposal to issue preferred stocks, all of which are proposed to be issued through private placement rather than public offering arguably to circumvent the aforesaid mandatory regulatory requirements.⁹⁰

Compared to common shares, preferred stocks are touted for its flexibility for the issuers and the investors to bargain for different contractual arrangements on voting, dividend payment, liquidation, redemption right and so on. As discussed in Part IV, state-owned enterprise reform involved the movement of state-owned capital in both directions, under which the relationship between common shareholders and preferred stockholders are much more delicate. On the one hand, mandatory regulatory requirements restrain relevant parties to bargain for special protection mechanism; on the other hand, market players find other ways to circumvent these requirements. Ultimately, it goes against the legislative intent to protect preferred stockholders.

⁸⁹ According to the Guiding Opinions, preferred stockholders are entitled to vote on significant matters such as merger, increase or reduction in registered capital over ten percent, liquidation, amendment to articles of associations which may affect preferred stockholder's interest. Besides, preferred stockholders can automatically regain pro rata voting rights if the issuer failed to pay dividend as agreed for two consecutive accounting years or three accounting years in aggregation.

⁹⁰ See 王会敏&耿利航 (Wang Huimin & Geng Lihang), 上市公司优先股发行实践和制度反思 [*Reflection on the Practice and Issuance System of Preferred Stocks by Listed Companies*], 东岳论丛 [DONG YUE TRIB.], issue 12, at 128 (2015).

B. Dissenting Preferred Stockholders' Appraisal Rights Have Not Yet Been Recognized Under Chinese Law

Appraisal right is a useful mechanism that can afford adequate ex parte remedies, properly balancing the interest of the majority and the minority.⁹¹ It respects minority preferred stockholders' right to refuse excessive risk-taking activities and does not overly constrain majority shareholders' right to take corporate actions to maximize its interest under the principle of capital majority representation.

As mentioned above, under Delaware laws, dissenting preferred stockholders are entitled to appraisal right unless specifically excluded in the contract ex ante and the methods to measure fair value could be stipulated in the contract. Appraisal right claim is an import weapon to deter majority common shareholders/ preferred stockholders from depriving minority preferred stockholders' legitimate interests.

However, under current Chinese law regime, preferred stockholders cannot effectively assert appraisal right to protect themselves against opportunism by majority shareholders as discussed below.

1. The Role of Appraisal Rights Under Chinese Law

Appraisal right was formally introduced into Company Law of the People's Republic of China in 2005. Under Article 74 and Article 142 of PRC Company Law (2005 Amended), a "shareholder" of both a limited liability company and a joint stock limited company can make appraisal right claim against several fundamental corporate actions, which include merger and split-up of the company.⁹²

⁹¹ See 叶陶冶 (Ye Taoye), 中国发展优先股制度研究 [Theory Studies on How to Develop Preferred Stocks in China], 上海交通大学 [Shanghai Jiaotong Univ.], at 79 (2008) [hereinafter Ye Article].

⁹² However, the scope fundamental corporate actions related to a limited liability company are broader than that of a joint stock limited company. Fundamental corporate actions related to a limited liability company include merge with others, to be split up, or *transfer substantial assets of the company to others*. A shareholder of a joint stock limited liability company has no appraisal action against transfer of all or substantial assets. See PRC Company Law, *supra* note 17, at art. 74.

2. Standard for Determining the Fair Value of Appraised Shares is Not Clear under Chinese Law

PRC Company Law does not impose any mandatory requirement on the standard for determine “reasonable” of appraised shares. For listed companies, the market practice is to follow the Stock Exchange’s guiding opinion by making reference to the average of trading price in the preceding 20, 60 or 180 trading days.⁹³

One noteworthy point is that DGCL⁹⁴ carves out certain exceptions to dissenting shareholders’ appraisal right. The major exception is so-called “market-out exception,” pursuant to which appraisal rights are not available to any classes or series of stock listed on a national securities exchange or held by more than two thousand holders.⁹⁵

However controversial it is, the current PRC Company Law does not recognize the “market-out exception.” Whenever a trigger happened, dissenting shareholders of even a listed company are entitled to exercising appraisal right. According to the administrative rules enacted by CSRC to implement Article 142 of PRC Company Law, listed company are required to remind, through public announcement within seven days upon approval of any merger or split-up, dissenting shareholders to exercise their appraisal rights. Many examples can demonstrate that this requirement is uniformly followed by listed companies, and the market practice is offering dissenting shareholders a “fair price” by reference to the average of trading price in the preceding 20, 60 or 180 trading days.⁹⁶

⁹³ See 深交所上市公司现金选择权业务指引 [Guiding Opinions on Appraisal Right in relation to Listed Companies] (promulgated by the Shenzhen Stock Exch., Sept. 6, 2011, effective Sept. 6, 2011) art. 15, CLI.6.158164 CHINALAWINFO.

⁹⁴ DEL. GEN. CORP. LAW § 262(b)(1).

⁹⁵ Francis Pileggi, *Chancery Confirms that Appraisal Rights Not Available for Shareholders who Could Receive Publicly Traded Shares of Acquirer*, DELAWARE CORPORATE & COMMERCIAL LITIGATION BLOG (Oct. 14, 2011), <http://www.delawarlitigation.com/2011/10/articles/chancery-court-updates/chancery-confirms-that-appraisal-rights-not-available-for-shareholders-who-could-receive-publicly-traded-shares-of-acquirer/>.

⁹⁶ See, e.g., 深发展 A: 吸收合并控股子公司平安银行异议股东收购请求权派发 [Reminder re Exercising Dissenting Shareholders’ Appraisal Right Against Merger Between Shenzhen Development Bank and PinAn Bank], 和讯网 [HEXUN] (May 8, 2012, 21:36), <http://bank.hexun.com/2012-05-08/141195658.html>.

However, few dissenting shareholders would choose to exercise their appraisal rights because the trading price of their shares after the announcement of merger or split-up is usually higher than the “reasonable price” determined by reference to the previous trading price. Only in some exceptional cases where the trading price of shares is drawn down by the announcement of merger or split-up, dissenting shareholders might choose to exercise their appraisal rights.

In sum, compared to Delaware court’s deference to the board’s business judgment on fair price, standard for determining the fair value of appraised shares is not clear under Chinese law. The market practice is following Stock Exchange’s regulatory requirements.

3. What Appraisal Right Means to Preferred Stockholders Under Chinese Law

In addition to “fair value” determination standard, another issue is that it is still unclear whether preferred stockholders can rely on appraisal right action or not for two major reasons:

a) The legal identity of preferred stockholders has not been officially recognized under PRC Company Law. Although Chinese scholars incline to believe that preferred stockholders are other “class shareholders” which shall be entitled to equal right to appraisal rights as common shareholders. This controversial issue needs to be solved by further legislation or judicial decisions.

b) Even though a preferred stockholder is qualified as a “shareholder” to make appraisal right claim, their interests may not be fully protected given the limited scope of fundamental corporate actions defined by PRC company law.⁹⁷

⁹⁷ Fundamental corporate actions defined by PRC Company Law are limited to 1) merge with others, 2) to be split up, and 3) transfer substantial assets of the company to others. Although, preferred stockholders’ class vote allowed by the Administrative Measures also broadly covers amendments to terms of articles of association related to preferred stocks, more than 10% reduction of registered capital in one event or in aggregation, issuance of preferred stocks and other matters as agreed in the articles of association, which may also be used by majority common shareholders/preferred stockholders to fundamentally change the expectation of minority preferred stockholders, such matters do not constitute fundamental corporate actions. See 中华人民共和国公司法(2014) [Company Law of the People’s Republic of China (2014)] (promulgated by the Nat’l People’s Cong.,

Merger and acquisition is one of the most important tools to reform state-owned enterprises. From 2008 to 2014, there were more than 1,700 merger and acquisition (excluding internal connected transaction) cases related to state-owned enterprises.⁹⁸ The number and transaction amount of merger and acquisition in relation to state-owned enterprises are expected to continue soaring. Under such trend, for the purpose of protecting preferred stockholders (either state-owned capital or private capital), their appraisal rights should be legally recognized both on traditional fundamental corporate actions that are tailored for protecting the interest of common shareholders and on other matters that may fundamentally change the expectation of minority preferred stockholders.

In sum, appraisal right system under Chinese laws needs overhauls to properly balance horizontal conflicts that are intensified after state-owned enterprise reforms. It is in urgent need to recognize preferred stockholders' appraisal right and amend the "fair value" value determination standard.

VII. CONCLUSION

Under U.S. laws, remedies granted by both contract laws and corporate laws focus on ex post protections. Bargained-for preference rights are respected unless violating public policy or positive law. This is consistent with courts' tradition not to second-guess the parties' bargained-for results and the board's independent business decisions. As some scholars observed, these legal principles arguably contribute to the flourishing of preferred stocks in the U.S., compared to some continental legal system countries such as France where the issuance of preferred stocks and protection of preferred stockholders' right are regulatory-oriented.⁹⁹

Unlike U.S. laws, Chinese laws focus on ex ante restrictions which arguably overly interfere with parties' freedom to negotiate

effective Mar. 1, 2014) art. 74 & 142, CLI.1.218774 CHINALAWINFO. See also Ye Article, *supra* note 91, at 43.

⁹⁸ See 2015 国企兼并重组报告: 新三板成国企重组新平台 [2015 Merger and Acquisition Report on State-Owned Enterprise: New Three Board Is New Platform For State-Owned Enterprise Restructure] (May 18, 2015), <http://mt.sohu.com/20150518/n413308143.shtml>.

