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## Third Party Funding in Litigation and Arbitration: A Dichotomy in China's Practice

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In recent decades, third-party funding in arbitration and litigation has grown exponentially in many jurisdictions and has become a matter of continuing debate in academia and practice. (See, for example, [here](#) and [here](#) for previous blog posts.) Currently, People's Republic of China ("PRC" or "China") legislation does not prohibit third-party funding, but it fails to address the issue in any of its provisions. As a result of the legislative gap, the legitimacy of third-party funding is largely at the discretion of the court. Interestingly, two recent judgments reflect the dichotomy of China's treatment of third-party funding in litigation and arbitration: PRC courts have taken a conservative and cautious attitude in reviewing funding companies taking stakes in litigation outcomes but have shown a friendlier stance toward third-party lenders in arbitration.

### Court Decision on Third-Party Funding in Litigation

In 2021, the Shanghai Second Intermediate Court rendered a landmark decision that denied the validity of a third-party funding agreement in litigation.<sup>1)</sup> The claimant in the case, Company A, is the first finance company to have invested in legal services. By an agreement with the respondent, Company B, Company A undertook to bear Company B's legal fees and expenses in a lawsuit in exchange for a 27% return of the actual amount of payments Company B received from the judgment. The agreement also provided that if Company B lost the case or failed to recover the amount ordered in the judgment, Company A shall bear the loss and shall not claim any refund from Company B. Pursuant to the agreement, Law Firm C (which was affiliated with Company A) acted as the counsel of Company B in the lawsuit. Notably, the legal representative, shareholder and director of Company A was a partner and full-time lawyer of Law Firm C when the third-party funding agreement was signed. Subsequently, Company A paid the litigation fees, but Company B failed to provide Company A with investment returns after it prevailed in the lawsuit and obtained monies from the execution of the judgement. As a result, Company A filed the present case requesting Company B to pay the investment returns as agreed, along with liquidated damages.

The court dismissed Company A's claims, deciding that the disputed third-party funding agreement was invalid and that Company B must return the litigation expenses advanced by Company A. The court held that the key to determining the validity of a litigation investment agreement was whether the content of the third-party funding agreement seriously affected the integrity of the litigation. First, as Company A was closely related to the law firm representing

Company B, Company A excessively controlled Company B's conduct in the litigation and infringed its freedom of litigation. There was neither a contractual mechanism to avoid conflicts of interests nor a constraint on Company A's control over Company B's decision-making in litigation. Second, the confidentiality clause in the funding agreement endangered the litigation order and fairness. As the information of the third-party funder was not disclosed to the court, the judges were put at risk of conflicts of interest with the third-party funder. The non-disclosure of the funding relationship also impeded the court from intervening when the third-party funder infringed on the party's freedom of litigation. Notably, the court harbored a negative attitude towards the practice of facilitating or encouraging parties to initiate litigation by lowering the ex-ante costs as this could increase the risk of hollowing out alternative dispute resolution mechanisms and harming the public interest.

### **Court Decisions on Third-Party Funding in Arbitration**

In contrast, two intermediate PRC courts recently confirmed the legality of third-party funding in arbitration in *Ruili Airlines Co. Ltd. and Yunnan Jingcheng Group Limited v CLC Aircraft Leasing (Tianjin) Co., Ltd.*<sup>2)</sup> These decisions concerned a CIETAC arbitral award rendered in proceedings involving third-party funding. The respondents from the arbitration resisted the enforcement of the award before the Wuxi Intermediate Court and, after their attempt failed, sought to set aside the award before the Beijing Fourth Intermediate Court.

Their applications were primarily based on three points. First, the third-party funder had conflicts of interest with the arbitrator, which cast doubt on the impartiality and independence of the tribunal. Second, as the arbitrator with potential conflicts of interest did not recuse himself, the fairness and due process of arbitral proceedings were undermined. Third, the third-party funder's access to case information violated the confidentiality of arbitral proceedings.

Both the Beijing and Wuxi courts held that the determination of whether third-party funding would lead to the setting aside of an arbitral award depended on whether the third party's financial support had breached the laws and arbitration rules and whether it had hampered the impartiality of the arbitral tribunal.

