M&A ARBITRATION GUIDE

M&A Arbitration Guide

Fourth Edition

Editor

Amy C Kläsener

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Publisher's Note

Global Arbitration Review (GAR) is delighted to publish the *M&A Arbitration Guide*.

For those unfamiliar with GAR, we are the online home for international arbitration specialists, telling them all they need to know about everything that matters. Most know us for our daily news and analysis service. But we also provide more in-depth content: books and reviews, conferences and handy workflow tools, to name just a few. Visit us at www.globalarbitrationreview.com to find out more.

Being at the centre of the international arbitration community, we regularly become aware of fertile ground for new books. We are therefore delighted to be publishing the fourth edition of this guide on mergers and acquisitions within the world of arbitration. It is a practical know-how text in two parts. Part I identifies the most salient issues in M&A arbitration, while Part II surveys substantive principles from select regional perspectives.

We are flattered to have worked with so many leading firms and individuals to produce the *M&A Arbitration Guide*. If you find it useful, you may also like the other books in the GAR Guides series. They cover energy, construction, mining, challenging and enforcing awards and intellectual property, in the same practical way. We also have books in the series on advocacy in international arbitration and the assessment of damages, and a citation manual (*Universal Citation in International Arbitration*). Our thanks to the editor, Amy C Kläsener, for her vision and energy in pursuing this project and to our colleagues in production for achieving such a polished work.

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Introduction

Amy C Kläsener[1]

M&A transactions generate a large number of disputes, many of which are procedurally complex. In this book, M&A disputes specialists pool their knowledge on working with problematic contracts in the most contentious disputes. We hope that their experience will be useful to practitioners and clients in preventing and managing M&A disputes. The chapters concentrate on the distinctive procedural aspects of M&A disputes and highlight the key role that substantive law can play in their generation and resolution. The book has a pragmatic focus on planning and contains a plethora of recommendations for minimising the potential for disputes and resolving them efficiently.

The book is divided into two parts, with Part I consisting of 10 chapters focusing on procedural and planning issues, and Part II surveying differences in the substantive and procedural laws that may play a role in M&A disputes.

Any dispute will be heavily influenced by the drafting of the arbitration clause. In Chapter 1, Anne Véronique Schlaepfer and Alexandre Mazuranic of White & Case address pre-arbitral dispute resolution mechanisms, expert determination clauses, and consolidation and joinder. They also consider whether mechanisms such as fast-track arbitration and emergency arbitrator provisions make sense in the M&A context.

Issues of joinder and consolidation present frequently in M&A arbitration. Yan Zhang and Nathaniel Lai of Sidley Austin address these issues in Chapter 2. Potential parties to an M&A arbitration include multiple sellers, guarantors and, increasingly, insurers. The contractual frameworks may include multiple SPAs,

1 Amy C Kläsener is a partner at Jones Day.

ancillary services or other agreements and insurance contracts. Whatever the context, failing to consider them at the transaction phase can add significant uncertainty, time and cost to the resolution of ensuing disputes.

Many M&A disputes can and should be resolved by expert determination rather than arbitration. However, procedural issues can arise when there is competing or overlapping jurisdiction between the expert and the arbitral tribunal. Dr Wolfgang Peter of Peter & Kim and Dr Daniel Greineder of McNair International address these issues in Chapter 3.

In Chapter 4, Thomas Webster and I consider how the advent of warranty and indemnity insurance will impact M&A arbitration. Warranty and indemnity insurance is now obtained in a large proportion of transactions. Although many or even most disputes will now be handled by the underwriting departments of insurers, the disputes that go to arbitration will raise new procedural issues and challenges.

Quantum determinations play a decisive role in many M&A disputes. In Chapter 5, three experienced quantum experts from AlixPartners, Andrew Grantham, Kai Schumacher and Greg Huitson-Little, offer strategies on how to maximise the value of expert evidence. This starts with identifying the expertise required, investigative and valuation works, and how to communicate complex valuation techniques successfully.

M&A transactions generate a large number of disputes, but a large proportion of them are successfully dealt with in expert determination proceedings and never reach arbitration. In Chapter 6, Sandy Cowan, Fiona Frith and Alexandra Kingston of Mazars share their insights on how to make the most of expert determination proceedings. This begins with selecting the right expert and defining an effective and efficient expert determination process.

In Chapter 7, Hussein Haeri, Clàudia Baró Huelmo and Giacomo Gasparotti of Withers provide an excellent introduction to third-party funding. Although third-party funding is not yet widely used in M&A arbitration, it is available as a further risk management tool.

The next two chapters address the two types of clauses in M&A contracts that generate the largest number of disputes. In Chapter 8, William S Dudzinsky, Lance J Phillips, Amy Chen and Michael Mannino of Eversheds Sutherland focus on purchase price adjustment clauses. Their chapter provides strategic advice for drafting purchase price adjustment clauses in light of their potential for generating disputes, including choice of dispute resolution mechanism, and a useful practitioner's checklist. In Chapter 9, Chris Drewe, Patricia Moroney

and James Fox of Mazars discuss the particularities of accounts warranties. The chapter provides a useful guide for disputes lawyers, explaining the complexity of interpreting and analysing these clauses from an accounting expert's perspective.

The capstone chapter of Part I is Chapter 10, which pulls together advice to parties on how to structure their contracts to minimise the potential for dispute. Jonathan M Moses of Wachtell, Lipton, Rosen & Katz discusses key clauses that aid parties in ensuring that the deal closes, defining and limiting liability, reducing the risk disputes arising from true-ups and earn-out clauses, as well as minimising the impact of disputes on ongoing business relationships.