⁹⁹ See 李晓珊 (Li Xiaoshan), 优先股的制度功能及理论视角之比较分析 [Comparative Studies on Theories and Functions of Preferred Stocks System], 证券法苑 [SEC. L. REV.], issue 12, at 405 (2014).

contract terms whereas ex post protection such as appraisal right remedies are underemphasized. Arguably, protection of preferred stockholders' rights under Chinese laws can be strengthened through advancing ex post protection mechanism such as breach of fiduciary claims and appraisal right action.

ANALYSIS OF THE THIRD PARTY INVOLVEMENT AS A NEW DEVELOPMENT IN CHINESE INTERNATIONAL ARBITRATION RULES

*Liu Xing'er**

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EDITOR'S NOTE:

This student note was written in 2014, the full version of which was part of the author's graduation thesis. We understand a few arbitration rules and other materials cited in this note may have been updated or revised with respect to the third-party participation in commercial arbitration procedure. Save for a few stylistic changes, the shortened version published here does not incorporate the latest rules and materials as many arguments were built particularly upon the then-effective rules. Nevertheless, the underlying theories and rationale for third-party participation remain largely intact.

I. INTRODUCTION

As the international commercial disputes are getting more and more complicated and diversified, third-party participation in arbitration has been increasingly common and become an unavoidable issue. This article intends to analyze, among others, the feasibility and evaluation of the third party involvement in arbitration procedure as one of significant innovations in recent development of commercial arbitration in China.

China has made considerable efforts since its accession to the World Trade Organization to provide a stable framework for foreign investment and economic growth. An important part of this reform is to develop international arbitration practice, which has been regarded as a preferred dispute resolution method for cross-broader transactions. The phenomenal trend of arbitration practice is reflected in the arbitration rules of different major institutions of China.

China International Economic and Trading Arbitration Committee (“CIETAC”), a foreign-related arbitration commission set up by the China Council for the Promotion of International Trade (also known as the China Chamber of International Commerce) (“CCPIT”), has been on the front page of local medias lately for its internal strife with its South China and Shanghai Sub-Commission, which have declared independence on October 22, 2012 and April 11, 2013, respectively.

The war started from the new amendments to its rules coming into effect on May 1, 2012. Both South China and Shanghai Sub-Commission rejected to apply the new rules and state themselves as independent commission. After Shenzhen branch changed its name into Shenzhen Court of International Arbitration (“SCIA”) with the new Arbitration Rules (“SCIA Arbitration Rules 2012”)¹ and Panel of Arbitrators, later in April 2013. CIETAC Shanghai changed its name into Shanghai International Arbitration Center (“SHIAC”) also with the new Arbitration Rules (“SHIAC Arbitration Rules 2013”)². It then updated its

¹ Full text of SCIA Arbitration Rules 2012 is available at <http://www.sccieta.c.org/download/files/document/20141117153011.pdf> (last visited December 31, 2016).

² Full text is available at http://cietac-sh.org/upload/day_130407/201304071023539471.pdf (last visited Dec. 31, 2016).

Arbitration Rules in May 2014 and January 2015 (“SHIAC Arbitration Rules 2014/2015”)³ together with the China (Shanghai) Pilot Free Trade Zone Arbitration Rules and updated in January 2015 (“Free Trade Zone Arbitration Rules 2014/2015”)⁴.

Though it is still controversial of whether it is legitimate or beneficial for the two former Sub-Commissions to be free from “chains” of CIETAC⁵, their new rules do have some significant improvement for international arbitration in Mainland China, borrowing some new ideas from international practice and combining with regional characteristics. One big innovation is that they both set new rules allowing third party to join the arbitration proceeding, which marks a significant progress in arbitration in China. Later, CIETAC published its new rules in Nov. 11, 2014 (“CIETAC Arbitration Rules 2014”)⁶ also addressing the issue of third party joinder in the current proceeding.

First, I will illustrate background information and the current international practice for third party involvement in arbitration, and the current debate about some concepts among scholars. Second, I will discuss the necessity and feasibility for China to have this third party coming into play in arbitration procedure by analyzing the legal framework and practical experiences in China. Last, I will give some suggestions on how to perfect the third-party rules in Arbitration Law in the future.

My main claim is that the involvement of arbitral third party is a significant innovation in international arbitration practice in China absorbing the advanced international experience. In order to achieve a further development, amendment to the Chinese Arbitration Law is called upon.

³ Full text is available at http://www.shiac.org/SHIAC/arbitrate_rules.aspx (last visited November 6, 2016).

⁴ Full text is available at http://www.cietac-sh.org/upload_files/file/2016/20160228221743_6619.pdf (last visited Dec. 31, 2016).

⁵ See Matthew Dresden, *Will the Real CIETAC Please Stand Up?*, CHINA LAW BLOG (May 21, 2013), <http://www.chinalawblog.com/2013/05/will-the-real-cietac-shanghai-please-stand-up.html>.

⁶ Full text available at http://cn.cietac.org/rules/rule_E.pdf (last visited Dec. 31, 2016).

II. AN OVERVIEW OF THIRD PARTY INVOLVEMENT IN ARBITRATION PROCEDURE

A. The Origin of Request for the Third Party Involvement in Arbitration Procedure

The third party involvement in litigation is the product of social economic, legal practice and legal theory exploration. It originates from the Roman law, and this system has been widely established in modern and current legal systems in many countries. For example, under Chinese Civil Procedure, a third-party is the party who has an independent right of claim to the subject matter in dispute in a certain case, but will be legally impacted by the result of the case, and therefore participate in the litigation which already started by the plaintiff and defendant.

The Chinese Civil Procedure Law has rules of allowing third parties whose interests are closely related to be involved in a civil case. Unfortunately, there are no provisions similar in the Chinese Arbitration Law. However, heavily influenced by civil procedure, administrative arbitration and labor arbitration, etc., third party involvement in commercial arbitration has been suggested to set up in the recent years frequently.

B. What Role does the Third Party May Play in Arbitration

1. As in SCIA, SHIAC and CIETAC—As an Actual Party

The third party can play as actual party, i.e. as Claimant or Respondent after joining the proceeding.

In SCIA Arbitration Rules 2012 art. 35, it says,

(1) After the commencement of the arbitral proceedings, a party may apply in writing to join an additional party under the same arbitration agreement to the arbitration . . . ;

(2) With the agreement in writing of each party and each third party, the arbitral tribunal has the power to permit one or more third parties to participate in the arbitration proceedings as Claimant or Respondent.

In SHIAC Arbitration Rules 2014, art. 31 Joinder of Third Parties⁷, it says,

The Claimant and the Respondent may request a third party to be joined in arbitration with its consent by a joint written application. A third party may also apply in writing to become a party in arbitration with the written consent of both parties. The tribunal shall decide on the joinder of a third party, or, if the tribunal has not been constituted, the Secretariat shall make such decision.

In Free Trade Zone Arbitration Rules 2014, art. 38 Joinder of Third Parties, it says,

The Claimant and the Respondent may request a third party to be joined in arbitration with its consent by a joint written application. A third party may also apply in writing to become a party in arbitration with the written consent of both parties. The tribunal shall decide on the joinder of a third party, or, if the tribunal has not been constituted, the Secretariat shall make such decision.

In CIETAC Arbitration Rules 2014, art. 18 Joinder of Additional Parties, it says,

(1) During the arbitral proceedings, a party wishing to join an additional party to the arbitration may file the Request for Joinder with CIETAC, based on the arbitration agreement invoked in the arbitration that *prima facie* binds the additional party. Where the Request for Joinder is filed after the formation of the arbitral tribunal, a decision shall be made by CIETAC after the arbitral tribunal hears from all parties including the additional party if the arbitral tribunal considers the joinder necessary.

...

⁷ This is the amendment to the third-party rules in the 2013 Rules. In this amendment, the third parties can join the arbitration proactively based on the consents of the parties in arbitration. This innovative amendment makes the rules regarding third parties more operative and applicable, which shows the feature of open but precision of the 2014 Rules.

(7) CIETAC shall have the power to decide not to join an additional party where the additional party is *prima facie* not bound by the arbitration agreement invoked in the arbitration, or where any other circumstance exists that makes the joinder inappropriate.

Although in both Rules of SHIAC and CIETAC, they are not clear like in SCIA whether the third party will act like an independent participant, separate from Claimant and Respondent, but the author still believes it means becoming Claimant or Respondent. The reasons are as follows: first, there is no historical precedent of an independent Third Party in China throughout the arbitration practice; second, the wordings are similar comparing these three rules; and third, according to the Reader's Guide to the Free Trade Zone Arbitration Rules 2014, it explains that

[i]n theory, the joinder of the non-signatory party can be considered as the situation that the parties of the existing proceeding has made a new arbitral agreement with the non-signatory party. However, considering the stability of the procedure, the tribunal or the Secretariat shall have the power to decide whether to allow this joinder.⁸

2. As an Independent Participant

The second role third parties can play after joining the proceeding is as the third parties themselves. Such an innovative role is too radical to China, and the author does not believe it is possible under current legal system.⁹ It will not be discussed here due to the limitation of words.

C. International Practice Regarding Third Party in Arbitration

The issue of third party joining the arbitral proceeding was first treated cautious by countries and institution rules. Recently,

⁸ 上海国际仲裁中心 (Shanghai International Arbitration Center) ET AL., 中国 (上海) 自由贸易试验区仲裁规则解读 [READER'S GUIDE TO THE FREE TRADE ZONE ARBITRATION RULES (translated by the author)], at 25 (Apr. 18, 2014), http://www.shiac.org/upload/day_140430/201404301048095277.pdf.

