EXPERT VIEW: THIRD-PARTY FUNDING IN ARBITRATION

OUT IN THE OPEN?

Dr Maxi Scherer[1] of **WilmerHale** examines the fundamental questions surrounding the disclosure of funding agreements in international arbitration

Third-party funding has become one of the "hot topics" in international arbitration. More and more parties, whether or not in financial distress, explore the possibility of using funders to provide the necessary capital to pay for their lawsuit. Although third-party funding has existed regarding litigation proceedings in various forms and in some jurisdictions for a long time, it nowadays attracts growing attention in the context of international arbitration.

Since the traditional common law prohibitions of champerty and maintenance have mostly faded away, a growing number of professional funders actively advertise and marketed their services for funding international arbitration proceedings. In return for funding a case, third-party funders typically seek a percentage of the proceeds of a successful case, or a multiple of the financed costs, or an amount calculated using a combination of those factors. The exact definition of third-party funding, however, remains elusive and its legal and ethical implications in international arbitration are uncertain.

In this context, one of the most difficult questions is whether, or to what extent, the existence of third party funding agreements should be disclosed in international arbitration proceedings. Recently, in an arbitration against a state pursuant to a bilateral investment treaty, the claimant disclosed publicly it had recourse to third-party funding. The claimant, Oxus Gold, issued a press release stating that it had "entered into a litigation funding agreement" and that under the terms of this agreement, "the Funder has agreed to pay [its] legal costs in relation to the international arbitration proceedings … on a non-recourse basis." The press release also explained that the claimant "has agreed to pay to the Funder a material portion of any final settlement of the arbitration claim against the Defendant."[2]

This upfront, voluntary and public disclosure of the existence of a funding agreement has intensified ongoing discussions in the international arbitration community as to whether these disclosures should become more common, or even mandatory. More precisely: When should a funding agreement, or its existence, be disclosed? What is the rationale for requiring that disclosure? What exactly should be disclosed (the existence of the funding agreement or the terms of agreement itself) and to whom? Who should impose and effectively enforce, any general and mandatory disclosure obligation?

This note aims at addressing some of those questions and discusses, in turn, the reasons that arguably justify a potential obligation to disclose funding agreements, the possible scope of any such obligation, and its modalities.

Rationale behind an obligation to disclose third-party funding agreements

While many reasons are typically advanced to justify imposing the disclosure of third-party funding agreements in international arbitration proceedings, two arguments seem particularly important and will be discussed below. First, disclosure of third-party funding agreements is arguably necessary to assess whether the funded party should be subject to an order for security for costs. Second, such disclosure is also arguably necessary to avoid possible conflicts of interest and to ensure that the arbitrators' impartiality and independence are maintained.

Disclosure of third-party funding agreements to assess the necessity of security for costs

In international arbitration proceedings, the allocation of liability for costs is usually left to the arbitral tribunal's discretion, unless the parties' agreement, the relevant arbitration rules or applicable statutes provide otherwise. While there are no express international standards, and although the "costs follow the event" rule whereby the losing party pays for its adversary's costs is not universally accepted, tribunals often allow the prevailing party to recover reasonable costs from the losing party.

In light of the complexity, and sometimes length, of international arbitration proceedings, the amount of costs awarded to the prevailing party can be quite significant. Therefore, parties more and more often seek security for costs at the outset of the proceedings. Although security for costs is not a universally accepted tool and unknown in many civil law jurisdictions, it has become increasingly common in international arbitration proceedings. Under currently prevailing standards, tribunals typically order security for costs if a party shows: (i) it has a *prima facie* case of succeeding on the merits; and (ii) the other party lacks financial means and thus is likely not to be in a position to satisfy a future adverse costs award.

The existence of a third-party funding agreement is likely to give rise to a number of issues regarding the costs of the arbitration.