Part II focuses on the choice of substantive law in M&A contracts. The first eight chapters provide a geographical survey focusing on the particularities of substantive law that may influence the outcome of M&A disputes. Each chapter is structured in the same way for ease of comparison. This edition includes chapters for China (Sidley Austin), Germany (Freshfields Bruckhaus Deringer), Italy (Fieldfisher), South Korea (Kim & Chang), Switzerland (Thouvenin), the United Kingdom (Pallas Partners) and the United States (K&L Gates).

In these chapters, the first section considers the frequency of M&A disputes for transactions. The range in frequency is due in no small part to the substantive law and the extent to which it allows disputes to proceed on statutory grounds notwithstanding contractual limitations of liability. In particular, certain civil law jurisdictions open the door to cases where there are allegations of intentional failure to disclose relevant information.

The second section considers the frequency of litigation versus arbitration as a dispute resolution mechanism. Although litigation remains a popular choice, arbitration has become the nearly ubiquitous choice for dispute resolution in many jurisdictions. While a boon to arbitration practitioners, the dearth of published decisions in M&A disputes makes books like this all the more important.

The following section assesses the relative frequency of types of M&A disputes, including price adjustment disputes, earn-out disputes, pre-contractual failure to disclose and fraud disputes, and disputes arising from misrepresentations and breaches of warranties. While this cannot be done with scientific precision, this Section demonstrates again that there are two camps – one tending to allow fraud disputes, and one tending to disallow them. This distinction may be so significant as to brand the former as buyer-friendly regimes and the latter as seller-friendly.

The fourth section of each chapter in Part II addresses the applicable standard in the case of fraud or a failure to disclose information in the transaction phase. The scope of this standard, and the extent to which parties may derogate from

it in contract, are key factors in determining the volume of fraud-related M&A disputes. This is without doubt a key factor that parties should consider in choosing the applicable substantive law for their agreement.

The next section addresses burden of proof issues. In some jurisdictions there is a shifting of the burden of proof in cases where one party has better access to information or has been accused of wrongdoing. This burden-shifting may, in turn, be characterised as procedural or substantive. Burden-shifting can give the party lacking evidence (usually the buyer) a significant advantage and can thus be relevant to the choice of law. Tribunals may be faced with thorny issues involving the confluence of burden-shifting mechanisms arising under substantive law and procedural mechanisms available in arbitration that exceed those that would normally accompany the burden-shifting mechanism in state courts of that jurisdiction.

Sixth, some laws contain rules on imputation, attribution or pooling knowledge of sellers with management or target representatives. As M&A contracts typically limit representations and warranties to the knowledge of a defined group of persons at the seller, it is possible that relevant information at the target is not disclosed and may form the basis for claims. Whether or not the applicable substantive law contains such doctrines can materially impact a buyer's chances of succeeding on some claims.

In the seventh section, each chapter describes the remedies available under the substantive law of that jurisdiction. While all jurisdictions allow for money damages, some jurisdictions prioritise specific performance or may even provide for rescission or unwinding of the transaction in certain circumstances. Both buyers and sellers are well advised to understand the scope of potential remedies under the chosen substantive law.

In the eighth section, the authors discuss how damages are to be calculated. As discussed in Chapter 5, the choice of method can have a significant effect on the measure of damages. Parties and arbitrators should be aware of this legal backdrop in preparing and assessing expert evidence.

Ninth, the authors address the potential overlap between contractual and tort claims arising from the same set of facts and circumstances. In certain jurisdictions, law or doctrine may prevent an injured party from asserting tort claims in parallel.

Tenth, the authors analyse whether a choice of law clause in respect of the M&A contract would be interpreted to extend to ancillary tort claims arising out of or in connection with the transaction.

In the eleventh section, the authors consider whether there are special substantive issues in the jurisdiction that bear consideration. Some jurisdictions may subject M&A transactions to substantive rules governing sale of goods, whereas others may subject them to laws governing general terms and conditions, consumer protection laws or laws concerning unfair contract terms. For example, some jurisdictions may enforce 'best efforts' requirements, while others will not.

Finally, each chapter considers any special procedural issues that may arise in M&A disputes. These include special rules regarding the form of arbitration agreements, rules regarding joinder and consolidation, expert determinations, court support of arbitration, and special issues involving set-aside or recognition and enforcement.

Part II concludes with an overview chapter, authored by myself, analysing the country surveys and demonstrating some of the ways in which the choice of substantive law in the M&A contract may affect the outcome of an M&A dispute.

Conclusion

My thanks go to the talented and experienced team of lawyers and experts who have come together to deliver a truly pragmatic guide for M&A and disputes practitioners. This book continues to break new ground by considering the procedural, substantive and strategic aspects of M&A disputes. We are all grateful to Global Arbitration Review for including this book in the series of GAR Guides and for the team's highly professional guidance and support.

Part II

Survey of Substantive Laws

CHAPTER 11

China

Yan Zhang, Friven Yeoh and Michael Wang[1]

Frequency of M&A disputes

There are no official statistics on the frequency of M&A disputes in mainland China. Nonetheless, the following statistics on disputes relating to equity investment, financial investment or corporate matters, published by major arbitration institutions in China and leading international arbitral institutions in which China-related M&A disputes are most often handled, provide an indication of the frequency of these disputes:

Arbitral institution	2021	2020	2019
China International Economic and Trade Arbitration Commission (CIETAC)	Disputes relating to equity investment and equity transfer accounted for 10.1% of the total[2]	Disputes relating to equity investment and equity transfer accounted for 12.4% of the total[3]	Disputes relating to equity investment and equity transfer accounted for 13.5% of the total[4]

1 Yan Zhang and Friven Yeoh are partners and Michael Wang is a managing associate at Sidley Austin LLP. The authors are very grateful to Minzhen Sun, senior legal assistant at Sidley Austin, for her assistance with research and drafting.