⁹ For more information, see 林一飞 (Lin Yifei), 论仲裁与第三人 [Analysis of the Third Party in Arbitration], 法学评论 [L. REV.], issue 1, at 91–97 (2000).

this system began to formulate mechanisms like multiple parties in one proceeding, other signatories of the arbitration agreement joining the proceeding, etc. Most of the mainstream arbitration rules have some rules about the conditions and methods for third party to join the arbitral proceedings. Especially in the new edition of UNCITRAL Arbitration Rules in 2010, it finally set forth the third party system in arbitration¹⁰ after heated debate, and non-signatory party joining the arbitral proceeding ensued thereafter.

1. International Practice—Only Need Consent of a Third Party and One of the Parties

In some arbitration laws and rules, only one of the parties and a third party's consent to arbitrate is enough.

In art. 22.1(viii) of the arbitration rules of the London Court of International Arbitration (“LCIA”) (2014), it sets forth that the tribunal can decide whether to include “one or more third persons,” “provided any such third person and the applicant party have consented to such joinder in writing.”¹¹

As stated in art. 11 of the arbitration rules of the Belgian Centre for Mediation and Arbitration (“CEPANI”) (2013),

A third party may request to intervene in the proceedings and any party to the proceedings may seek to have a third party joined. The intervention may be allowed when the third party and the parties to the dispute have agreed to have recourse to arbitration under the CEPANI Rules.¹²

¹⁰ See UNCITRAL Arbitration Rules 2010, Section III, art. 17(5): “The arbitral tribunal may, at the request of any party, allow one or more third persons to be joined in the arbitration as a party provided such person is a party to the arbitration agreement, unless the arbitral tribunal finds, after giving all parties, including the person or persons to be joined, the opportunity to be heard, that joinder should not be permitted because of prejudice to any of those parties.”

¹¹ Full text available at http://www.lcia.org/Dispute_Resolution_Services/lcia-arbitration-rules-2014.aspx (last visited Dec. 31, 2016).

¹² Full text available at http://www.cepani.be/sites/default/files/images/hayez_reglement_arbitrage_cepani_en_dec2014_1.1.pdf (last visited Dec. 31, 2016).

2. International Practice Requiring Consent of All Parties

Both in art. 4 of the Swiss Rules of International Arbitration (2012)¹³ and art. 22(5) of the arbitration rules of the Milan Chamber of Arbitration (2010), the decision of a joinder of third parties shall be made upon request by the third parties or by the parties of the existing arbitral proceeding, after consulting with all of the parties, taking into account all relevant circumstances.¹⁴

In *Netherland Code of Civil Procedure* (1986), art. 1054, it sets forth the most detailed provisions regarding third party involvement ever, which regards third party in arbitration similar to the one in civil proceeding. It applies to two situations: The first possibility is that the third party with crucial interests with the result of the proceeding should apply in written; The other possibility is that the parties of the existing proceeding believe that the third party needs to make compensation and apply to grab the third party into the existing proceeding. It also requires a written consent of all parties. Other similar provisions can be found in *the Sixth Part of Belgian Judicial Code (Amended 1985)*, art. 1696 bis. (Note that the Belgian Judicial Code not only requests all parties' written consent, it also requires the consent from the Tribunal).

D. Some Concepts about Third Party in Arbitration

Not all parties other than the contracting parties can be introduced into the existing arbitral proceeding. Arbitration agreements are “creatures of contract” and “contractual by nature,” the argument follows that “international arbitration would run the risk of being denaturalized if it strays too far afield from the very tenets upon which it is premised.”¹⁵ Currently there are several opinions about how to define third party in arbitration.

The first opinion virtually reiterates what has been defined in

¹³ Full text available at https://www.swissarbitration.org/sa/download/SRIA_english_2012.pdf (last visited Dec. 31, 2016).

¹⁴ Section I, art. 4(2). Cf. The innovative provision art. 14 of the Rules of Arbitration and Conciliation of VIAC (Vienna Rules), art. 14(1), which also permit joinder after hearing all parties and the third party to be joined as well as after considering all relevant circumstances.

¹⁵ Pedro J. Martinez-Fraga, *the Dilemma of Extending International Commercial Arbitration Clauses to Third Parties: Is Protecting Federal Policy While Accommodating Economic Globalization a Bridge to Nowhere?*, 46 CORNELL INT'L L.J. 291, 298 (Spring 2013).

civil litigation: only those people who participate in the case since he or she has independent right of claim to the subject matter in dispute, or will be legally impacted by the result of the case. However, in light of the substantial differences between arbitration and litigation it may not be 100% appropriate to repeat.

The second opinion is to distinguish third party who has an independent right of claim and who has dependent right of claim. This theory introduced the concept that the arbitral third party has to be a non-signatory of arbitration agreement in the first place, also maybe called as “non-signatory parties.”¹⁶ According to the Chinese Arbitration Law, art. 4, arbitration agreement should be in writing, which is based on the New York Convention, into which China entered in 1986. However, in practice, a lot of countries have recognized alternative forms of an arbitration agreement, like oral or implied. The author believes that more attention should be paid to the genuine “meeting of minds” to decide who are the real parties to the arbitration agreement rather than rigidly looking at the signatures.

The third opinion is the third party in arbitration is a non-signatory party who participates into, or intervenes a commenced arbitral procedure because this party satisfies certain conditions. In author’s view, here “certain” conditions are not specific enough and easy to cause ambiguity. Also, the non-signatory here might also be signatory parties of other arbitral agreement, and there is possibility of merging case, then it just enlarges the concept of third party in arbitration.

In author’s conclusion, there should be four conditions to let the third party participate into an arbitral procedure. The third party in arbitration must first come out of an arbitral procedure. Also, this party should have his or her own legal interest in this case. Third, according to party autonomy principle, in order to join the existing proceeding, to involve the third party, it must be requested by (one of the) parties, not by tribunal itself¹⁷. Fourth, the

¹⁶ See Dr. Stavros Brekoulakis, *The Relevance of the Interests of Third Parties in Arbitration: Taking a Closer Look at the Elephant in the Room*, 113 PENN ST. L. REV. 1165, 1166 (Spring 2009): “FN 1: . . . A non-signatory party, however, should be distinguished from a third party, as, strictly speaking, the former is a person that has consented to an arbitration agreement and thus is bound by it, notwithstanding the fact that the person failed to sign it.”

¹⁷ For further detailed analysis, please see Part III below.

time for the third party to participate should follow the rules set in Civil Procedure Law, i.e., between the commencement of the arbitral procedure and rendering result of the procedure.¹⁸ Last, it should also be approved by the relevant arbitral institution in principle to ensure the procedural stability. Nevertheless, without specific reasons, an arbitral organization should not reject the participation of a third party.

III. NECESSITY AND FEASIBILITY OF ALLOWING THIRD PARTY INVOLVEMENT IN INTERNATIONAL ARBITRATION IN CHINA

A. Necessity

The dawn of 21st century has witnessed the booming of modern business, especially transnational transactions, involving multiple parties to complete a single project, who are connected by separate bilateral contracts with different dispute resolution clauses. The non-signatory parties might play an important role in the project or performing the contract, but cannot participate or initiate an arbitration proceeding. These non-signatory parties will still be outside the arbitration despite the fact that their interests are crucial to the case.¹⁹

Like civil litigation system, arbitration should also allow the third party to involve in order to achieve justice, especially when the third party play a crucial role in performing the contract. There are some scenarios that might need such mechanism:

- Transfer of property and escape debt. In this case, the parties might not have an actual dispute, but to forge a dispute in order to help one party to gain illegitimate benefits by taking advantage of an arbitral award to transfer property and escape debt to a third party outside of the case, so as to hurt the interests of such third party.
- In contract assignment, the original signatories of the contract deliberately conceal the fact that the parties to the agreement have already changed, and force one party to perform the contract to the other party, so as to deprive the legitimate contractual right of the true creditor.

¹⁸ The objections by the non-signatory party are beyond the limit of our discussion in this paper.

¹⁹ Dr. Stavros Brekoulakis, *supra* note 16, at 1165.

- Fake debt relationship. Parties of such fake relationship force the guarantor to perform the liability through the arbitral award, so as to occupy the guarantor's property.
- Joint property owner conspires with one party of an arbitration to reach an award that the jointly-owned property belongs to himself/herself alone, or deprive the legal right of other creditors by making the debtor to fulfill all obligations.
- Controlling shareholder manipulates the company and benefits from an arbitration with large amount of financial repercussions. It will harm the interests of other shareholders.
- Parent company might suffer from the breach of a contract signed by its subsidiary and another party, although the parent company is not a signatory party.²⁰

All the above examples indicate that the legitimate interests of a third party may be influenced without being involved in the arbitration. This certainly does not comport with the purported intention of arbitration as a party-autonomous alternative mechanism for dispute resolution

However, in China, since there was no third party involvement in arbitration, the dispute settlement cost was great and the proceedings are relatively long. In *Jiangsu Material Group Light & Textile Corporation v. Top Capital Holdings Ltd., (Hong Kong) & Prince Development Ltd., (Canada)* (1998), the Supreme People's Court of China ruled that when the arbitral tribunal had no power to rule on third party's liability, injured party can sue the third party separately as remedy. This ruling indicates that only by introducing the third party involvement in arbitration can the parties get the most satisfactory results and make the arbitration proceeding more efficient.

