Arbitration-Favored Policy Has its Boundary: Case Study and Takeaways for China

(This post is written by Chen Zhi, a Ph.D. candidate at the University of Macau, a trainee lawyer in Mainland China)

The arbitration-favored policy has been adopted by many jurisdictions across the world in recent years, as the support of arbitration by local judiciaries has been viewed as an important standard for gauging the business environment of a jurisdiction. While the decision of Morgan v. Sundance Inc. rendered in May 2022 by the Supreme Court of the USA illustrates that arbitration-favored policy has its boundary, this seems a trend emerging from the laws and legal trends in other jurisdictions.

Summary of the Fact

This case concerned a class action initiated by a former employee, Morgan against Sundance Incorporate (the owner of a Taco Bell franchise restaurant, hereinafter "Company") regarding the arrear of overtime payment in the context of Federal law of the USA.

Albeit there was an arbitration agreement incorporated in the contract between Morgan and the Company, the Company failed to raise any motion about the arbitration agreement at the outset and defended as if the arbitration agreement did not exist.

Nearly 8 months after the commencement of the litigation, the company raised jurisdictional objection by invoking the omitted arbitration agreement and filed the motion to compel arbitration under the 1925 Federal Arbitration Act (hereinafter "FAA"). Morgan argued that the Company had waived the right to arbitrate. By measuring the case against the standard for the waiver as set out in the precedent of the Court of Appeal of Eighth Circuit, the court of first instance ruled in favor of Morgan and rejected to refer the case to arbitration.

Nonetheless, the Court of Appeal of the Eighth Circuit had adopted the

requirement for waiver based on the “federal policy favoring arbitration”. Under the new requirement, Morgan shall furnish the proof showing prejudice incurred by the delay, and overturns the trial court’s decision thereby.[i] The case was subsequently appealed before the Supreme Court of the USA.

Supreme Court’s Decision

It is not surprising that lower courts in the USA have been consistently adopting specific rules for arbitration in the name of the arbitration-favored policy, which is contradictory to the proposition of the Supreme Court.[ii]

In the Morgan case, the Supreme Court holds that the Appeal Court of the Eighth Circuit has erred in inventing a novel rule tailored for the arbitration agreement, and reiterates that the arbitration agreement shall be placed on the same footing as other contracts. In the unanimous opinion delivered by Justice Kagan, the Supreme Court explicitly states that:

“*Accordingly, a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation.*” [iii]

In this regard, the arbitration agreement shall not be distinguished from other types of contracts in the context of Federal Law, under which the prejudice will generally not be asked about in the assessment of waiver. By Stripping off the requirement of prejudice, the Supreme Court remands the case to the Court of Eighth Circuit for reconsideration.

The Supreme Court does not delve into the jurisprudence behind arbitration-favored policy but simply states that the purpose of this policy is to make arbitration agreements as enforceable as other contracts, but not more. [iv]

The Main Concern of Morgan v. Sundance Inc.

In the context of American law, the grounds for equal treatment emerges from Section 2 of the 1925 Federal Arbitration Act, which stipulates that an arbitration agreement is valid and enforceable unless the grounds for revocation of any contract as set out in law or equity were found. Against this backdrop and in collaboration with the drafting history of the enactment of the Federal Arbitration Act, the Supreme Court has set out the basic principle that the arbitration

agreement shall be placed on the same footing as other contracts, by which the arbitration-favored policy does entitle a higher protecting standard for arbitration agreement, as stated in Granite Rock Co. v. Teamsters:

"[…]the *'policy' is merely an acknowledgment of the FAA's commitment to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate and to place such agreements upon the same footing as other contracts.*"[v]

Through the decision in the Morgan case, the equal treatment principle is recapped and stressed, by which the arbitration-favored policy creates no new rules tailored for waiver of arbitration clauses under the legal framework of the USA.