2 China International Economic and Trade Arbitration Commission (CIETAC), 2021 CIETAC Working Report, http://www.cietac.org/index.php?m=Article&a=show&id=18233 (in Chinese).

3 CIETAC, Annual Report on International Commercial Arbitration in China (2020–2021), http://www.cietac.org/Uploads/202201/61e6705d45949.pdf (last accessed 21 October 2022).

4 CIETAC, Annual Report on International Commercial Arbitration in China (2019–2020), http://www.cietac.org/Uploads/202207/62c55b2fc3b5c.pdf (in Chinese).

Arbitral institution	2021	2020	2019
Shanghai International Arbitration Center (SHIAC)	Disputes relating to corporate equity and investment management accounted for 12% of the total[5]	Disputes relating to corporate equity and investment management accounted for 12.24% of the total[6]	N/A
Beijing Arbitration Commission (BAC)	Disputes relating to financial investment accounted for 32.34% of the total[7]	Disputes relating to financial investment accounted for 37.92% of the total[8]	N/A
Shenzhen Court of International Arbitration (SCIA)[9]	Disputes relating to equity investment accounted for 9.48% (677 cases) of the total[10]	Disputes relating to investment accounted for 9.12% (680 cases) of the total	Disputes relating to investment accounted for 5.36% (419 cases) of the total
Hong Kong International Arbitration Centre (HKIAC)[11]	Corporate disputes accounted for 19.5% of the total 81.6% of all arbitrations submitted to HKIAC in 2021 were international in nature. Parties from mainland China ranked second among the top users	Corporate disputes accounted for 18.3% of the total 72.3% of all arbitrations submitted to HKIAC in 2020 were international in nature. Parties from mainland China ranked second among the top users	Corporate disputes accounted for 17% of the total 80.9% of all arbitrations submitted to HKIAC in 2019 were international in nature. Parties from mainland China ranked second among the top users

5 Shanghai International Arbitration Center (SHIAC), 2021 Annual Report, https://www.shiac.org/pc/SHIAC?moduleCode=search&securityId=GA7js2nWmygWfeB30N5AIw (last accessed 30 November 2022).

6 SHIAC, 2020 Annual Report, https://www.shiac.org/pc/SHIAC?moduleCode=search&securityId=fGja1PqIP31dBK9HkmrhEw (last accessed 30 November 2022).

7 Beijing Arbitration Commission (BAC), 2021 BAC Annual Report, http://www.bjac.org.cn/news/view?id=4105.

8 BAC, 2020 BAC Annual Report, http://www.bjac.org.cn/news/view?id=3890.

9 Based on statistics shared by Shenzhen Court of International Arbitration (SCIA) Secretariat in October 2022, in response to an enquiry by the authors. In addition, between 1 January 2022 and 26 October 2022, there were 526 SCIA-administered cases arising out of disputes relating to equity investment.

10 SCIA, 2021 Statistics, http://www.scia.com.cn/en/index/newsdetail/id/3652.html (last accessed 21 October 2022).

11 Hong Kong International Arbitration Centre (HKIAC), 2009–2021 Statistics, https://www.hkiac.org/about-us/statistics. The statistics were shared by HKIAC Secretariat in response to an enquiry by the authors. Of all the corporate disputes administered by HKIAC, corporate governance, shareholder and post-M&A disputes are the frequent types of disputes. In addition, between 1 January 2021 and 15 August 2022, there were 51 HKIAC-administered cases arising out of M&A deals.

Arbitral institution	2021	2020	2019
Singapore International Arbitration Centre (SIAC)	Corporate disputes accounted for 14% of the total 86% (405 cases) of all arbitrations submitted to SIAC in 2021 were international in nature. Parties from mainland China ranked second among the top foreign users (94 parties from mainland China)[12]	Corporate disputes accounted for 7% of the total 94% (1,018 cases) of all arbitrations submitted to SIAC in 2020 were international in nature. Parties from mainland China ranked third among the top foreign users (195 parties from mainland China)[13]	Corporate disputes accounted for 29% of the total 87% (416 cases) of all arbitrations submitted to SIAC in 2019 were international in nature. Parties from mainland China ranked third among the top foreign users (76 parties were from mainland China)[14]

Form of dispute resolution

According to the Annual Report on International Commercial Arbitration in China published by CIETAC,[15] 259 arbitration commissions in China accepted a total of 400,711 cases in 2020. The number increased to 415,889 cases accepted by 270 Chinese arbitration commissions in 2021.[16] By comparison, in 2015, domestic Chinese arbitral institutions accepted a total of 136,924 cases.[17]

12 Singapore International Arbitration Centre (SIAC), Annual Report 2021, https://siac.org.sg/wp-content/uploads/2022/06/SIAC-AR2021-FinalFA.pdf (last accessed 21 October 2022).

13 SIAC, Annual Report 2020, https://siac.org.sg/wp-content/uploads/2022/06/SIAC_Annual_Report_2020.pdf (last accessed 21 October 2022).

14 SIAC, Annual Report 2019, https://siac.org.sg/wp-content/uploads/2022/06/SIAC-AR_FA-Final-Online-30-June-2020.pdf (last accessed 21 October 2022).

15 CIETAC, Annual Report on International Commercial Arbitration in China (2020–2021), p. 5, http://www.cietac.org/Uploads/202109/6154261524149.pdf

16 Ministry of Commerce of the People's Republic of China, Annual Report on International Commercial Arbitration in China (2021–2022), http://tradeinservices.mofcom.gov.cn/article/yanjiu/hangyezk/202209/137595.html (in Chinese).