There are altogether three necessities of introducing third party involvement in arbitration: 1) to protect the third party's interests according to the principle of equality and fairness; 2) to improve efficiency and reduce legal costs by the simplified system; 3) to ensure the arbitrator can grasp a clear picture of the whole case to avoid missing evidences and facts, etc.

²⁰ 周征 (Zhou Zheng), 仲裁裁决对案外第三人利益侵害及防止 [The Adverse Effect and Its Prevention to the Third Party outside the Arbitration of An Arbitral Award], 法制博览 [LEGALITY VISION], issue 8, at 42-44 (2014).

B. Feasibility

1. Supporters of Third-party Involvement

(a) In Accordance with the Arbitration Values of Justice and Benefit

Benefit and justice are two values emphasized in arbitration. Procedures are designed to serve these values, thus introducing the third party involvement in arbitral proceeding fits these two values. To introduce third party can solve the problems all in one proceedings with no further litigation or arbitration proceedings which may cost additional money, time and energy.

Another function of this third party system is to investigate the case facts thoroughly in order to solve disputes completely, and avoid contradictory awards. From this point of view, it also fits the value of justice of commercial arbitration. Therefore, it is feasible to establish the system of third party involvement in arbitration since it reflects and unifies the value of justice and benefit.

(b) Party Autonomy

Party autonomy here means that it is the parties that choose arbitral methods, arbitration institution, arbitrators, arbitral procedure and the applicable laws to resolve their dispute.

Here as set forth in Arbitration Rules of SCIA art. 35, SHIAC art. 31 and Free Trade Zone art. 38, as long as all parties consent in writing to join the third party, the tribunal will allow it. In CIETAC, the tribunal only needs to “hear from all parties including the additional party,” without specifically indicate the agreement should be in writing. Since party autonomy is the primary character of arbitration, such agreement should be respected by the tribunal.

(c) Extending the Scope of an Arbitration Agreement

The theoretical basis to extend the scope of an arbitration agreement is in the contract law. The relativity of contract means that the rights and obligations only bind contractual parties. However, current international practice allows a third party to ask for remedy as a beneficiary of the contract. Note that under the

rules requiring all parties to consent in writing, a new arbitral agreement has been formed. Therefore, it still remains within the scope of the arbitration agreement and the doctrine of party autonomy. This is the least controversial basis to commence a multiparty arbitration. This doctrine should only be discussed for the more controversial scenarios below which are mostly on the basis of implied consent, evidenced by conduct or fact pattern developed by non-signatories theories.²¹

(d) Jurisprudential Basis

i. Fair and Reasonable Expectation Principle

In international commercial arbitration practice, a third-party non-signatory who wishes to rely on fair and reasonable expectation principle must prove that extending the scope of the arbitration agreement is fair and reasonable to the benefits of signatories and the third party itself. In the author's opinion, to apply this principle, we need to first determine the true intention based on the signatories' behavior, and then to see whether the benefits are fair and reasonable.

ii. Third Party Beneficiary

This situation usually happens when an arbitration clause in a contract explicitly allow the non-signatory parties who receive the benefit of the contract to enforce such clause against signatories.²² To make one step further, some tribunals also apply this doctrine when they can find the common intentions of the signatories to grant such benefits to the non-signatory party. According to Hosking, the latest trend of this doctrine is "toward greater recognition of third party beneficiary rights and application of a test which has at its touchstone the 'intention' of the parties."²³

All the above theories of extending the arbitration agreement

²¹ Such scenarios are listed in Part III, Scenario 2, 3 & 4 below.

²² To distinguish from the estoppel doctrine below, the arbitral tribunal must analyze the intentions of the parties at the time of contracting before applying this theory.

²³ James M. Hosking, *The Third Party Non-Signatory's Ability to Compel International Commercial Arbitration: Doing Justice without Destroying Consent*, 4 PEPP. DISP. RESOL. L.J. 469, 527 (2004), available at <http://digitalcommons.pepperdine.edu/drlj/vol4/iss3/6>.

to the third party beneficiary does not require express agreement formed by the three parties.

This theory is normally less controversial since there normally are evidence of clear intention of the signatories to protect such third parties, therefore convenient for tribunals to apply without many theoretical obstacles.

iii. The Group of Companies Doctrine

This doctrine, probably the “best-known theory to extend the scope of the arbitral agreement,”²⁴ is applied to find arbitration obligations in situations where required deliveries. In the landmark *Dow Chemical* case, not only the signatories, Dow Chemical A.G. and Dow Chemical Europe, started the arbitration against Isover Saint Gobain, Dow Chemical France and their parent company Dow Chemical Company (both non-signatories) were also applicants. The respondent quickly challenged the standing of the latter two applicants since they are non-signatory parties.

Then the tribunal has to decide the question of whether the arbitration agreement can bind non-signatories who actually participate in performing the contract? Considering the role the parent company and the French subsidiary played, the true intention of all parties, the tribunal rejected such objection in its interim award, and held that even if single members may have a distinct juridical identity, tribunal must take into account the fact that Dow Chemical Company and its subsidiaries actually formed “a group of companies constitute one and the same economic reality.” Under such circumstances, the arbitration clause contained in the agreement signed by one or some of the subsidiaries with another company shall also bind the other non-signatory parties within such group of companies. What’s worth noting in this case is that the tribunal did not abandon the requirement of party autonomy. On the contrary, the tribunal has made such decision on the premise of recognizing such party autonomy, and the tribunal believes that applying the group of companies theory at the same time does not violate the true intention of parties.

²⁴ Simon Brinsmead, *Extending the Application of An Arbitration Clause to Third-Party Non-Signatories: Which Law Should Apply?*, available at <http://ssrn.com/abstract=980483> (last visited Dec. 31, 2016).

The group of companies theory relies on two elements, an objective and a subjective one. First, to find the “actual existence of a group of companies under common ownership, operating and being managed closely by the parent company;”²⁵ Second, it should be “represented by the implied acquiescence of the parent company to the contracts entered by the subsidiary and the participation of the parent company in the formation, performance and/or termination of the contract.”²⁶ This doctrine is undergoing important changes, since traditionally, the veil of a legal personality was lifted only when it came to fraud, but invoking the group of companies’ doctrine it is also lifted when there was no wrongdoing.

It is important to consider that the UNCITRAL Working Group on Arbitration sustained that the group of companies fact pattern might not require a written arbitration agreement, noting that this theory had been applied repeatedly by arbitral tribunals and even had been approved by some courts.²⁷ According to its report, the doctrine required proof of the following:

- 1) that the legally distinct company being brought under the arbitration agreement is part of a group of companies that constitutes one economic reality [. . .];
- 2) that the company played an active role in the conclusion and performance of the contract; and
- 3) that including the company under the arbitration agreement reflects the mutual intention of all parties to the proceedings.²⁸

However, as UNCITRAL noted, national courts tend to interpret the written requirement more liberally “in accordance with

²⁵ Rafael Boza, *Caveat Arbitrator: The U.S.-Peru Trade Promotion Agreement, Peruvian Arbitration Law, and the Extension of the Arbitration Agreement to Non-Signatories. Has Peru Gone Too Far?* CURRENTS: INT’L TRADE L.J. 17, 68 (2009).

²⁶ *Id.*

²⁷ See Yaroslau Kryvoi, *Piercing the Corporate Veil in International Arbitration*, 1 GLOBAL BUS LAW REV. 169, 177 (2011), citing The Secretary General, *Report of the Secretary General on Possible Uniform Rules on Certain Issues Concerning Settlement of Commercial Disputes: Conciliation, Interim Measures of Protection, Written Form for Arbitration Agreement*, Addendum ¶¶ 11, 12(m), and 12 n.1 delivered to the U.N. Commission on International Trade Law [COITL], Working Group on Arbitration, U.N. DOC. A/CN.9/WG.II/WP.108/ADD.1 (JAN. 26, 2000).

²⁸ Kryvoi, *supra* note 29.

international practice and the expectations of the parties.”²⁹

In general, the “group of companies” doctrine has been used for quite some time and in a considerable amount of awards by arbitral tribunals to justify the extension of an arbitration agreement to third non-signatory parties without making a new express agreement, allowing them to take more informed and therefore more equitable decisions.

This doctrine, however, becomes controversial when it comes to the conflict of laws rules and public policy. The German Federal Supreme Court set aside the judgments of lower courts using the group of companies doctrine and chose not to follow the *Dow Chemical* approach in a case involving a third party closely connected to signatory parties in a license contract, saying that there was no necessity to protect such third party in the present case.

Another opposing opinion focuses on whether such doctrine can form *lex mercatoria* (commercial custom law). The author believes that since such doctrine is still under development and most countries have not recognized it forming *lex mercatoria*, then it might be too early to categorize it as a customary law in international trade or commercial practice.³⁰ The U.K. even questions and refuses to adopt such doctrine. In *Perterson Farms Inc. v. C&M Farming Ltd.*, Judge Langley refused to follow the *Dow Chemical* approach and believes that there is no such doctrine in the English law that governs the arbitration clause.³¹

Therefore, succeeding in the arbitration based on this doctrine is only “half of the battle,” as Schwedt and Grothaus put it, so that “the decision to go for arbitration against non-signatories of the arbitration agreement must thus be taken with eyes wide open.”³²

²⁹ *Id.*

³⁰ 蔡滢炜 (Cai Yingwei), 公司集团理论及其风险防范 [The Group of Companies Doctrine and How to Control its Risk], 法律图书馆 [LAW-LIB.COM], Dec. 13, 2012, http://www.law-lib.com/lw/lw_view.asp?no=23055.

³¹ *Id.*, citing *Perterson Farms Inc. v. C&M Farming Ltd.*, EWHC 121 (Comm. Ct. Arb. 2004).