The Complexity of Arbitration-favored Policy and the Boundary

Recent years have witnessed state courts' preference to embrace the notion of "arbitration-favored policy" or "pro-arbitration policy". Nonetheless, the arbitration-favored policy is a sophisticated and vague concept without an agreed definition worldwide. In principle, this policy flows from the well-recognized characteristics of international commercial arbitration such as autonomy, expediency, efficiency, and enforceability across the world. As per the analysis of Prof. Bremann, there are at least 12 criteria for gauging the arbitration-friendliness policy.[vi]

Likewise, Justice Mimmie Chan at the Court of the Instance of Hong Kong SAR fortifies 10 pro-arbitration principles employed by courts in Hong Kong towards enforcement of arbitration awards in the case of KB v S and Others, which sets up relatively high thresholds for parties to challenge arbitral awards in the enforcement stage, as the Chan J. highlights: (1) the courts' reluctancy to looking to the merits of the case, (2) challenger's duty to make a prompt objection against any alleged irregularities under the bona fide principle and, (3) the court's residual discretion to enforce the award albeit the statutory grounds of rejection has been made out.[vii] Similar principles can also be extracted from decisions by courts in other jurisdictions like Singapore. [viii]

In the author's view, these considerations for arbitration-favored policy can be distilled as the following four limbs:

(1) adherence to the parties' autonomy to the largest extent,

(2) promoting the fairness and efficiency of commercial arbitration,

(3) minimizing the judicial interference throughout the arbitration proceedings, including the stages before and after the issuance of the arbitral award, among others, refraining from conducting the review on the merits issue of the case unless in exceptional circumstances and nullifying arbitral award based on trivial errors,

(4) providing legal assistance to arbitration proceedings for the promotion of fairness, expediency and efficiency (i.e., auxiliary proceedings for the enforcement of arbitration agreement and award, issuance, and execution of interim reliefs, taking of evidences).

As to the field of arbitral jurisdiction, the arbitration-favored policy always takes the form of the validation principle, where at least four scenarios are present in legal practice:

First, when confronted with the issue of the law governing arbitration agreement, and more than one laws are relevant, courts are required to apply laws that are in favor of the effectiveness of the arbitration agreement, either by virtue of statutory regulations[ix] or provided as one of the considerations in judicial practice.[x]

Second, courts are declined to intervene in the dispute over arbitral jurisdiction before the decision of the arbitration tribunal is rendered, as a result of the negative effect of the *competence – competence* principle to ensure the integrity and efficiency of arbitration proceedings.[xi]

Third, the invalidity of the matrix contract does not necessarily negate the arbitration agreement incorporated therein as per the widely-accepted separability doctrine.[xii]

Fourth, the courts will interpret in a manner that is likely to give effect to the arbitration agreement, particularly where the arbitration agreement is pathological in form or substance.[xiii]

At least one of the aforesaid scenarios emerges from legislation or judicial practices in jurisdictions featuring or advocating arbitration-favored policy, in which courts are always inclined to refer the case to arbitration. Nonetheless, the

arbitration-favored policy does not mean that the court will give effect to the arbitration agreement unconditionally. The aforesaid Morgan case demonstrates that arbitration-favored policy has boundaries in the context of American law, taking the form of the equal treatment principle.

The boundary of arbitration-favored policy also emerges from laws and legal practices in other jurisdictions, as representative examples, the BNA case by the Court of Appeal of Singapore, the Kabab-Ji case by the Supreme Court of the UK, and the Uber case by the Supreme Court of Canada will be further illustrated below:

BNA Case

In this case, at issue before Singaporean courts was the law governing arbitration agreement, where the parties had designated PRC law as the governing law of the contract and expressly set out the term "arbitration in Shanghai" in the arbitration clause. The plaintiff objected to arbitral jurisdiction after the commencement of arbitration proceedings before the tribunal and subsequently resorted to courts in Singapore for recourse against the tribunal's decision ruling that the arbitration agreement was valid under the laws of Singapore.

The plaintiff contended that the laws of China shall be applied, while the respondent argued that the arbitration clause in dispute was alleged to be invalid under PRC law, and submitted that the Singaporean court shall apply laws that are more in favor of the effectiveness of the arbitration agreement under validation principle hence the governing law shall be the laws of Singapore. The Singapore High Court applied Singaporean law and the dispute was filed before the Court of Appeal of Singapore.