17 CIETAC, Annual Report on International Commercial Arbitration in China (2015), p. 9, http://www.cietac.org/Uploads/201704/5901b2f95155b.pdf (last accessed 21 October 2022).

Compared with litigation, however, arbitration is overall still less frequently used to resolve disputes in China. The National Judicial Statistics published in the Gazette by the Supreme People's Court of the People's Republic of China (SPC) show that national courts at all levels accepted approximately 15.54 million civil cases in 2020 and 19.24 million civil cases in 2021.[18]

That said, in the authors' experience, in cross-border M&A transactions where at least one of the parties is non-Chinese, arbitration is more likely to be adopted.

Mediation is another common form of dispute resolution in China. Unlike the practice in many common law jurisdictions, arbitrators in China can also act as mediators in the same case. This is stipulated in the Chinese Arbitration Law.[19]

Expert determination and other forms of alternative dispute resolution apart from arbitration and mediation are rarely employed in China.

Grounds for M&A arbitrations

The typical grounds giving rise to M&A arbitrations relating to China are summarised below:

Failure to complete the transaction	Frequent M&A transactions may fail to complete for a variety of reasons. In the authors' experience, the more common 'failure to complete' scenarios that give rise to disputes in China are: • lack of regulatory approval: without the necessary government approvals, a contract is deemed to be established but not effective, such that completion cannot take place; and • lack of asset appraisal: state-owned assets are subject to pre-sale asset appraisals and approvals from government authorities, without which completion cannot take place and the M&A agreement can be deemed void or unenforceable as a matter of Chinese law

18 2021 National Judicial Statistics – see http://gongbao.court.gov.cn/Details/a6c42e26948d3545aea5419fa2beaa.html – and 2020 National Judicial Statistics – see http://gongbao.court.gov.cn/Details/0bce90201fd48b967ac863bd29059b.html – published in the Supreme People's Court Gazette (last accessed 28 November 2022).

19 The Chinese Arbitration Law at Article 51 provides: 'The arbitration tribunal may carry out conciliation prior to giving an arbitration award . . . If conciliation leads to a settlement agreement, the arbitration tribunal shall make a written conciliation statement or make an arbitration award in accordance with the result of the settlement agreement. A written conciliation statement and an arbitration award shall have equal legal effect.'

Price adjustment	Very frequent Price adjustment mechanisms, also often known as valuation adjustment mechanisms, have been widely adopted in China-related M&A transactions. The legality and enforceability of these clauses was previously hotly debated in China and among Chinese lawyers. See details below
Earn-out	Frequent
Pre-contractual failure to disclose or fraud	Frequent
Breach of representations and warranties	Frequent

Fraud and failure to disclose

M&A agreements in China, like other contracts, are governed by the general provisions of the new Chinese Civil Code (Civil Code), which took effect on 1 January 2021. Pursuant to Articles 148 and 149 of the Civil Code, if one party or a third party, by means of fraud, causes the other party to perform a civil juristic act (e.g., executing an agreement) against its true intentions, the affected party shall be entitled to apply to court or arbitral institution to rescind the act.

According to Article 152 of the Civil Code, this right to rescind a contract is extinguished where the party concerned:

- fails to exercise its right to rescind within one year of the date on which it becomes aware or should have become aware of the cause for recission;
- either expressly or by conduct waives its right to rescind the contract after it becomes aware or should have become aware of the grounds for rescission; or
- fails to exercise its right to rescind within five years of the date of occurrence of the civil juristic act involved.

Article 157 of the Civil Code provides that where a civil juristic act is rescinded, the property acquired as a result of the act shall be returned; if the property cannot be returned or restitution is unnecessary, compensation is due at its estimated price. The party at fault shall compensate the other party for resulting losses. If both parties are at fault, liability shall be apportioned.

Even before or during the conclusion of a contract, one party may be liable for damages if it is found to have (1) engaged in consultation with malicious intent under the guise of concluding a contract, (2) intentionally concealed key facts regarding the conclusion of the contract or provided false information, or (3) committed any other act contrary to the principle of good faith.[20]

Apart from civil liability, serious fraud can lead to criminal liabilities, including (1) up to 10 years' or life imprisonment, or (2) fines or confiscation of property.[21]

There are no specific disclosure standards under Chinese law. Rather, it is mainly an issue of contract drafting; to the extent that parties represent in their agreements that appropriate disclosures have been made but failed to do so, that can give rise to liability.

Burden of proof

Civil Procedure Law (2021 Amendments)

Each party bears the burden of providing evidence for its claims. However, if a party and its representative are unable to collect for objective reasons, or if a court considers the evidence necessary for trying a case, the court will investigate and collect evidence.[22] Tribunals in China have the power to conduct their own investigation and evidence collection per the Chinese Arbitration Law (Article 43) and arbitral institutions' rules. However, in practice, this power is not often exercised.

Evidence should be provided in a timely manner. If evidence is provided late, unless the producing party has an acceptable explanation, the court may deem the evidence inadmissible or adopt the evidence but reprimand or fine the party.[23] Arbitration conducted in China adheres to similar principles.

Standard of proof

The typical standard of proof in civil cases is on the balance of probabilities.[24] Article 109 of the Interpretation of the SPC on the Application of the Civil Procedure Law (2022 Amendments) raises the standard of proof if fraud is alleged, requiring fraud to be proved beyond a reasonable doubt.

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20 See Civil Code, Article 500.

21 Chinese Criminal Law, Article 266.

22 Civil Procedure Law (2021 Amendments), Article 67.

23 ibid., Article 68.

