

# PRC Companies in International Arbitration: Is third-party funding feasible?

by Steven C. Nelson

As mentioned in our previous article, the costs of commercial arbitration in Hong Kong are pretty high. Third-party funding, however, could be one of the possible solutions for companies to consider. Consider the situation where a company has exhausted every possible effort to restore its production and business operation following the COVID-19 pandemic, but then suddenly a multinational corporation (“**MNC**”) with which the company has a long-term cooperation seeks to terminate a contract due to its inability to perform the contract for the next 5 years due to the COVID-19 pandemic in its home country. Such termination is clearly a breach of contract, assuming of course that performance is not excused by reason of the pandemic under a force majeure clause or applicable law.

No doubt, this would deal a significant blow to the company, one which is even aggravated by the difficult business environment.

The problem the company faces is that, on one hand, the counterparty is clearly a defaulting party with ample assets. So if the company commences arbitration (the contract contains a clause providing for arbitration in Hong Kong), and wins the case, the counterparty’s assets should be sufficient to enable the company to enforce the arbitral award.

However, the company will need to utilize its limited capital to pay for the arbitration costs, which is a considerable amount of money in the current economic climate. On the other hand, the counterparty, as a MNC, would normally have sufficient reserve funds to handle any litigation or arbitration costs.

In this situation, third-party funding can not only provide timely financing to the company but may also benefit another party. The company would receive funds to carry out an arbitration, while the third party would earn a fairly high rate of return on its investment.

But is there any underlying risk behind such a match made in heaven? In this article, we will try to share how third-party funding works in practice and provide some thoughts

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regarding the factors that companies should take into consideration.

### **How does third-party funding work?**

“Third-Party Funding” is a method whereby a party to a dispute obtains funding to carry out arbitration proceedings from a third party that is unconnected to such dispute. It has not historically been popular with the courts. A highly esteemed English judge, Lord Denning, once wrote in his judgement in ***Re Trepca Mines Ltd*** that a third-party funder “*might be tempted, for his own personal gain, to inflame the damages, to suppress evidence, or even to suborn witnesses*”. It is for this reason that third-party funding has, until recent years, been prohibited in common law jurisdictions<sup>1</sup> to prevent any abuse of judicial proceedings or the perversion of the course of justice due to the manipulation of proceedings by third-party funders.

On the other hand, a consequence of prohibiting third-party funding is that some litigants have to forfeit their right to recourse due to their inability to afford high litigation costs, which is, of course, itself contrary to principles of justice. Therefore, in the past decades, Britain and Australia, which are common law jurisdictions like Hong Kong, have confirmed the legitimacy of third-party funding in both litigation and arbitration. While Hong Kong does not yet allow such funding of court litigation, the Arbitration Ordinance (Cap. 609) (the “**Ordinance**”) was amended in 2017 to allow third-party funders to provide economic support to arbitration proceedings. Subsequently, a Code of Practice for Third Party Funding of Arbitration (the “**Code of Practice**”) has been adopted. It became effective on February 1, 2019 and now defines and regulates funding agreements and responsibilities of both parties thereto.

### **How does third-party funding actually work in international commercial arbitrations?**

Before a third-party funder decides whether to provide funding, it first makes an independent assessment of the case and the likely enforceability of the resulting arbitral award. Hence, companies seeking such funding need to provide the funder with case details and principal evidence. The third-party funder will usually appoint an independent legal team to analyse the case and evidence and make its own assessment of the case outcome and the enforceability of the award. Generally, the third party institution would also have certain requirements as to the minimum amount at issue in the arbitration; for example, some institutions require that the amount in dispute not be less than US\$5 million.

If the third-party funder decides to fund the company, the parties will negotiate the terms of funding and enter into an agreement. There are different funding institutions in the market, and their terms of funding vary as well. For example, if the third party agrees to afford all of the costs of arbitration, it would require the funded company to reimburse two or three times the principal amount of the funding provided (or a proportion of the total amount of arbitration recovery) as compensation its risk.

## **What factors should the funded company take into account?**

Firstly, one of the reasons companies choose arbitration to resolve disputes is the confidentiality of arbitration. However, when introducing a third party into the case, the company is obviously required to disclose considerable documents to the third party for its consideration as to possible funding. These materials may involve information with business sensitivity. Although the third party will undertake a confidentiality commitment to the company, this is still one of the factors to be taken into account carefully by the funded company, depending on the sensitivity of the information.

The second largest factor to be taken into account is the possible conflicts of interest between the funded company and the third party. Generally, the interests of the company and the third party are aligned. However, in certain cases, the parties may have conflicts of interest.

For example, when the case reaches a certain phase at which the company is willing to consider settlement with the counterparty but there is a gap between the amount of settlement the company is willing to accept and the amount expected by the third party. This may occur where the return to the third party is connected to the amount recovered by the funded company in the arbitration. At the same time, there are many factors other than the settlement amount that the company needs to take into account when considering a settlement, such as the management time and attention required to continue prosecuting the case and perhaps even a possibility of future cooperation between the company and the counterparty to the dispute. In this situation, the company may want to reach a settlement while the funder prefers to proceed with the arbitration.

In the above scenario, the company needs to rely on the professional advice of its legal team to make an objective assessment of the overall direction of case and the strength of the evidence for the company to weigh in deciding on a settlement. The professional integrity of the lawyers is particularly important at this moment because, although the funded party is the lawyer's client, it is the funder which actually pays all expenses incurred by the lawyer. Nevertheless, the rules of professional conduct lawyers require that they consider only the best interests of their clients.

The abovementioned Code of Practice also regulates the possible conflicts of interest, requiring the funder not to interfere with the lawyer of the funded party or attempt to limit or impede the moral and fiduciary obligations of the lawyer to its clients. In the event of any conflict of interest between the funder and the funded party, the legal representative to the funded party must have the right to act freely in a manner that is in the best interests of the funded party, even it is not in the funder's favour. These protective arrangements can be explicitly included in the funding agreement.

## **Conclusion**

When a company has a dispute with an important business partner that has committed an obvious breach of contract for which the company can commence an arbitration and claim its rights, but the company is not willing to invest its limited capital in paying

potentially large arbitration costs, pursuing third-party funding could be a solution worthy of consideration, and a win-win situation for both the funder and the funded party may be achieved.

Another very practical impact of such funding is that it must be disclosed to the arbitral tribunal and the counterparty; this in itself may have a considerable deterrent effect on the counterparty. That is so because the third party would not make any investment unless it has already made an independent assessment of the merits of the case and concluded that the case is strong and supported by evidence. Such a positive result of that assessment will have a certain impact on the counterparty's consideration of how to respond to the arbitration, the strategies to be adopted in the arbitration and whether the counterparty should take the initiative to discuss the possibility of settlement with the funded company.

<sup>1</sup> Since third party funding involves doctrines of maintenance and champerty.

Maintenance means a third party with no interest in a legal action provides funding to support a party in its legal action. Champerty is when a person provides funding whether in part or in full to a party in its legal action for the purpose of taking a reward from the funded person's successful outcome of the legal action.