The Court of Appeal opines that the validation principle can only be taken into consideration when there are other laws that can compete with PRC law to be the governing law of arbitration clause,[xiv] as all factors point to China as the proper law and Singapore was not the seat in the context of Article 10 of International Arbitration Act, this case shall be given to Chinese courts to decide.[xv] Therefore, the Appeal Court overturned the controversial decision by the Singapore High Court which determined Singapore as the seat by twisting the meaning of arbitral seat.[xvi]

Per the decision in the BNA case, the validation principle is only applicable where

some prerequisites are met. While parties expressly reach an intention likely to negate the arbitration agreement without other competing factors, the court shall not rewrite the contract to nakedly validate the arbitration agreement.

Kabab-Ji Case

In this case, a Paris seated tribunal decided to extend the arbitration agreement to Kout, the parent company to the signatory which had been actively engaging in performance and re-negotiation of the contract in dispute, while not being a signatory to the contract. The tribunal's decision was under the scrutiny of judiciaries in the UK at the enforcement stage.

Unlike the scenario in the BNA case, there were two competing factors regarding the determination of the proper law of arbitration agreement in Kabab-Ji: laws of England as the designated laws governing the main contract and the laws of France as the *lex arbitri* fixed in the contract. While the French laws turn out to be more in favor of the effectiveness of the arbitration clause, the Supreme Court of the UK rejected enforcing the arbitral award for lack of valid arbitration agreement via the application of English law as the proper law of arbitration clause. The court stresses in the decision that the validation principle does not apply to issues concerning the formation of a contract, and hence this principle was not relevant in deciding the issue of non-signatory.[xvii] And departing from the validation principle as set out in its precedent.

Per the decision of the Supreme Court of the UK, the extension of the arbitration agreement to non-signatory pertains to the formation of an arbitration agreement rather than the interpretation of the contract, which is contrary to the approach employed by French courts over the same case scenario. The decision in the Kabab-Ji case has given rise to controversies, as a commentator pointed out, the English court may be criticized for stepping over the line.[xviii] Nonetheless, the decision of Kabab-Ji is to some extent in line with the stringent attitude toward the non-signatory issue of arbitration agreement that judiciaries in England have consistently taken.[xix]

Uber Case

The dispute arose out of the putative employment relationship between Heller, a delivery driver, and UberEATS, a Toronto-based subsidiary of Uber. During the litigation, UberEATS filed a motion to compel arbitration by invoking the

arbitration clause embedded in the boilerplate service agreement between Uber and all drivers who sign in for service of Uber.

The Supreme Court of Canada finds the arbitration clause unconscionable based on two main findings: (1) inequality of bargaining power between Heller and Uber, (2) improvidence produced by the underlying arbitration clause. The court stresses the fact that according to the arbitration clause, arbitration proceedings shall be administered under the Rules of Arbitration of the International Chamber of Commerce, which requires US$14,500 in up-front administrative fees for the commencement of the putative arbitration proceedings. Also, Amsterdam shall be the place of arbitration per the arbitration clause, hence further fees for traveling and accommodation will be incurred thereby. The court ruled that the arbitration clause was invalid and rejected to compel arbitration.[xx]

The judgment also discusses the arbitration-favored policy contention, stating that arbitration is respected based on it being a cost-effective and efficient method of resolving disputes.[xxi] By this logic, arbitration clauses creating a hurdle toward cost-effective and efficient resolution of disputes will not be safeguarded albeit the arbitration-favored policy is applicable.

The Uber case illustrates that different values may at odds with each other in the application of arbitration-favored policy, hence trade-offs will be presented before decision-makers. As discussed by Prof. Bremann, one given policy or practice may be pro-arbitration in some respects while anti-arbitration in other respects, further, the implication of arbitration-favored policy may also be detrimental to policies extrinsic to arbitration.[xxii] In the Uber case, two kinds of conflict are present simultaneously, first, upholding the effectiveness of the underlying arbitration clause may be detrimental to the policy for the protection of those who are vulnerable(trade-off between arbitration-friendly policy and extrinsic policies), second the enforcement of alleged parties' autonomy taking the form of "arbitration administered by ICC in Netherland" is likely to be detrimental to the expediency and efficiency nature of arbitration(trade-off between arbitration-favored policy and extrinsic).