24 Interpretations of the Supreme People's Court on the Application of the Civil Procedure Law of China 2022 (2022 Amendments), Article 108.

Article 95 of the Provisions of the SPC on Evidence in Civil Proceedings stipulates that where a party concerned refuses, without any justifiable reason, to provide evidence within its control, and a party bearing the burden of proving the fact pending proof alleges that contents of that evidence is disadvantageous to the party in control of the evidence, the court may determine that the allegation is tenable.

Knowledge sharing

We have found no statutory rules on the pooling of knowledge of sellers with management or other representatives of the target.

Remedies

All remedies available under the Civil Code are available to a successful claimant in an M&A arbitration in China. Typical remedies for breach of contract include specific performance, remedial measures such as repair, rework and remuneration reduction, as well as compensation for loss.[25]

If the performance fails to meet the agreed requirements, and there is no clear agreement in the contract on the remedies available, unless the agreement is supplemented either by parties' subsequent agreement or in accordance with Article 510 of the Civil Code (which provides that, in the absence of the parties' subsequent agreement, gaps in agreements shall be determined in accordance with relevant clauses of the contract or based on trade practices), the aggrieved party may, in light of the nature of the subject matter and the degree of loss, reasonably choose to request the other party to repair, substitute or redo the work, return the goods, or reduce the price or remuneration.

Measure of damages

Damages are awarded mainly on a compensatory (rather than punitive) basis.

The amount of compensation shall be equal to that caused by the breach of contract, including the profits receivable upon satisfactory performance of the contract, provided it does not exceed the amount that was foreseen or ought to have been foreseen at the time of conclusion of the contract.[26]

25 Civil Code, Article 577.

26 ibid., Article 584.

Liquidated damages

Pre-agreed liquidated damages can be varied by a court or arbitral tribunal. When the liquidated damages are lower than the damage actually incurred, a party may apply to court or arbitral tribunal for an increased sum; when the liquidated damages are significantly higher than the damage actually incurred, a party may apply to make an appropriate reduction.[27] If the parties agree on liquidated damages for delays in performance, the breaching party remains required to perform its obligations after paying the liquidated damages.

Deposit

Articles 586 and 587 of the Civil Code provide that the parties may agree that one party pay a deposit to the other as a guarantee for its performance. Upon the performance of the obligor's duties, the deposit shall be offset against the price or refunded to the obligor. If the party paying the deposit fails to perform its obligations under the contract, that party has no right to demand the return of the deposit. If the party that accepts the deposit fails to perform its obligations under the contract, it can be required to refund twice the value of the deposit.

If an agreement provides for both liquidated damages and deposit payment, the non-breaching party may choose to apply either provision.[28]

Mitigation

Article 591 of the Civil Code provides that when a party has breached the contract, the non-breaching party has to take appropriate measures to mitigate its losses and cannot recover for loss arising from its failure to do so. Reasonable expenses incurred by the mitigating party shall be borne by the breaching party.

Article 592 of the Civil Code provides that if both parties breach the contract, each party shall bear its own respective liabilities under the contract. If one party breaches the contract and causes loss to the other party, but the other party is at fault for the occurrence of the loss, the amount of compensation for loss can be reduced accordingly.

Availability of tort claims

Unless specifically excluded by the arbitration agreement, a claim in tort can be a valid cause of action in arbitration.

27 ibid., Article 585.

28 ibid., Article 588.

Under Chinese law, a claimant is free to choose whether to claim based on contract or tort.[29]

It should be noted that, even if the claimant is bringing a tort claim that arises from a contractual breach, it remains bound by the arbitration agreement (so long as the arbitration agreement is drafted to cover such disputes). An SPC ruling in September 2020 made clear that parties may not avoid arbitration by tactically choosing tort (over contract) as the cause of action. In the 2020 case, the plaintiff brought an intellectual property infringement suit against a contractual counterparty and a third party as co-defendants. The Shanghai Intellectual Property Court held that the dispute between the plaintiff and the contractual counterparty should be resolved by arbitration as it fell within the scope of a valid arbitration agreement. This was upheld on appeal by the SPC, which noted that even though a third party was joined as co-defendant in the tort claim, the dispute between the parties to the arbitration agreement should still be resolved separately by arbitration.[30]

Law applicable to tort claims

The applicable law of the contract agreed by the parties may not necessarily be the applicable law governing a claim in tort.

Pursuant to Article 44 of the Law of the People's Republic of China on Application of Laws to Foreign-Related Civil Relations (i.e., the conflict law in China), liabilities in tort shall be governed by the *lex loci delicti*, save that where the parties concerned have a common habitual residence, the law of the common habitual residence shall apply. Agreements on the application of law reached by the parties concerned after the occurrence of the tort shall prevail.

Hence, unless otherwise agreed after a tortious activity occurs, a claim in tort shall be governed by *lex loci delicti* or laws of the common habitual residence. If a tortious activity occurs in China, it is highly likely that Chinese law will apply.

Special substantive issues

For China-related M&A disputes, two substantive issues under Chinese law require special attention: (1) the doctrine of *force majeure* and change of circumstances, and their interplay with the material adverse change (MAC) provisions that are often key in M&A contracts; and (2) price adjustment mechanisms or valuation adjustment mechanisms (VAMs).

29 ibid., Article 186.

30 (2020) Zui Gao Fa Zhi Min Zhong, No. 1360 Zhi Yi.