The courts first held that there was no reasonable legal basis for the arbitrator to recuse himself. The Beijing Fourth Intermediate Court confirmed that the evidence available in this case was not sufficient to prove that the arbitrator had an interest in the third-party funder, nor was there a situation where he should have recused himself according to the PRC Arbitration Law or the applicable arbitration rules but failed to do so. As such, the lack of impartiality of the tribunal was not established.

Second, the courts found that the party had proactively disclosed the existence of third-party financing to the arbitral tribunal, and during the arbitration proceedings the parties had exchanged opinions and evidence on the legality of the third-party financing. Therefore, there was no factual basis for finding that the arbitral tribunal had violated the arbitration rules or that the third-party funding might have affected the fairness of the arbitration.

Third, both courts held that the involvement of third-party funding did not necessarily result in a breach of confidentiality. The central requirement of confidentiality is the non-disclosure of the

arbitration to the public for the purpose of preserving the commercial secrets and social image of the parties. Discourse of privileged information to funders, which only involves a limited number of third parties, is therefore not a violation of the principle of confidentiality in arbitration.

## Commentary

Although these two cases cannot draw a deterministic statement of PRC courts' attitude towards third-party funding, they still shed light on the courts' divergent stances on third-party funding in arbitration and litigation. Arguably, third-party funding is an instrument that lowers the threshold cost of initiating arbitration and litigation and that inevitably commercializes dispute resolution process. Presumably, conflicting court treatment of third-party funding in arbitration and litigation is attributable to the different nature of those two forms of dispute resolution in China.

Litigation, with its "public goods dimension", discourages the third-party finance that could encourage frivolous lawsuits, compromise attorney-client privilege, and pose ethical risks. First, China's legal culture and ethical principle of communal harmony sustain the popularity and use of amicable dispute resolution by mediation and negotiation, rather than prioritizing litigation. In the first decision discussed, the Shanghai Second Intermediate Court expressed its concern that third-party funders, in pursuit of greater benefits in litigation, could hinder the parties' use of mediation, settlement, and other alternative dispute resolution methods. Besides, third-party funding may incur arbitrary and even abusive suits as the party bringing the lawsuit is not personally liable for the costs of litigation. Second, third-party funders tie their financial interests to the outcome of the dispute resolution and may directly or indirectly interfere with the parties' behaviors and decision-making process. Notably, China's Civil Procedure Law itself is alert to the intervention of non-litigants in litigation proceedings, which may be read as scepticism towards third-party funders. In light of the above, PRC courts may impose rather stringent standards when reviewing the validity of third-party funding in litigation.

By comparison, arbitration is characterized by "private justice features" and values party autonomy and commercial demands. Therefore, PRC courts and arbitral institutions take a more liberal stance towards third-party funding of arbitration. Generally, the involvement of third-party funding does not, by itself, justify the annulment of an arbitral award unless it breaches legislation and undermines the integrity of arbitration. In addition, China values the utility of third-party funding in promoting the use of arbitration, as it enables indigent parties to initiate arbitration proceedings. Most importantly, given the legal and regulatory acceptance of third-party funding in international arbitration practice, China needs to adopt a friendly position in third-party funding to demonstrate its pro-arbitration attitude and enhance its competitiveness as an arbitral seat.

Meanwhile, it is worth mentioning that both PRC courts and arbitral institutions unequivocally require parties to disclose third-party funding agreements at the initial stage of adjudication.<sup>3)</sup> Disclosure of third-party funding enables tribunals to oversee funders' participation and prevent their excessive interference, to guarantee fair proceedings. This also facilitates the initiation of the recusal procedure when third-party funders and adjudicators have personal or professional connections. Undisclosed conflicts of interest between adjudicators and the third-party funder severely jeopardize the integrity of dispute resolution proceedings and constitute a basis for challenging judicial or arbitral decisions.

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### References

- ?1 (2021) Hu 02 Min Zhong 10224 Hao
- ?2 (2022) Su 02 Zhi Yi 13 Hao; (2022) Jing 04 Min Te 368 Hao
- ?3 See, e.g., Beijing Arbitration Commission Investment Arbitration Rules

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