³² Krinstin Schwedt & Julia Grothaus, *When does An Arbitration Agreement have A Binding Effect on Non-Signatories? The Group of Companies Doctrine vs. Conflict of Laws Rules and Public Policy*, KLUWERARBITRATION.COM (30 July, 2014), <http://kluwerarbitrationblog.com/blog/author/kirstinschw>

iv. Estoppel

The common law doctrine, Equitable Estoppel, is frequently used in the U.S. judicial practice to expand the scope of arbitration agreement. Although China is a civil law country, the principle of good faith/bona fide is often used to the similar effect of estoppel doctrine. The doctrine of estoppel means that “one is not allowed to contradict itself to the detriment of others, has been expanded in use to cover situations where third party beneficiaries of a contract containing an arbitration clause evade liability on the mere basis of being a non-signatory.”³³

There are three possible scenarios to apply this doctrine: First, when a non-signatory receives a direct benefit from a contract, the arbitration clause in this contract can bind such party because of this theory and cannot refuse to comply. Second, when a non-signatory party has a close connection with the signatories, or certain misconduct has an inseparable connection with such non-signatory party, then such doctrine shall apply. Third, signatories have reliance on the non-signatory’s performance of the contract, etc., which contains an arbitration clause.³⁴

Estoppel means to extent the arbitration agreement to create a right not as a party but as an important player who is just like a real party shouldering contractual responsibility. The non-signatory arbitration issue arises when a party, as an outsider of the contract, cannot deny that the other signatory in dispute has the right to rely on such arbitration agreement contained. Some also think that in case of arbitration, estoppel prevents the imbalance of a non-signatory party receiving benefits from a contract but escape responsibility when dispute arises, or prevents a non-signatory from claiming that because of not having signed the arbitration agreement it cannot be obliged to join arbitration when it has consistently required that other provisions of the same contract containing the arbitration clause should be enforced to benefit it.³⁵

edt/.

³³ VLADIMIR PAVIC, *Non-Signatories and the Long Arm of Arbitral Jurisdiction* 224, in *RESOLVING INTERNATIONAL CONFLICTS—LIBER AMICORUM TIBOR VARADY* (Peter Hay et al. eds., Central European University Press, 2009).

³⁴ Tang, *supra* note 27, at 20.

³⁵ Clint Corrie, *Challenges in International Arbitration for*

In brief, the essence of equitable estoppel is that a party may not take advantage out of rights and relationships created by a contract while it avoids at the same time fulfilling the obligations of that same contract because it finds them inconvenient. Arbitral tribunals have interpreted the estoppel doctrine in that sense, applying it in practice in a growing number of cases to avoid possible situations of abuse and arrive to a just decision. Here, the tribunal can use this theory to overcome the requirement of a new express agreement by parties.

However, this doctrine might also meet some obstacles in using to extent the scope of arbitration agreement due to the following reasons:

First, the estoppel doctrine does not go in line with the doctrine of justifiable reliance in common law system. Therefore, not all American courts receive this notion and there are some special applicable standards through the development of legal practice.³⁶

Second, the estoppel doctrine, being a common law notion, has no direct application now in China. Therefore, we can foresee some reluctance from the tribunal to extend the scope of an arbitration agreement based on this theory.

Despite the above two possible reasons to make it more controversial, the principle of estoppel is indeed quite logical to adopt when introducing the third party into the existing proceeding.

(e) Practical Needs in Commercial Arbitration Process

As the Chinese economy booms, cases of international commercial arbitration are on the rise in China. The increasing number of cases has led to the following practical needs to involve third parties in commercial arbitration:

i. Merger and Acquisition of Enterprises

Non-Signatories, in *COMPARATIVE LAW YEARBOOK OF INT'L BUS.* 29, 59 (2007).

³⁶ For example, the court of Alabama believes that unless the contract language demonstrates that the dispute does not limit to signatories, and one of the applicant has to base its application on "intertwined claims" to allow this doctrine to apply. Michael A. Rosenhouse, *Application of Equitable Estoppel to Compel Arbitration by or against Nonsignatory-State Cases*, 22 A.L.R. Issue 6, 387.

In case of merger, courts and tribunals tends to hold that the third party will be bound by the arbitration clause attached to the contract. In *Fyrnetics (HK) Ltd., v. Quantum Group, Inc.*³⁷, Fyrnetics entered into a license agreement with Quantum, in relation to a biomimetic sensor that Quantum had developed and patented. Fyrnetics was merged with Kidde and subsequently dissolved as a separate corporate entity. When a dispute arose out of the license agreement, Kidde filed a claim against Quantum before the US courts, notwithstanding the fact that the license agreement contained an arbitration clause. Kidde argued that it was not bound by the arbitration clause in the license agreement, which had been signed and agreed by Fyrnetics, rather than Kidde. The Seventh Circuit Court rejected Kidde's argument upholding the district court's ruling that

[w]hen Kidde caused Fyrnetics to be merged into Kidde and then dissolved, Kidde voluntarily assumed the obligation of Fyrnetics' licence agreement Kidde, which is making claims that are partly those of Fyrnetics, cannot escape application of the license agreement's arbitration requirement by effectively legislating Fyrnetics out of existence.

ii. Assignment—Transfer of Contractual Rights and Obligations

Originally, it was disputed whether arbitration agreements could be transferred by way of assignment. Now it is universally accepted that arbitration agreements are as assignable as any other contract.³⁸ There are three questions arose on this issue:

First, whether the assignee is required to specifically consent to the arbitration clause contained in the assigned contract. Here, the rule of automatic transfer of arbitration clauses prevails, according to which general consent of the assignee to assume the main contract is sufficient for the contained arbitration clause to be transferred as well. Second, whether the debtor is required to consent to the assignment of the arbitration clause. The prevailing

³⁷ *Fyrnetics (HK) Ltd. v. Quantum Group, Inc.*, 293 F.3d 1023, 1027 (7th Cir. 2002).

³⁸ See in general, GARY BORN, *INTERNATIONAL COMMERCIAL ARBITRATION* 1187 (2nd ed., Kluwer 2009).

view here is that in the absence of any indication of the contrary the transfer of an arbitration agreement is not dependent on the prior consent of the debtor.³⁹ Exceptionally, consent of the debtor will be needed when the original parties have excluded the assignment⁴⁰ of an arbitration agreement. The last question is which law will apply to determine the validity and effects of the assignment of the arbitration clause. The authors argue that the issue of validity of the assignment of the arbitration clause should be determined by non-national substantive rules that primarily focus on the consent of the assignee. Therefore, it is mostly determined by national laws, which are more technical and will usually provide for other requirements apart from consent of the assignee, including for example the requirement that the debtor is notified of the assignment. Chinese Civil Law does not have a clear provision regarding this issue, but the legal practice has already shown that if the consent by the assignee, then the debtor should be bound by the arbitration clause contained in the main contract.⁴¹

iii. Transfer of Debt

By assuming the debt of the transferor, the transferee will also be bound by the arbitration clause attached to the debt. In the ICC case *L v. M*⁴² a contract for the construction of hospitals in Russia was concluded between M, a Turkish contractor and P, a Russian owner. Subsequently, L, another Russian company, intervened in the contract and provided guarantee for the debt of the original owner vis-à-vis the Turkish contractor. As the original contract provided for an ICC arbitration clause in Geneva, the Turkish contractor brought an arbitration claim against P and L. L argued that it was not bound by the arbitration clause, but the tri-

³⁹ FOUCHARD GAILLARD GOLDMAN ON INTERNATIONAL COMMERCIAL ARBITRATION, para. 717 (Emmanuel Gaillard & John Savage, eds., Kluwer Law International, 2009).

⁴⁰ Here the exclusion of assignment of an arbitration clause can be either express or implied.

⁴¹ 李志强 (Li Zhiqiang), 合同转让对仲裁条款效力的影响仲裁与法律 [The Impact of Contract Transfer to the Arbitration Agreement], 中国国际经济贸易仲裁委员会 [CN.CIETAC.ORG], at 55-76, 2002, <http://cn.cietac.org/theoryresearch/Theory.asp?stitle=%BA%CF%CD%AC%D7%AA%C8%C3%B6%D4%D6%D9%B2C3%CC%F5%BF%EE%B5%C4%D3%Bo%CF%EC> (last visited Dec. 31, 2016).

⁴² LUKoil-Permnefteorgsintez, LLC v. MIR, Swiss Federal Tribunal, 20 ASA Bull. 482 (2002).

bunal rejected its argument, holding that—on the basis of the factual circumstances of the case—L had effectively assumed, rather than merely guaranteed, P’s debt and obligations arising out of the construction contract was sufficient for L to be bound by the arbitration clause contained in the construction contract too.⁴³ Such determination by the tribunal rules out the necessity to form a new express agreement as well.

iv. Right of Subrogation

The Paris Court of Appeal in its 13 November 1992 decision rejected an application to set aside an award against an insurance company which the tribunal had found to be subrogated into the arbitration clause concluded by the insured. The court held that “as a consequence of the subrogation of an insurance company in the rights and duties of its insured, the arbitration clause is transferred to the insurer with the claim and the rights of the insured, as it is an accessory thereof.”⁴⁴ In the Partial Award of 17 May 2005, issued by a tribunal under the Netherlands Arbitration Institution Rules, a joint venture entered into a contract for the supply and delivery of machines with an Italian manufacturer. After an accident occurred due to defective machines, the insurer of the joint venture reimbursed part of the damages suffered by a third party, and subsequently they brought an arbitration claim against the successor of the Italian manufacturer. The arbitral tribunal rejected the respondent’s argument that the tribunal had no jurisdiction over the claimant insurance company. The arbitral tribunal held that the insurers had been automatically subrogated into the arbitration clause, contained in the main contract:

Technically, subrogation gives the third party the same rights as the original creditor which also includes accessory rights. The Tribunal considers that an arbitral clause is such an accessory right and that the principle of the severability of the arbitral clause . . . does not extend beyond the case of nullity of the main agreement of affect subrogation. Moreover, from a policy

⁴³ *Id.*, at 491.