Material adverse change

In M&A contracts, MAC clauses provide buyers with the right to terminate the agreement (a walk away right) if certain defined material adverse changes occur during the execution of the contract and prior to closing of the deal. Therefore, the definition of MAC (or material adverse effect (MAE), a similar concept) is often carefully negotiated between the parties to clarify the risk allocation arising from adverse future developments to the extent possible. Customarily, this definition includes a long list of exclusions, the occurrence of which are defined not to constitute MACs. In many jurisdictions, it is common practice to carve out *force majeure* events (such as the covid-19 pandemic) from the definition of MAC. This puts the risk of *force majeure* on the buyer, meaning that the buyer may not walk away from the transaction without liability in reliance on the occurrence of a *force majeure* event.

Force majeure under Chinese law

That may not be the default case in Chinese M&A agreements. Chinese law[31] specifically excuses parties from performance of contractual obligations owing to *force majeure* events occurring, even if the parties have not reached any express *force majeure* provisions. However, if the parties have reached express agreement as to what does or does not constitute *force majeure*, usually their agreement will govern rather than the *force majeure* provisions of the Chinese law. Accordingly, if the parties fail specifically to carve out specified *force majeure* events from the definition of MAC, the buyer may rely on Chinese law to argue that it has a statutory right to walk away. It is important, therefore, to understand what constitutes a *force majeure* event under Chinese law.

To qualify as a *force majeure* event under Chinese law, a party has to prove that the event is objective, unforeseeable, unavoidable and insurmountable.[32]

The event must be 'objective' in the sense that it cannot be a self-inflicted event by the party itself seeking to rely on *force majeure*. As to the 'unforseeability' criterion, the relevant time for the purposes of evaluating foreseeability is the time when the contract is executed.[33] 'Unavoidability' and 'insurmounta-

31 Civil Code, Article 590.

32 ibid., Article 180.

33 Dispute over Construction Contract between Hunan Shuntian Construction Group Co., Ltd and Yiyang Ziyang Business Investment and Development Co., Ltd. (2018) Zui Gao Fa Min Zai No. 442.

bility' require the party relying on *force majeure* to establish that even if reasonable endeavours were undertaken, the intervening event was so serious that it could not be overcome.[34]

Chinese law also requires a party relying on *force majeure* to comply with the notice and proof requirements under Article 590 of the Civil Code. A notification or proof will generally be considered timely if it is made within the period specified in the parties' contract or, if the contract is silent, within a reasonable time.

If a *force majeure* event is established, the party who is unable to perform a contract owing to the *force majeure* event is in part or wholly exempted from liability. Further, if a *force majeure* event renders it impossible to achieve the purpose of a contract, either party may terminate the contract. If the contract has been performed, a party may, in accordance with the circumstances of performance or the nature of the contract, demand that the other party restore such party to its original state.[35]

Change of circumstances

In the event a court or tribunal deems the doctrine of *force majeure* inapplicable, events such as the covid-19 pandemic are likely to trigger the applicability of the Chinese legal regime on change of circumstances.[36]

To establish a change of circumstance, the following criteria must be met: (1) the purpose of the contract must be shown to be substantially frustrated as a matter of change; (2) the party relying on a change of circumstance must also establish that the change is unforeseeable at the time of the contract, and that it is not a business risk; and (3) the party claiming change of circumstance would also have to show that it will be 'obviously unfair' to insist on continued performance of the contract.[37] Business risks foreseeable by the parties at the time of signing the contract (such as fluctuations in price of shares) do not qualify.[38]

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34 Dispute over Custody Contract of Port Goods between Quanzhou Branch of PICC Property and Casualty Co., Ltd and Haikou Port Container Terminal Co., Ltd (2017) Zui Gao Fa Min Shen No. 3252.

35 Civil Code, Article 566.

36 ibid., Article 533.

37 Application for Retrial of Civil Judgment on Maritime Salvage Contract Dispute between South China Sea Rescue Bureau of the Ministry of Transport and Archangelos Investments E.N.E. and Shanghai Representative Office of Hong Kong Anda Olsen Co., Ltd (2016) Zui Gao Fa Min Zai No. 61.

38 'Selection of Typical Cases of Force Majeure and Change in Circumstances from the Perspective of Public Health Emergencies' (Peking University Press, 2020), pp. 179–86.

If a change of circumstances is established, the adversely affected party may renegotiate with the other party. When negotiations fail to resolve the matter, the affected party may request the court or arbitral tribunal to modify or terminate the contract.

Takeaway

The SPC determined in 2020 that covid-19 constitutes a natural disaster for the purposes of Article 117 of the Contract Law (now Article 590 of the Civil Code).[39] The Shanghai High Court also took the view that the covid-19 pandemic is considered a *force majeure* event.[40] Additionally, the China Council for the Promotion of International Trade (CCPIT) has issued covid-19 *force majeure* certificates to enterprises in China since February 2020.[41] Although these do not constitute conclusive evidence and do not guarantee a finding by a court or tribunal that covid-19 constitutes a valid *force majeure* event in any particular case such as to excuse performance, they nevertheless lend support to a buyer in terminating an M&A contract that contains a MAC clause that is silent on *force majeure* events.

There have been cases in which parties have successfully convinced Chinese courts[42] or tribunals[43] that the covid-19 pandemic constituted *force majeure* or a change of circumstances so that their obligations under the agreed deal were

39 Guiding Opinions of the Supreme People's Court of the People's Republic of China (SPC) on Several Issues concerning the Proper Hearing of Civil Cases Involving the Covid-19 Pandemic Pursuant to the Law (I), (II) and (III).

40 Shanghai High Court Q&A on application of law in Covid-19 related cases, amended in 2022

41 China Council for the Promotion of International Trade (CCPIT), 'CCPIT Provides COVID-19 Force Majeure Certificates and Other Services' (March 2020), https://en.ccpit.org/infoById/40288117668b3d9b0170d2952a7f0799/2 (last accessed 21 October 2022).