The answer to the said trade-offs remains unresolved, as there is no agreed standard by far, and courts in different jurisdictions can be divergent on this issue. As a prime example, while there is a discrepancy regarding the number of tribunal members between the rules of the arbitration institution and the

arbitration clause, where the former provides a mandatory sole-arbitrator regulation for consideration of expedition and efficiency, the latter had designated a three-member-tribunal, the court of Singapore upheld the preemption of arbitration rules over the arbitration clause,[xxiii] while Chinese court once ruled in favor of the arbitration clause and rejected to enforce the award rendered by the sole arbitrator.[xxiv]

Takeaways for China

The arbitration-favored policy is a complicated notion that includes a myriad of separate and to some extent, conflicting considerations. In a general sense, courts embracing arbitration-favored policy are reluctant to negate the arbitration agreement. However, there are some exceptional instances where:

(1) the vindication of the arbitration agreement will produce prejudice to other values that are extrinsic to arbitration, such as the rule of law principle, the consistency of legal practice, policies for the protection of vulnerable parties, etc., like the situations in Morgan case and Uber case, and,

(2) the interpretation or implementation of the arbitration clause will undermine other considerations among the arbitration-favored policy, for instance, while the enforcement of the arbitration clause can be low-efficient and costly, or the validation principle may be contrary to the parties' true intention, like the situations in BNA case and Kabab-Ji case.

Therefore, every jurisdiction shall tailor the arbitration-favored policy for its legal system and meet its own needs, instead of employing a dogmatic understanding of the policy.

Like other rising economic bodies like India,[xxv] China is also moving toward a jurisdiction that is "arbitration-favored" under the Belt and Road imitative and the blueprint for the construction of the Guangdong- Hong Kong- Macao Greater Bay Area. Against this backdrop, judiciaries are taking more liberal approaches that are tended to give effect to arbitration agreements that are likely to be considered invalid previously, particularly in disputes regarding the choice of law issue and the substance of the arbitration agreement. [xxvi]As to the formal requirement of arbitration agreement, the Supreme People's Court also made a great leap in dispensing with the stringent approach by acknowledging the effectiveness of an arbitration clause as set out in a draft contract not being

signed by neither party, based on the findings that the parties have discussed and finalized the arbitration clause in the draft of the contract during the negotiating phase.[xxvii]

Moreover, the Draft Revised Arbitration Law released in late July 2021 provides more liberal approaches for the validity of arbitration agreements, which includes:

(1) the recognition of *ad hoc* arbitration agreement in foreign-related disputes,

(2) the relaxing requirement for a valid arbitration agreement, where parties' failure to designate a sole arbitration institution does not negate the arbitration agreement,

(3) the promulgation of extension of the arbitration agreement to non-signatories in some types of disputes, and

(4) the adoption of a new framework of *competence-competence* principle that is more in line with the international framework as set out in UNCITRAL Model Law.[xxviii]

These attempts have been heatedly debated and are by and large arbitration-favored and laudable by lifting the unreasonable hurdles for the autonomy, expediency, and efficiency of arbitration. Nonetheless, recognizing the validity of arbitration agreement is not the sole consideration, lawmakers, judiciaries, and other participants in commercial arbitration of Mainland China will confront trade-offs during the law-making and implementation of the rules under the arbitration-favored policy. As a corollary, an arbitration agreement can be safeguarded to the extent it is in line with the basic principles that are placed at a higher level.

[i] Morgan v. Sundance, Inc. 596 U. S. ____ (2022) (Supreme Court of USA, decided on 23 May 2022).

[ii] Amicus brief of Law Professors in Morgan v. Sundance, Inc., 596 U.S. ___ (2022), pp. 11-12, available at https://www.supremecourt.gov/DocketPDF/21/21-328/207550/20220106140817376_Morgan%20amicus%20brief%20final.pdf last visited on 21 November 2022.

[iii] Morgan v. Sundance, Inc. 596 U. S. ____ (2022) (Supreme Court of USA,

decided on 23 May 2022).