In particular, one can easily imagine situations in which a party in financial distress obtains the necessary capital to entertain a claim in international arbitration proceedings thanks to third-party funding, but does not have the financial means to pay any adverse costs in case its claim is unsuccessful. In such a case, it is unlikely that the prevailing party may recover its costs from the losing party which obtained funding. It is equally unlikely that the prevailing party may turn to the third-party funder to recover its costs. Some funding agreements specifically provide that the funder is not liable for adverse costs. More importantly, however, the arbitral tribunal very likely lacks jurisdiction to order the third-party funder to pay adverse costs because the funder is not a signatory to the arbitration agreement or a party to the arbitration proceedings. Unless the arbitration agreement is construed to have been extended (e.g., under available theories of *alter ego*, implied consent, etc.) or *de facto* assigned to the funder, the tribunal lacks jurisdiction to order the funder to pay any adverse costs.

To avoid a situation in which the prevailing party is unable to recover reasonable costs because the opposing party has been able to entertain the arbitration due to third-party funding, it might be preferable to require disclosure of the funding at the outset of the arbitration. With that disclosure, the tribunal is in a position to assess whether it is necessary to order the funded party to provide security for costs. The tribunal might order security for cost if the funded party lacks financial means to participate in the arbitration but for the existence of the funding agreement, and thus is likely not to be in a position to satisfy a future adverse costs award.

The existence of a funding agreement, however, cannot automatically lead the tribunal to order security for costs, particularly under currently prevailing standards for such orders. For instance, ▶

- it might well be that the funded party has significant financial capacities and decided to use third-party funding for other reasons (e.g., to manage risk or facilitate cash flow).

Disclosure of third party funding agreements to avoid conflicts of interest

The requirement of an impartial and independent tribunal is undoubtedly one the most fundamental principles in international arbitration. The seemingly growing percentage of cases involving third-party funding, as well as the limited number of professional funders active in the field of international arbitration, is likely to raise issues of conflicts of interest threatening the tribunal's impartiality and independence.

For instance, assume that in arbitration A1 one of the parties is funded by the funder F and X is the presiding arbitrator in this case; assume further that X is counsel to the claimant in another unrelated arbitration A2 and that the claim is funded by the same funder F. The fact that X's fees in A2 are paid by F and that X is likely to have significant contacts with F on the basis of the funding agreement, makes it inappropriate for X to sit as an arbitrator in A1. In other words, X is likely not impartial and independent *vis-à-vis* the claimant in A1 since the claimant is funded by the same funder F that also has a say on X's financial income in A2.

If the resolution to the problem illustrated by this example seems self-evident, irrespective of the specific provisions on impartiality and independence in the governing arbitration statute and rules (i.e. X should not be able to sit as arbitration in A1), such a resolution implies that X is aware of the existence of a funding agreement. Accordingly, to be in a position to assess possible conflicts of interest, it is necessary for the arbitral tribunal to be informed about the existence of third party funding agreements from the outset. It could potentially seriously disrupt the arbitral process if the arbitrator learns about the existence of the funding agreement during the course of the proceedings and needs to step down after a significant part of the arbitration has already been completed.

Scope of the obligation to disclose third-party funding agreements

Although there exist, as detailed above, valid arguments for imposing disclosure of third party funding agreements in international arbitration proceedings, such a disclosure obligation will be difficult to establish and implement in practice. Indeed, it is difficult to define what constitutes a "third-party funding agreement" and thus should fall within the scope of a disclosure obligation relating to such agreements.

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Third-party funding has sometimes been defined as "any financial solution offered to a party regarding the funding of proceedings in a given case."[3] Such a broad definition would cover not only funding agreements, as the one described in the Oxus Gold press release, but also other types of funding such as, for example, lawyers' contingency fees (or other success oriented fee arrangements), certain types of insurance products, as well as any ad hoc solution (e.g., money borrowed from grandmother). Accordingly, if one were to use such a broad definition, a party might arguably have to disclose the existence of funding arrangements in all of the situations mentioned above.

The definition of third-party funding could, of course, be narrowed by adding to the above mentioned definition further requirements, such as: (i) the funder has to be a third-party to the proceedings (thus excluding lawyers' contingency fees or other success fee arrangements); (ii) the funder has to be a professional (thus excluding ad hoc solutions like money borrowed from grandmother); and (iii) the funder is paid a percentage of a favourable award or a cost multiple (thus excluding certain types of insurance products).