⁴⁴ Paris Court d’Appel, Nov. 13 1992, Rev. Arb. 632 (1993) with note Jean-Louis Goutal. However, *cf.* the U.S. *contra* decision in Valley Casework, Inc. v. Comfort Constr. Inc., 76 Cal. App. 4th 1013, 1024 (Cal. Ct. App. 1999).

perspective, the Tribunal also considers that a debtor who agreed to arbitrate disputes stemming from a particular legal relationship, should not be able to avoid arbitration when a third party satisfies the creditor and by operation of law is subrogated into the rights of that creditor.⁴⁵

v. Representation: Agency and Apparent Authority

Although the exact meaning of agency and representation varies slightly across jurisdictions, the basic proposition behind these theories is that a party (agent) executes a contract on behalf of another person (principal).⁴⁶ The main question here is whether the principal must provide the agent with specific authorization to enter into an arbitration clause, as opposed to general authorization to conclude a substantive contract; and if yes, whether the specific authorization would need to take a particular form. It is prevailing deemed that when an agent possesses power to conclude a substantive contract, specific authorization to conclude an arbitration clause is required.

Broadly, there are two typical factual scenarios where a party may rely on agency and apparent authority when dealing with corporations: First, a company, more likely the subsidiary or an affiliate, concludes a contract representing another company of the same group, most likely the parent; Second, an employee or a shareholder or a corporate officer of a company concludes a contract representing the company. In both of the above scenarios, the claimant will often prefer to bring an arbitration claim directly against the company rather than against the subsidiary or the employee. The subsidiary might merely be a sham company with limited financial resources.⁴⁷

2. Opponents of Third-party Involvement

Many scholars have opposed to introducing third party in arbitration based on the following grounds:

⁴⁵ *Id.*, paras. 26–27 of the award.

⁴⁶ See UNIDROIT Principles of International Commercial Contracts, art. 2.2 (2004); see also Restatement (Third) Agency para. 2.01 (2006).

⁴⁷ STAVROS BREKOULAKIS, *THIRD PARTIES IN INTERNATIONAL COMMERCIAL ARBITRATION* 56 (Oxford University Press, 2008).

(a) Party Autonomy and Autonomy of Arbitration Agreement

They believe that an arbitral tribunal's jurisdiction only comes out of the authorization of the parties through arbitration agreement. No outsider could authorize the tribunal to exercise such jurisdiction simply by application as a third party.⁴⁸ Also in case of assignment, the rule of automatic transfer violates the principles of separability and "autonomy of arbitration agreements," and it undermines the independent status of the arbitration agreement from the main contract.⁴⁹

Even if it is allowed theoretically to involve the related third party in case there is new arbitration agreement, what about the situation where no express agreement is found? Without express agreement, the tribunal shall not include the related third party against the party autonomy.

As regard to the fact that parties accept the set of arbitration rules means their consent to all the provision. True, but it is still arguable whether all parties agreeing on a set of rules are perfectly aware of the existence of non-consensual third-party mechanism. In this sense, the party autonomy has not been fully respected.

(b) Certainty of Parties in Arbitration

Certainty is one of the main reasons to have the contract in the first place. By adding a third party into the proceeding is against this principle. Also, the parties chose to arbitrate instead of to litigate is because of the unofficial nature of arbitration, thus giving the tribunal such power to involve the related third party would possibly hurt the initial intention of the signatory parties.

As Hosking pointed out, the "third party problems" do exist, and among several problems listed, it might create uncertainty.⁵⁰

(c) Confidentiality and Cost-Efficiency

Arbitration should be confidential in principle compared

⁴⁸ 乔欣 (QIAO XIN), 《仲裁权论》 [ANALYSIS OF RIGHTS IN ARBITRATION], at 281 (2009).

⁴⁹ See STAVROS BREKOULAKIS, *supra* note 70, at 32.

⁵⁰ Hosking, *supra* note 57, at 561.

with litigation, and it excludes any third party. Its procedure, evidences, documents related, etc. are not public to the outside world in general. If allowing the third party to be involved, there might be dangers of exposing the trade secrets, which is definitely against the parties' will to choose arbitration.

Also, some scholars believe that allowing the third party involvement could procrastinate the existing proceeding, and make it more complicated and prolonged, and increase parties' cost of arbitration at the same time. As is known to all, the life of arbitration is its efficiency, hence allowing the third party to involve is no doubt making the arbitration lose its advantage as an Alternative Dispute Resolution (ADR).⁵¹

(d) Lack of Legal Basis in Arbitration Law

Chinese Arbitration Law has no stipulation regarding third party involvement in arbitration. From this point, we cannot act beyond the legal boundary.

According to the 1994 Arbitration Law, Art. 4, in China parties must have the intention to arbitrate (as the substantial requirement), and also a written arbitral agreement (formalistic requirement), then the arbitral tribunal can exercise its jurisdiction. Therefore, according to the Arbitration Law, the non-signatory, i.e. the third party here has no basis to step into the existing proceeding without an arbitration agreement with signatories.

(e) Court Enforcement

Internationally, New York Convention on Recognition and Enforcement of Arbitral Awards (1958) ("New York Convention")⁵² is the primary international mechanism for recognition and enforcement of awards. According to the New York Convention, it might have some problem enforcing the awards involving a third-party. The arbitral tribunal might have to re-composed after introducing the third party, therefore the tribunal or the arbitral

⁵¹ 林一飞 (Lin Yifei), 论仲裁与第三人 [Analysis of the Third Party in Arbitration], 法学评论 [L. REV.], issue 1, 91-97, 97 (2000).

⁵² *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, New York, 10 June 1958, United Nations Treaty Series, vol. 330, No. 4739, 3, available at http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII_1_e.pdf.

proceeding is different from the ones agreed by parties of the original contract in the beginning. Under this circumstance, the party who loses the case might invoke the New York Convention and request the place of recognizing and enforcing the arbitral award to refuse recognition and enforcement according to art. V(1)(c)⁵³—“[a]ward deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration”

3. Why the opponents' views are wrong

(a) Restricted Allowance of Third Party Does Not Jeopardize the Autonomy of Arbitration Agreement in Case of Assignment and the Party Autonomy

In the case of assignment, the principle of separability (autonomy of arbitration agreement) has little relevance. The transferee substitutes the transferor and assumes its legal position all together and in exactly the same terms. The transferee “enters into transferor’s shoes.” The transferee cannot choose to assume the transferor’s substantive right only without the attached arbitration clause. The arbitration clause is in effect attached to the mechanism whereby the substantive rights of the contract will be enforced in case of default of a party. Hence, here the principle of separability creates no theoretical impediment to the automatic transfer of arbitration clause. Here no need of consent.

It should be distinguished with the case where a new party is added to the original parties in a contract containing an arbitration clause, where the principle of separability is more relevant. This is the case when adding a third party for the purpose of joinder, and when specific consents to arbitrate are obtained, there should be no obstacle.

Also as to the party autonomy, it does not jeopardize the “meeting of minds,” they just simply come up with new “meeting of minds” by signing a new arbitration agreement by signatory parties and non-signatory party of the old agreement. Moreover, not only party autonomy has not been jeopardized, the very reason

⁵³ *Id.*, art. V(1)(c).

to have the third party involvement is to respect such autonomy—if all parties agree to add the third party, why not do so if they are efficient and cost-benefit? In fact, the latest change about the third party involvement in arbitration by major arbitration institutions in China stands upon the rationale, as related parties are allowed to join the proceeding in case the new arbitration agreement is formed.

Here comes a trickier question—what about the situation when there is no express agreement among the parties?

The parties choose arbitration because they want an efficient and fair decision of the tribunal. When strictly following the party autonomy principle will probably hurt the efficiency and fairness of the decisions, then only two choices are left: to accept the decision that is inefficient and unfair, or to carve out a rule to reach an efficient and fair in certain extreme circumstances. The author believes anyone understanding why arbitration exists will choose the latter, since to reach efficient and fair decisions are our goal, while the principle of party autonomy is just a tool to reach such goal. It is necessary and legitimate to adjust and improve the tool to reach the ultimate goal. Putting this theory into our case is to hold a positive attitude towards the involvement of third party into the existing proceeding, even sometimes without the express consent of all parties. When there is a gap between the current system and the practical obstacles, it is always a good choice to improve our system to solve the problems, instead of ignoring them, because one the practice has some problem, it means our system and theory might need to be improve.

Also, as can be clearly seen from the jurisprudence basis and practical need analysis of such mechanism, most of the theories like fair and equitable principle, third party beneficiary, estoppel, alter ego, assignment, etc. all support giving the tribunal the discretion to decide whether to include the third party without having to form a new express agreement by all parties.

(b) As Long as the Parties Have a New Agreement with the Third Party, there is No Obstacle in Certainty of Parties

Once a new arbitration agreement, whether express or implied, is formed, the parties to an arbitration will be ascertained. Parties do so out of their own consideration and certainty here is

not a problem. It is actually still all about party autonomy. To involve the related third party is to effectively control the risk of conflicting awards from overlapping parallel proceedings, thus to solve the dispute one and for all.