[iv] *Ibid.*

[v] Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 489 U. S. 487(1989), as quoted in Granite Rock Co. v. Teamsters, 561 U. S. 287, 302 (2010) (Supreme Court of USA, decided on 24 June 2010).

5 These considerations are: (1) to what extent does it render international arbitration economical in term of time or cost? (2) to what extent does it ensure consent to arbitrate and enhance the scope for party autonomy? (3) to what extent does it effectuate the likely intentions or expectations of the parties? (4) to what extent is it consistent with the *lex arbitri* or the institutional rules chosen by the parties? (5) to what extent does it, consistent with party intent, enable the tribunal to exercise sound discretion and flexibility on matters of arbitral procedure? (6) to what extent does it ensure the independence and impartiality of arbitrators? (7) to what extent does it protect a party's right to be heard? (8) to what extent does it promote accuracy in the administration of justice? (9) to what extent does it minimize, to the fullest extent reasonably possible, the intervention of national courts in the arbitral process? (10) to what extent does it help ensure that the resulting award will be an effective one? (11) to what extent does it enable the resulting award to withstand challenges in an annulment or enforcement action? (12) to what extent does it expand the categories of legal claims treated as arbitrable? See George A. Bermann, *What Does it Mean to be 'Pro-Arbitration'?,* Arbitration International, Volume 34 (2018), p. 343.

[vii] KB v S. and Others, [2015] HKCFI 1787, para.1(Hong Kong Court of First Instance, decided on 15 September 2015).

[viii] China Machine New Energy Corporation v Jaguar Energy Guatemala LLC, [2020] SGCA 12, para. 87(The threshold for the finding of breach of natural breach for the purpose of vacating arbitral award is a high one and can only be crossed in exceptional cases.) (Appeal Court of Singapore, decided on 28 February 2020).

[ix] See Article 178 (2) of Private International Law of Switzerland ("As regards its substance, the arbitration agreement shall be valid if it conforms to the law chosen by the parties, or to the law applicable to the dispute, in particular the law governing the main contract, or to Swiss law.").

[x] Enka Insaat Ve Sanayi AS v. OOO Insurance Company Chubb, [2020] UKSC 38, para. 97 (Where the clause in question is an arbitration clause, because of its severable character its putative invalidity may support an inference that it was intended to be governed by a different law from the other provisions of the contract […]) (Supreme Court of the UK, decided on 9 October 2020). See also BCY v. BCZ, [2016] SGHC 249, para. 74 ("[…] governing law of the main contract should only be displaced if the consequences of choosing it as the governing law of the arbitration agreement would negate the arbitration agreement even though the parties have themselves evinced a clear intention to be bound to arbitrate their disputes.") (Singapore High Court, decided on 9 November 2016).

[xi]Article 16(1) of UNCITRAL Model Law on International Commercial Arbitration("[…] an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract.")

[xii] Tomolugen Holdings Ltd and Another v. Silica Investors Ltd and other appeals, [2015] SGCA, para. 60 (Singapore court should adopt a *prima facie* standard of review when hearing a stay application) (Court of Appeal of Singapore, decided on 26 October 2015). Fiona Trust & Holding Corp. v. Privalov [2007] UKHL 40 para. 13, (Arbitration clause shall be construed in accordance with the presumption that parties are likely to have intended any dispute arising out of the underlying contract to be decided by the same body.) (House of Lords of the UK, decided on 17 October 2007).

[xiii] "[W]here the parties have evinced a clear intention to settle any dispute by arbitration, the court should give effect to such intention, even if certain aspects of the agreement may be ambiguous, inconsistent, incomplete or lacking in certain particulars…" Insigma Technology Co Ltd v Alstom Technology Ltd [2009] 3 SLR(R) 936, para. 31, as quoted in HKL Group Co Ltd v Rizq International Holdings Pte Ltd, [2013] SGHCR 5, para. 13 (Singapore High Court, decided on 19 February 2013). See also ?????? and ??? v. Ace Lead Profits Ltd and another, [2022] HKCFI 3342? para. 53 (Arbitration clause is not nullified by the non-existence of putative arbitration institution) (Hong Kong Court of First Instance, decided on 4 November 2022).