The question remains, however, why such narrowly-defined third-party funding agreements should be subject to mandatory disclosure requirements whereas other similar types of funding – falling within the scope of the broader definition – should not be disclosed. In particular, the reasons discussed above to justify the disclosure obligation arguably apply not only to third-party funding agreements in the narrow sense, but – at least partially – also to the broader types of funding agreements. For instance, the concerns about liability for adverse costs may be equally justified if the claimant has recourse to funding by contingency fee arrangements or grandmother's money. Similarly, conflicts of interest can potentially also arise if Y sits as presiding arbitrator in an arbitration where the claimant is funded by an insurer which

at the same time is insuring a significant matter handled by Y as counsel in another proceeding. In sum, the real difficulty in this area relates to the imprecision of the definition of "third party funding agreements" and thus the determination of the situations in which funding arrangements in international arbitration proceedings should be subject to disclosure obligations.

Modalities of the obligation to disclose third-party funding agreements

Assuming that the above described difficulties regarding the definition of "third-party funding agreements" and the scope of any disclosure obligation relating thereto can be resolved, further questions remain as to the modalities of such a disclosure obligation.

First, what exactly should be disclosed: the mere existence of a third party funding arrangement, or the actual funding agreement itself? Funders will generally be reluctant to disclose the exact terms of any funding agreement they have entered into. However, in some situations, the assessment of potential conflicts of interest might well require considering the exact terms of the funding agreement. For instance, in the above mentioned example of arbitrator/counsel X, the assessment of X's impartiality and independence as chairperson in arbitration A1 might depend on how much control the funder has over the claimant represented by X as counsel in arbitration A2. The outcome might not be the same depending on whether or not the funder has substantial control over the conduct of the proceedings in A2 (including a veto right on settlement offers, the choice of counsel, or other strategic issues).

Second, to whom should the third party funding be disclosed: the arbitral tribunal, or all parties and players involved in the arbitration? The above discussed reasons for disclosure (i.e., to assess the necessity for security for costs and to avoid conflicts of interest) suggest that a disclosure to the arbitral tribunal in the first instance might be sufficient. This is because the tribunal will be the ultimate decision maker with regard to security for costs and conflicts of interests. However, disclosure only to the arbitral tribunal could raise important issues of procedural fairness or the right to be heard for the other party, which did not have the opportunity to present its case on the questions related to costs or conflicts of interest.

There continue to exist fundamental theoretical and practical questions about whether mandatory disclosure of third party funding should be required, and if so to what extent

Finally, who could impose and enforce a general and mandatory obligation to disclose third party funding agreements? To include disclosure requirements in industry self-regulated codes – such as, for instance, the **English Association of Litigation Funders'** Code of Conduct from November 2011[4] – seems unlikely. In any event, membership in the English Association of Litigation Funders and, consequently, their Code of Conduct is purely voluntary and thus lacks effective sanction mechanisms. It has been suggested that institutional arbitration rules should include provisions to require disclosure of third-party funding agreements in arbitration proceedings conducted under those rules. One might question, however, what a possible and adequate sanction of a breach of such a disclosure obligation could be.

At this stage in the debate in the international arbitration community, questions surrounding the definition of third-party funding, let alone a requirement to disclose such funding, are far from resolved. There continue to exist fundamental theoretical and practical questions about whether mandatory disclosure of third party funding should be required, and if so, to what extent. It remains to be seen whether agreed standards will be developed and whether pragmatic solutions will be identified in response to what has become an issue of growing concern in international arbitration. ■

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[2] Oxus Gold Announcement of Funding Agreement between Oxus Gold plc and Calunius Capital, dated 1 March 2012, available at http://uk.reuters.com/article/2012/03/01/idUS101378+01-Mar-2012+RNS20120301
[3] RDAI/IBLJ Roundtable 2012, Third Party Funding in International Arbitration in Europe: Part 1 – Funders' Perspectives, *International Business Law Journal*, 2012, vol. 2, p. 207, 209.
[4] http://www.judiciary.gov.uk/NR/rdonlyres/75D4F49E-BDC640BC-B379-B5A1DA82BED9/0/CodeofConductforLitigationFundersNovember2011.pdf