Even though sometimes it is not agreed in writing by all parties, the tribunal will make such decision to let the third party join based on prime facie finding of the common intention of the parties, thus it is only a very minor sacrifice of the certainty of parties in Scenario 2, 3 and 4 below in Part III.

By mentioning party control over the process, the author is actually talking about the principle of “procedural party autonomy,” which provides parties with “the freedom to contractually determine the circle of persons entitled to participate in the arbitration proceedings.”⁵⁴ It is in Dr. Brekoulakis’s opinion that since arbitration is a flexible dispute resolution mechanism, allowing third parties based on parties’ needs is acceptable.⁵⁵ He also says such freedom may create an “artificial discrepancy between the substantive and the procedural aspect of the same multiparty relationship,” especially when it might hamper the efficient resolution of the dispute.⁵⁶ He summarized that this principle should be subject to certain limitations, i.e. it cannot overturn the substantive arrangements involving third party.⁵⁷

(c) Since Parties are Willing to Let the Third Party Involve, the Confidentiality is Not in Issue; Also, This System Increases the Efficiency in the Long Run

The advantage of confidentiality of arbitration is opposed to the openness of litigation, and the targets of such protection are unrelated public from the whole society. The third party involved is someone who has a legal interest with the subject matter in dispute thus might already be aware of the disputed facts. In addition, this party has to fulfill four conditions mentioned so not any

⁵⁴ See Dr. Stavros Brekoulakis, *The Relevance of the Interests of Third Parties in Arbitration: Taking a Closer Look at the Elephant in the Room*, 113 PENN ST. L. REV. 1165, 1166 (2009). This principle is in stricter sense compared with party autonomy in point (i) above since it only focuses on the party control over the procedure.

⁵⁵ *Id.*

⁵⁶ *Id.*, at 1182.

⁵⁷ *Id.*, at 1184.

random outsider can become third party. Even if the third party does not know much about the case, the very action of consent in writing by actual parties means either they believe it is the better solution, or they voluntarily waive the confidentiality requirement. The outside world still does not know the details of three-parties' arbitral procedure, thus confidentiality has not been jeopardized. If there are still concerns when not all parties have express agreement,⁵⁸ some mechanisms can be designed to protect the confidential information without exposing to the public because of the third party involvement. For example, make the third party obligatory to keep information of the case secret by signing a confidentiality agreement and if such third party ever breaks this agreement, he or she might have to shoulder civil liability or even criminal responsibility.⁵⁹ Then a question can be raised—should a third party ever be allowed to participate in an arbitration if there are confidentiality restrictions that block the party's access to certain evidence in a case? The answer should be still probably yes in author's view, since the tribunal can ask the three parties to come up with a new agreement about the confidentiality of evidences. If all of them agree to let the third party access to certain evidences in the proceeding; if they cannot reach such an agreement, they can let the tribunal to arrange separate hearings under the condition of not seriously impeding the procedure, and give the tribunal the authority to decide whether such separate proceedings are enough to solve the disputes. If it is not feasible to separate the proceedings and make a fair decision, then the tribunal has the discretion to reject the application of such joinder.

As to the opinion that the procedure will be more complicated and prolonged, and cost will go up in one single case, it might be too partial without seeing the whole picture in the long run. If it requires a new case separately brought by the third party, the arbitral tribunal will face a whole new proceeding, which will cost definitely more both in time and in money. It is a strategy to deal with relevant problems once for all, and it can achieve the goal of increasing efficiency and make arbitration a more advantageous dispute resolution option. In the Reader's Guide of the

⁵⁸ Please refer to scenario 3 & 4 in Part III.

⁵⁹ 席涛 (Xi Tao), 论仲裁中的第三人问题 [*An Analysis of Third Party Involvement in Arbitration*], 仲裁与法律 [ARBITRATION & LAW], issue 2 (2004), available at <http://cn.cietac.org/magazine/91-7.shtml>.

Free Zone Arbitration Rules, it also introduces the reason to allow the third party involvement with similar words.⁶⁰

Therefore, bringing the arbitral third party into the existing proceeding is to pursue to the fairness and efficiency of arbitration, which are in a higher level of values comparing with confidentiality. In case of a conflict, some compromise is reasonable to achieve those higher values.

(d) Arbitration Law Itself Needs Improvement in Third Party Involvement

There are mainly two models to establish the system of allowing the third party to join the current arbitral proceedings—the direct model and the indirect one. The indirect model, which gives sole discretions to the arbitrator and tribunals and therefore more flexible, is frequently adopted by the common law countries. However, there are some problems like too much power of the tribunal, increasing instability while decreasing predictability of the third party system, potential neglect of parties' rights due to lack of deciding power, etc. The countries choosing direct model often have a corresponding legislation to make it more stable and in order, are often civil law countries. For China, a civil law country, the direct model is more appropriate to the legislating environment.

For the direct model, it also has two ways: first is to have relevant system set forth in local arbitration institution like what SCIA and SHIAC did; two is to have a clear system established in the Arbitration Law itself. The author believes that solely let local institutions to set up the third party involvement system might lead to a problem of inconsistency and chaotic since the study and understanding of arbitral third party might differ slightly and not so accurate. It has potential danger of disturbing the judicial review of arbitration, and might make the arbitration itself as a dispute resolution mechanism unpredictable. Therefore, to generally guide the local institution rules, it is very necessary that the Arbitration Law be revised, to directly establish this system, in order to better ensure the legitimate rights of parties and the stability of law

⁶⁰ See 中国（上海）自由贸易试验区仲裁规则解读 [READER'S GUIDE TO THE FREE TRADE ZONE ARBITRATION RULES] 22 (2014), available at http://www.shiac.org/upload/day_140430/201404301048095277.pdf.

in the society.

In 2004, the Interpretation of the Supreme People's Court concerning Some Issues on Application of the Arbitration Law of the People's Republic of China (Draft Calling for Comments) has provisions about third party involvement⁶¹. Although it is not adopted in the end due to various reasons, it already proves the feasibility of establishing this system by legislators based on the principle of justice and efficiency value of arbitration. From the opposite view, according to the principle that "those not prohibited by the law are allowed (法无禁止即允许)," it can be read as implicitly allowing the third party to participate into the arbitral proceeding without banning it, which is exactly why these arbitration institutions can adopt this system without violating the Chinese Arbitration Law.

The Arbitration Law of PRC is adopted in 1995. Now 20 years has past, there are plenty of discrepancies between the Arbitration Law itself and the actual arbitration practice. It was enacted at the very beginning phase of Chinese arbitration system, and now with the rapid development of economic and globalization of commerce, so many cases involving the third party cannot be avoided. It might cause the following problems in arbitration practice:

First, it might cause contradictory awards, which could greatly undermine the authoritativeness of arbitration. Since if the third party is forbidden to join the case, this party can only make a separate case, either by arbitration or litigation, then awkwardly enough, it is possible to have the contradictory decisions of two cases. The reasons can be the incompleteness of the investigations of the two cases, or the differences in ability of counsels who represent the two cases, etc. Second, it goes against the general trend of international arbitration practice. We already describe the

⁶¹ In this Draft, Chapter One, About the Validity of Arbitration Agreement, art. 1 it says "When the third party exercise rights of one of the signatories of the arbitration agreement, this third party is bound by such agreement." This provision makes the non-signatory an arbitral third party, which is clearly beneficial to the enlargement of scope of arbitral third party. [2004年7月22日《最高人民法院关于适用〈中华人民共和国仲裁法〉若干问题的解释(征求意见稿)》中“一、关于仲裁协议的效力”的第1条规定：“.....第三人行使订立仲裁协议的一方在仲裁事项中的权利的，仲裁协议对第三人有效。”这条界定的行使仲裁协议所在合同的权利而成为仲裁第三人，明显有利于仲裁第三人范围的扩大。]

current development status of international arbitration rules and national laws, which all made a solid theoretical foundation of the building of arbitral third party system in China, like the above-mentioned fair and equitable principle, third party beneficiary, estoppel, alter ego doctrine, etc. Third, it goes against the value of efficiency that makes arbitration more attractive to commercial dispute settlement. If a legal system lacks the arbitral third party system, then the third party can only make a separate claim or litigation for remedy, which will cause the waste of legal resource and prolong the process of solving the problem ultimately.⁶²

Therefore, lacking national law basis just reflects the fact that the Arbitration Law needs to be amended and this proposal has indeed been submitted to the legislature in 2010.⁶³ Now the time to amend is quite mature after the greatly developed international arbitration rules and national laws as guidance, and with local arbitration institutes' rules like SCIA Rules 2012, SHIAC Rules 2014, Free Zone Arbitration Rules 2014 and CIETAC Rules 2014 all set forth good examples. It is an integration process of international rules and the Chinese Arbitration Law, and a product merging the international arbitration practice and the unique characteristics of dispute resolution in the modern China. All these institution arbitration rules are systematic innovation inside the arbitration legal framework, and they are one of the most open and flexible internationalized arbitration rules in China.

(e) There is No Basis for the Court to Refuse Enforcement of Arbitral Award Based On the New Arbitration Agreement Involving the Third Party

Since all parties have agreement in writing, there is no flaw in procedure, and courts will have no reason not to recognize the arbitral awards involving third party. For the implied consent or

⁶² See 谭璇 (Tan Xuan), 浅谈仲裁第三人制度的缺失与构建 [Analysis of the Absence and Building of the Arbitral Third Party System], 法制与经济 [LEGAL & ECON.], issue 9 (2013).