42 (2022) Jing 01 Min Zhong 162; (2021) Chuan 0108 Min Chu 574.

43 In an equity investment, the seller agreed to compensate the buyer in cash if the net profit of the target company fails to meet certain financial targets within a certain period after completion of the investment. The net profit fell below the threshold and the seller refused to pay. In an arbitration brought by the buyer, the seller argued that performance of the target company had been adversely affected by the covid-19 pandemic and, therefore, it was entitled to be exempted from its contractual obligations citing the change of circumstances doctrine. The tribunal accepted the seller's arguments and reduced the payment by half. 'Application of Situation Change System in VAM Cases', https://www.jingtian.com/Content/2022/05-06/1741274545.html (in Chinese).

to be excused or varied. Some courts were more conservative in applying that doctrine and rejected the argument, finding that there was no causal connection between the pandemic and non-performance of the obligation.[44]

Hence, to avoid uncertainty arising from unforeseeable events such as the covid-19 pandemic, parties to China M&A contacts are advised to negotiate and document carefully how the risks associated with unforeseeable events are to be allocated among the parties. Specifically, parties should clearly set out in the MAC definition whether *force majeure* events are to be included or excluded, as there exist statutory provisions on *force majeure* (or the somewhat overlapping change of circumstances concept) under Chinese law, which can apply in the absence of express *force majeure* provisions between the parties.

Valuation adjustment mechanism

VAMs have been widely used in Chinese private equity deals (especially minority investments) during the past decade. VAMs refer to arrangements between an investor and a financing raiser (often the target company or its majority shareholder) when reaching an equity financing agreement to resolve uncertainties about future development of the target company, information asymmetry and agency costs between the parties to the transaction. VAMs provide mechanisms for adjustment to the valuation of the prospective target company, and might be in the form of share repurchase or cash compensation obligations.

A typical example of a VAM would be an exit mechanism (e.g., redemption or put option) guaranteeing the new investor (either by the target company or the existing shareholders) a minimum annual percentage return calculated by reference to its investment amount, with or without a further variable component. The amount might be payable regardless of whether the target is making a profit or suffering a loss, and often the right is triggered if the target company fails to complete a qualified initial public offering within an agreed period upon closing the investment.

VAMs and their legality and enforceability under Chinese law have been frequently disputed before Chinese courts or tribunals during the past decade.

For a time, different courts arrived at different conclusions as to the validity of VAMs under Chinese law. Some courts were of view that a VAM that provides for a guaranteed fixed return is prohibited under Chinese law and thus invalid

44 (2020) Min 0802 Min Chu No. 5966; (2021) Yue 01 Min Zhong 28121.

and unenforceable;[45] or that a VAM between an investor and the target company is invalid as it is a disguised lending transaction rather than an equity investment and thus could harm other stakeholders' interests. Other courts have taken the position that a VAM entered into between an investor and the target's original shareholder (as opposed to between an investor and the target company itself) is not prohibited under Chinese law. This was affirmed by the SPC in 2012 in the influential *Haifu* case[46] and its progeny.

The Minutes of the National Courts' Civil and Commercial Trial Work Conference issued on 8 November 2019 (Jiu Min Ji Yao) provided long-awaited clarity on VAM-related issues. It confirmed that (1) a VAM agreement between a new investor and existing shareholders of the target company is valid, and (2) a VAM agreement between the shareholders and the target company is also valid and the implementation of such an agreement (e.g., allowing a redemption of the investors' investments) is permitted so long as certain conditions are satisfied. The court or tribunal will consider whether the implementation of a VAM agreement between the shareholders and the target company violates the principle that a shareholder is prohibited from withdrawing its paid-up capital contributions, and the principle that a company may not acquire its own shares unless otherwise permitted by law.[47]

It is typically advised that the investment return rate in the VAM formulation, if any, should not exceed the upper limit financing cost in private lending transactions. Where the VAM return rate is more than the maximum private loan rate,[48] a court or arbitral tribunal applying Chinese law is likely to find any return in excess void, effectively lowering the VAM return rate to the maximum private loan rate permitted.

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45 Disputes relating to contract between DLP Investment Holdings and Fanyong Meng (Higher People's Court of Hebei Province (2016) Civ Shen Zi No. 4562).

46 *Suzhou Industrial Park Haifu Investment Co., Ltd. v. Gansu Shiheng Non-Ferrous Resources Recycling Co., Ltd, Hong Kong Der Co., Ltd, and Lu Bo*, in a case of dispute over an agreement for an increase in capital (Min Ti Zi (2012) No.11). The SPC held: 'If the price adjustment does not harm the interest of the company and its creditors and does not violate the prohibitive provisions of laws and regulations, it will be valid as long as it is the true intention of the parties.'

47 See Chinese Company Law, Articles 35 and 142.

48 Provisions of the Supreme People's Court on Several Issues concerning the Application of Law in the Trial of Cases involving Private Lending, Article 25.

Special procedural issues

Two procedural issues in M&A arbitrations are worth noting: the binding effect of an arbitration agreement on certain non-signatories; and expert appointments.

Binding effect of an arbitration agreement on certain non-signatories

As in many jurisdictions, China adopts the norm that an arbitration agreement only binds signatories. There are a few limited exceptions specifically permitted by Chinese law, including:

- successors to a party after a merger or division;
- heirs to a party after that party's death;
- insurers who have obtained rights of subrogation, subject to certain limitations; and
- transferees when a creditor's rights or debts are transferred, unless the parties agree otherwise or the transferee explicitly objects to or is unaware of the existence of a separate arbitration agreement.[49]

There are also a few situations that are grey areas. Particularly relevant in the M&A context, it is not completely clear under Chinese law whether a non-party can be bound by an arbitration agreement in the following situations and, therefore, a separate analysis is required in each case.