[xiv] BNA v. BNB and another, [2019] SGCA 84, para. 95. (Court of Appeal of Singapore, decided on 27 December 2019).

[xv] *Ibid*., at para. 102.

[xvi] See BNA v. BNB, [2019] SGHC 142, para. 101(agreement referring to Shanghai instead of PRC is not a reference to seat) (Singapore High Court, decided on1 July 2019). Ironically, contrary to the plaintiff's assertion and the Singapore court's wariness, the validity arbitration clause at issue was subsequently confirmed by the Chinese court following the conclusion of judicial review proceedings before the Singapore Court of Appeal, as set out in Daesung Industrial Gases Co Ltd v. Praxair (China) Investment Co Ltd (2020) Hu 01 Min Te No.83 (Shanghai No.1 Intermediate People's Court, decided on 29 June 2020). See also José-Antonio Maurellet, Helen Shi, et al., *PRC Court Confirms Validity of "SIAC-Shanghai" Clause*, available at https://dvc.hk/en/news/cases-detail/prc-court-confirms-validity-of-siac-shanghai-clause/ last visited on 21 November 2022.

[xvii] Kabab-Ji SAL v. Kout Food Group, [2021] UKSC 48, para. 51 ([Validation principle] is not a principle relating to the formation of contracts which can be invoked to create an agreement which would not otherwise exist.) (Supreme Court of UK, decided on 27 October 2021).

[xviii] Andrew Tweeddale, *The Validation Principle and Arbitration Agreements: Difficult Cases Make Bad Law*, The International Journal of Arbitration, Mediation and Dispute Management, Volume 88, Issue 2 (2022), p. 248.

[xix] The restrictive approach emerges from the Peterson Farms v. CM Farming Ltd., [2004] EWHC 121, as cited in Andrea Marco Steingruber, Consent in International Arbitration (UK: Oxford University Press, 2012), p. 156.

[xx] Uber Technologies Inc. v. Heller, 2020 SCC 16, paras. 93 – 94(Federal Supreme Court of Canada, decided on 26 June, 2020).

[xxi] *Ibid*., at para. 97.

[xxii] George A. Bermann, *What Does it Mean to be 'Pro-Arbitration'?,* Arbitration International, Volume 34 (2018), pp. 343-353.

[xxiii] AQZ v. ARA, [2015] SGHC 49 (2015) (Singapore High Court, decided on 13 February 2015).

[xxiv] Noble Resources International Pte Ltd v. Good Credit International Trade

Co Ltd, (2016) Hu 01 Xie Wai Ren No. 1 (Shanghai No.1 Intermediate People's Court, decided on 11 August 2017).

[xxv] Like India, see Aditya Singh Chauhan and Aryan Yashpal, *Change to Improve, Not to Unhinge—A Critique of the Indian Approach to International Arbitration*, Indian Journal of Arbitration Law, Volume X, Issue 2 (2021), pp. 1-11.

[xxvi] See Helen Shi, *Have Chinese Courts Adopted an Arbitration- Friendly Approach Towards International Arbitration?*, in Neil Kaplan, Michael Pryles, et al. (eds), International Arbitration: When East Meets West: Liber Amicorum Michael Moser(Netherlands: Kluwer Law International, 2020), pp. 235-244.

[xxvii] Luck Treat Limited v. Zhongyuancheng Co, Ltd, 2019 Zui Gao Fa Min Te No.1(Supreme People's Court of China, decided on 18 September 2019).

[xxviii] Terence Wong et al, *China: Draft Revised Arbitration Law of PRC Published for Comments*, available at https://www.mondaq.com/china/arbitration-dispute-resolution/1104356/draft-revised-arbitration-law-of-prc-published-for-comments- last visited on 4 December 2022. See also Weina Ye et al, *Key Changes under Revised Draft of PRC Arbitration Law*, available at https://hsfnotes.com/arbitration/2021/08/11/key-changes-under-revised-draft-of-pcr-arbitration-law/, last visited on 4 December 2022.