⁶³ See 全国人民代表大会法律委员会关于第十一届全国人民代表大会第三次会议主席团交付审议的代表提出的议案审议结果的报告 [Report of the Law Committee of the National People's Congress on the Proposal submitted by the Presidium of the 3rd Session of the 11th National People's Congress] (Dec. 25, 2010).

consent by some of the parties, the court may not be able to conclude there is no basis to include the third party, since there are clear basis as mentioned above which tribunal might make use of. Then it should be less difficult than expected in terms of enforcement.

For the enforcement issues of New York Convention in international awards, first there is no basis for the art. (1)(c) to apply since three parties all consent to the third party to participate, therefore there is no “difference not contemplated by” problem here. Also, if all parties agree the same place of arbitration, and the national law of the seat of arbitration allows the court or arbitral tribunal to enforce the non-signatories joining the proceeding, then the award made does not violate the New York Convention and should not be refused to recognize and enforce. From this point it is also obvious that it is quite important for the arbitral award recognition and enforcement if a country has a legal system to support the third party involvement. Therefore, the potential problem of enforcing by court under the New York Convention does not constitute impediment to the establishment of the third party system in arbitration; to the contrary, it just proves why the Arbitration Law needs to be amended as a basis for this system to develop in China.

IV. PRACTICE SUGGESTIONS

Based on the above analysis, the author has concluded the following scenario listing under what conditions can a third party be involved in the current proceeding.

TABLE OF DIFFERENT SCENARIO OF THIRD PARTY INVOLVEMENT⁶⁴

Scenario Number	Agree	Disagree	Whether third party should be involved
1	A, B & C		Yes
2	A & B	C	Yes
3	A (B) & C	B (A)	Yes
4	A (B)	B (A) & C	Yes
5	C	A & B	No

⁶⁴ Assume that the signatory parties are Party A & B, and Party C is a related third party.

Scenario Number	Agree	Disagree	Whether third party should be involved
6		A, B & C	No

A. Scenario 1

Here, a new arbitration agreement is formed, so according to the above analysis there should be no problem to involve the third party.

B. Scenario 2

When the third party is not willing to join, then the tribunal should analyze the possible effects to the parties to decide whether to let such third party to join. This is under the stricter condition that C has a very close and direct relationship with solving the dispute completely, and if the tribunal do not add C, there is very high probability that A and/or B might sue C separately. Therefore, to see as a whole, dragging C into the arbitral decision does not cause additional burdens or harm to C although it seems that the tribunal is against its will in current phase. In addition, if C believes enforcing it to join the proceeding might cause it damages, C can ask for compensation.

C. Scenario 3 & 4

In scenario 3 & 4, one of the signatory parties does not agree to involve the third party, which seems to be against the principle of party autonomy and the contractual nature of arbitration in traditional theories, thus becomes the spotlight of disputes about this issue.

It is the author's belief that the third party system in arbitration should also be applied in this case. It is because there could only be two considerations why one of the signatory parties rejects the joining of the third party: First, out of legitimate consideration, i.e. it does not benefit such party, or probably damage its interest. To drag the third party into the proceeding can only procrastinate the arbitral procedure. Second, out of malicious intention, such party intends to prevent the third party coming into play so that the interest of the other signatory party might be damaged, or not be-

ing able to fulfill the aim to arbitrate, or to protect its own interest, etc.

Then we can further analyze these two considerations: Under the first consideration, to involve the third party should not go too far to damage the other party's interest. Otherwise, it is against the initial intention of arbitration. Under this circumstance, the author suggests to have partial award⁶⁵ first—to award first on the disputes between the rejecting party (who does not have any related interest with the third party) and the other signatory party, and let the rejecting party finish its arbitration proceeding first. Such measure is in line of the current theories and practices of arbitration. As to the confidentiality issue, the proceeding can be separate into two, or to present evidences separately, or to sign a confidentiality agreement among the three parties⁶⁶. Under the second consideration, when the rejecting party is malicious, then the tribunal should allow the third party to join, and do not consider the rejecting party's bad will. As to determine whether the rejecting party is out of good will or bad will, the tribunal should base on the comprehensive circumstances and evidences to make a decision.

D. Scenario 5 & 6

In scenario 5 & 6, both of the signatory parties do not want the third party to be involved, then the third party system should not apply here. In scenario 5, C can just use litigation to solve the dispute with A and B, and to C there is no more possible harm to choose litigation compared with arbitration. In scenario 6, all three parties reject the third party involvement, which is not necessary to consider whether it might bring harm to any party since it is their joint agreement, which is in line with the party autonomy and the contractual nature of arbitration, both from theoretical and practical point of view.

⁶⁵ See 陈治东 (CHEN ZHIDONG), 国际商事仲裁 [INTERNATIONAL COMMERCIAL ARBITRATION] 239 (1998).

⁶⁶ 石育斌 (Shi Yubin), 国际商事仲裁第三人新论 [New Study on the Third Party of International Commercial Arbitration], 华东政法学院学报 [J.E. CHINA UNI. POL. SCI. & L.], issue 4, at 41 (2004).

V. SUGGESTIONS TO AMEND THE ARBITRATION LAW AND CONCLUSION

A. *Suggestions to Amend the Chinese Arbitration Law*

The third party involvement in arbitration is an indispensable system in the process of development of Chinese commercial arbitration. The question is how to make a system that does not go against the traditional theories, and also reflexes the core values and practical needs of arbitration.

Considering the practical condition of Chinese legal practice and the complexity to build a third party system in commercial arbitration, it is not possible to “build Rome in one day.” Instead, it is better to borrow other international experience and combine it with domestic cases so far, and amend the Chinese Arbitration Law based on them.

For the design of Chinese arbitral third party system, challenges are less to new express arbitration agreement type of third party involvement. The system should distinguish different possibilities depending on whether the third party is a party of the original arbitration agreement (like the scenario in Art. 37 of the Free Trade Zone Arbitration Rules 2014⁶⁷), or outside the original arbitration agreement but with crucial contractual interests or rights in the case. Also, the theories mention in Part II can be used by the tribunal as the basis to involve the third party out of its discretion even without a new express agreement among the three parties, just like scenario 3 & 4 listed in Part II.⁶⁸ Noted that in arbitration, the power of the tribunal comes from the authorization of parties, and no matter how to decide on the third party involvement, the autonomy of the contract signatories should always be respected. In detail, there are altogether four issues to be considered:

⁶⁷ Free Trade Zone Arbitration Rule 2014, available at <http://www.shiac.org/English/FreeTradeZoneRuleEN.pdf>.

⁶⁸ However, it is in the author's view that the detailed theoretical basis in Part II should not be put into the Arbitration Law since it is the basic law. Listing the possible theories might constrain the tribunal from exercising its discretion using other theories to involve the third parties and prevent the theories from further developing in practice in the future. Also, since no provisions containing these theories so far have been adopted by Chinese institutional rules, it is still premature for them to be put into law.

1. The Method of Third Party Joining the Existing Proceeding

Such third party, as a non-signatory, could not join based on the arbitration agreement. Therefore, it could only join based on application by either the third party itself or the signatories or parties of an arbitration case. The arbitral tribunal should never actively introduce third party into the case without application procedure by either third party or parties of the current arbitration no matter how crucial the third party is to the case. But even the third party or parties of arbitration already apply for the joinder, the third party still need the tribunal's agreement to allow such joinder (as the Reader's Guide of the Free Zone Arbitration Rules explains, it is to ensure the procedural stability).

2. The Time Frame of the Third Party to Join the Arbitration

It can only join after the arbitration proceeding is commenced since there is no contractual basis to become a claimant or a respondent. Of course, due to the finality characteristic of arbitration, it is not possible for third party to join after the award is rendered. Therefore, the time frame (as discussed in Part I. 4) should fall between the commencement of the arbitration proceeding and the tribunal's final decision.

3. The Connection with Third Party System in Chinese Civil Procedure

How can the third party's legal rights be protected when the parties of the arbitration do not agree with its application to join the case? In the Chinese Arbitration Law, there should be a relevant mechanism to avoid arbitration in bad faith, or using arbitration to hurt other's interests, i.e. to have a provision stating that

[w]hen the third party, after its application is submitted to the tribunal, could not obtain parties' consent and thus got rejected by the tribunal, such third party can bring a claim in the local intermediate court. If the court after viewing the case, believes that the third party should be involved in the current arbitral proceeding, then the arbitral tribunal can use such valid court decision as a basis to make a decision. If the

court holds the opposite, then the paused proceeding should go on and the third party shall cover any damages caused.

This kind of mechanism is an exception situation for the three-party consent requirement in order to achieve the justice of the case.

4. About the Possible Change of Tribunal

Here we can borrow the relevant provisions Free Trade Arbitration Agreement and the SHIAC on the procedural condition of including the non-signatories into the current proceeding, *i.e.* to assume the third party has waived its right to nominate the arbitrator it applies to join a case. Under such condition, there would be no possible objection of enforcement based on New York Convention art. V(1)(c)⁶⁹ saying that the tribunal is different before and after the joinder.

B. Conclusion

The third party involvement in arbitration procedure is a significant innovation for Chinese commercial arbitration. It minimizes the practical obstacles by subjecting it to the condition of written consent of all three parties. However, since these brand new development has not been testified enough by the arbitration practice, we should also hold a cautious view towards it before we finally recognize its positive effect and keep revising it according to the practice. To further develop this system, amend to the Chinese Arbitration Law is needed and careful design is called upon to ensure the maximum achievement of justice and efficiency of case.

⁶⁹ New York Convention, *supra* note 54.