Contract providing performance to a third party

Article 522 of the Civil Code, replacing Article 64 of the Contract Law, provides that where performance of a contract is to a third party, the third party may directly request performance by the obligor and claim breach of contract against the obligor where it is provided by law or by contractual parties' agreement. It is a welcome change that brings Chinese law in line with most civil and common law jurisdictions that have reformed their rules on privity of contract.

This provision may come into play in M&A deals where parties agree that the buyer, as a post-closing covenant, is responsible for buying directors and officers (D&O) insurance for directors of the target company within a specified period after closing. If the buyer fails to comply with such a covenant, the directors would be entitled to request that the buyer perform that obligation or claim

49 Articles 8(1), 8(2) and 9 of the Interpretation of the Supreme People's Court on Certain Issues Concerning the Application of the Arbitration Law of the People's Republic of China; Minutes of the National Courts' Civil and Commercial Trial Work Conference issued on 8 November 2019 (Jiu Min Ji Yao).

breach against the buyer so long as the contract so provides. In the event that the M&A contract contains an arbitration clause, it would be interesting to see if a director can bring an arbitration against the buyer, or seek to be joined to any existing arbitration between the buyer and the seller. The jury is still out as to how courts and tribunals in China will interpret this provision and whether they will use it to find jurisdiction over third parties who are to receive performance from a contract party.

Piercing the corporate veil

Piercing the corporate veil is not a new legal concept. It can be particularly relevant in the M&A context where, for example, a parent company as a non-party to the acquisition agreement in fact exercises control over the target or subsidiary in the process of signing or performing the agreement. Unlike tribunals in some jurisdictions that have pierced the corporate veil,[50] courts and tribunals applying Chinese law have been cautious about applying this principle, and there are few publicly reported cases in which a party has successfully used this doctrine to join a non-signatory parent company to an arbitration.

Group of companies doctrine

The 'group of companies' doctrine can be traced to the International Chamber of Commerce (ICC) award in the *Dow Chemical* case.[51] The ICC tribunal found jurisdiction over a non-signatory to the arbitration agreement, on the basis that it had effectively individually participated in the conclusion, performance and termination of the underlying contract, consistent with the mutual intentions of the parties. The award was upheld by the Paris Court of Appeal.[52] That said, no official view has been taken by the judiciary on the application of this doctrine in China. Therefore, courts and arbitral tribunals in China are likely to continue to take a prudent approach and conduct their own analysis based on the specific facts and circumstances of each individual case.

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50 For example, *Aloe Vera of America, Inc v. Asianic Food (S) Pte Ltd and another* [2006] 3 SLR(R) 174 (Singapore).

51 International Chamber of Commerce, Case No. 4131, Y.C.A. Vol. IX (1984), 131.

52 *Rev. Arb.* 1984, 98.

Expert appointments

In M&A disputes, expert opinions on accounting issues, industry practice or damage assessment are often necessary. In Chinese M&A arbitrations where such expertise is required, traditionally the tribunal will take the initiative to retain an expert to produce an expert report to assist it. This tradition is evident from, for example, Article 44(1) of the CIETAC Rules, which clarifies that 'the arbitral tribunal may consult with experts or appoint appraisers to conduct expert appraisals on specialized issues in the case'. This is different from the practice commonly adopted in common law jurisdictions in which each party will retain its own expert (as provided in Article 5 of the International Bar Association's Rules on the Taking of Evidence in International Arbitration), who will be cross-examined by the opposing side's counsel, or put in a 'hot tub' expert conference with the tribunal leading the questioning.

APPENDIX 1

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Yan Zhang is a partner in Sidley Austin's global arbitration, trade and advocacy practice, based in Hong Kong. She focuses her practice on acting for clients in international commercial arbitration under various institutional and ad hoc rules. Yan also has a decade of experience as an international transactional lawyer practising in New York, Hong Kong and Shanghai, having advised private equity funds and multinational companies in M&A and other corporate transactions.

Yan has been ranked in various legal publications for her work, including *Chambers Global: China Dispute Resolution/Arbitration*, *Chambers Greater China Region* (Dispute Resolution/Arbitration), *Who's Who Legal: Arbitration 2022* and *The Legal 500 Asia Pacific 2018 – International Arbitration*, and was shortlisted as a Commercial Arbitration Lawyer of the Year for IFLR's Women in Business Law APAC Awards 2022. In addition to her work as counsel, Yan also sits as an arbitrator.

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Michael Wang is a managing associate in Sidley Austin's global arbitration, trade and advocacy practice, based in Shanghai. Michael has acted for clients in international arbitration cases conducted under various institutional rules and in a wide variety of industries. In addition to his work as counsel, Michael has also acted as tribunal secretary and has supported case management.

Michael is a prolific author and has published more than 20 articles in academic journals. He received his PhD from East China University of Political Science and Law, and LLM degrees from both University of California, Berkeley School of Law, and University of Stockholm. He also holds a PRC Legal Professional Qualification Certificate.

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M&A disputes can be unique in their hostility and complexity. The *M&A Arbitration Guide* – published by Global Arbitration Review – is a practical guide on what merger parties should think about when it comes to disputes. It pools the wisdom of specialists on how to prevent these disputes arising and how best to resolve them when it is too late. The guide is structured in two sections. Part I consists of 10 chapters on planning and procedural issues, covering everything from drafting clauses to how to structure contracts to minimise the potential for disputes. Part II offers a geographical survey of important differences in national laws that may affect the outcome of a dispute. It is written by 39 specialists from a variety of backgrounds and takes a practical approach throughout.

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