



# Hong Kong court refuses to enforce an arbitral award on the basis of violation of public policy

5 November 2018

In *Z and Y* [2018] HKCFI 2342, the Hong Kong Court of First Instance (CFI) refused to recognize and enforce an arbitral award (Award) of the China Guangzhou Arbitration Commission (Commission) on the basis that enforcement under section 95(3)(b) of the Hong Kong Arbitration Ordinance would be contrary to the public policy of Hong Kong. This is a rare example of the Hong Kong courts invoking such grounds. The judgment also dealt with commonplace arguments to challenge jurisdiction and enforcement, which will be of interest to arbitration users.

## Background

The arbitration was commenced by the applicant against the respondent under a guarantee purportedly signed by the respondent in 2014. Under this instrument, the respondent was to guarantee a debt of CNY¥10.23 million allegedly due to the applicant by a Chinese company known as HD, accrued under eight supply contracts whereby the applicant sold plastic raw materials to HD. Around the same time, HD's affiliate company (known as MD) purportedly entered into eight supply contracts with the applicant, under which MD would supply to the applicant the exact amount and types of goods supplied by the applicant to HD. This was essentially a back-to-back arrangement where goods were passed from MD to the applicant and then to HD.

Leave to enforce the award was originally granted by the CFI on 28 August 2017 as part of the standard procedure in an *ex parte* application for leave. The respondent then applied to the CFI to set aside the enforcement order on the following grounds.

## Illegality ground

The respondent argued that the various supply contracts were sham arrangements to hide what was in reality loans between the applicant and HD, the act of which contravened People's Republic of China (PRC) law and constituted the criminal offence of "fraudulent contracts."

In this regard, the respondent adduced evidence to show that it was abnormal for the applicant, HD, and MD to have entered into their transactions because

- HD and MD only purchased raw materials for their own use in their ordinary course of business;
- the types of raw materials required and used by them were different; and

- HD and MD were both scaling and closing down their businesses, and it did not make sense for there to be purchases of such large amounts. Accordingly, it was inconceivable for there to be back-to-back transactions.

In response, the applicant merely pointed out that this illegality ground had been argued by the respondent in the arbitration which was dismissed by the tribunal.

In examining this ground, the CFI clarified that it should neither review the merits of the award, nor is any mistake of fact or law made by the tribunal a ground to set aside or refuse enforcement. However, the CFI held that the tribunal had failed to give any adequate reasons as to why it had concluded that the illegality ground had not been established by the respondent and should be dismissed. The CFI found the respondent's case as to the sham transactions of the supply of materials to be credible, and was supported by evidence. The allegations of such unlawful loans therefore raised serious issues of illegality and possible offenses under PRC law, which the CFI thought the tribunal had not thoroughly considered.

Accordingly, the CFI said that it would offend notions of fairness and justice to enforce the award when it might be tainted by illegality, and when a significant issue brought before the tribunal for determination had not been seen to be properly considered and determined, contrary to the parties' legitimate and reasonable expectations.

Other grounds raised by the respondent to resist enforcement – capacity, invalid guarantee, and lack of proper notice – were rejected. However, the CFI was sympathetic to the illegality argument raised under the invalid guarantee ground, which it had addressed above.

#### **Invalid arbitration agreement ground**

The respondent argued that there was no valid arbitration agreement as it only provided that the parties to the guarantee "may" apply to the Commission for arbitration. Further, the guarantee was not signed by the applicant, and there was no evidence that it had agreed to the document or become a party to the guarantee and the arbitration agreement.

The CFI held that although the arbitration clause in the guarantee stipulated that any party "may" apply for arbitration for any dispute, case law ruled that once a party applies to exercise this option, the other party would be bound to accept the reference (*Hermes One Ltd v. Everbread Holdings Ltd* [2016] 1 WLR 4098). As such, the CFI rejected the respondent's submission that there was no binding arbitration agreement because the arbitration clause was uncertain and not mandatory.

However, onto the respondent's argument that the guarantee was not signed by the applicant, the CFI noted that the question of the validity of the guarantee under PRC law was not addressed in the award. There was no reason given to support the tribunal's finding that there was a valid guarantee under PRC law, apart from the fact that it was signed by the respondent as a person with legal capacity, and did not contravene any law and should be enforced. In the CFI's view, the tribunal's failure to adequately explain why it upheld the validity of the guarantee casted doubt on its acceptance of the existence of a valid and binding arbitration agreement between the applicant and the respondent.

#### **Commentary**

The CFI ruled that it would be contrary to the public policy of Hong Kong to enforce the award since the tribunal had failed to give adequate reasons as to why it accepted the guarantee to be valid and legally enforceable, in light of the respondent's illegality claims.

This case constitutes one of the rare instances where an arbitral award was refused recognition on the basis of a violation of Hong Kong's public policy. Based on our analysis of the case, the CFI cannot be said to have invoked the public policy ground loosely. The CFI displayed genuine concerns in recognizing and enforcing an award that, on the evidence before the court, may have been tainted by illegality that had not been thoroughly considered by the tribunal.

Without a doubt, national courts should adopt a pro-enforcement stance to uphold the sanctity of arbitration. Courts should also treat the enforcement of awards "almost [as] a matter of administrative procedure" and be "as mechanistic as possible" (*KB v. S* (HCCT 13/2015)). However, safeguards exist to prevent the enforcement of awards tainted by illegality arising out of the underlying contract. This case serves as a confident reminder that the Hong Kong courts continue to uphold the notions of fairness and justice that underpin the judicial system.

## Contacts



**Timothy Hill**  
Partner, Hong Kong  
T +852 2840 5023  
[timothy.hill@hoganlovells.com](mailto:timothy.hill@hoganlovells.com)



**James Kwan**  
Partner, Hong Kong  
T +852 2840 5030  
[james.kwan@hoganlovells.com](mailto:james.kwan@hoganlovells.com)



**James Ng**  
Registered Foreign Lawyer, Hong Kong  
T +852 2840 5024  
[james.ng@hoganlovells.com](mailto:james.ng@hoganlovells.com)



**Damon So**  
Partner, Hong Kong  
T +852 2840 5018  
[damon.so@hoganlovells.com](mailto:damon.so@hoganlovells.com)



**Kathy Tang**  
Trainee Solicitor, Hong Kong  
T +852 2840 5978  
[kathy.tang@hoganlovells.com](mailto:kathy.tang@hoganlovells.com)

## [www.hoganlovells.com](http://www.hoganlovells.com)

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses. The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members. For more information about Hogan Lovells, the partners and their qualifications, see [www.hoganlovells.com](http://www.hoganlovells.com).

Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.

© Hogan Lovells 2018. All rights reserved.