European Federation for Investment Law and Arbitration

Comments of the European Federation for Investment Law and Arbitration (EFILA)
on the Draft Report of the ICCA-Queen Mary Task Force
on Third-Party Funding in International Arbitration*

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Introduction

EFILA welcomes the ICCA-Queen Mary Task Force's attempt to articulate a set of principles and best practices on third party funding in international arbitration ("**Draft Report**") and wishes to comment on selected issues for consideration by parties, funders, counsel and arbitrators.

Definition of 'third-party funder' (Chapter 3)

The Task Force proposes the following working definition (Draft Report, p. 39) (suggested amendment added):

> "The term 'third-party funder' refers to any natural or legal person who is not a party to the dispute but who enters into an agreement either with a disputing party, an affiliate of that party, or a law firm representing that party:
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> a) in order to provide material support or to finance part or all of the cost of the proceedings, either individually or as part of a selected range of cases, and
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> b) such support or financing is provided through a non recourse facility in return for remuneration and/or reimbursement wholly or partially dependent on the outcome of the dispute."

EFILA's comment

As the Draft Report acknowledges, "*[t]his broad definition facilitates consideration of the full range of funding models […]*" as "*[d]efinitions that are too narrow may exclude certain funding arrangements, like via one-time special purpose vehicle, from falling within the*

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scope of application of certain guidelines, like IBA Guidelines on Conflicts of Interest in International Arbitration, that under Standard 6(b) require disclosure and possible disqualification of an arbitrator reappointed several times in a case involving the same funder." (Draft Report, pp. 39-40, emphasis added)

Against this background, the following question arises: what is the risk that an **over-inclusive definition** would create? The potential risk seems to be that a too broad definition might lead to subjecting the entire spectrum of financing arrangements to requirements set for "proper" third party funding and, assuming they are disproportionately burdensome, an over-inclusive definition might prevent future development of alternative forms of disputes financing. On the other hand, if certain arrangement is not covered by the definition, there is a risk that it might be perceived as "unlawful" or at least as not legitimate vis-à-vis an arrangement covered by the definition.

Another question to be addressed concerns the **focus of the definition**: should the definition identify specific types of conduct, like claims assessment and risk-assumption, rather than to be focused on categories of actors providing financing? Additional variable to consider is the level of control exercised by the funder, which boils down to the question whether one wants to regulate the activity of providing third party funding or rather the actors (*i.e.* institutions) providing third party funding.

If the definition is "actor-focused", the issue that arises is whether providers of third party funding should be treated (functionally) as financial institutions and thereby regulated accordingly. It needs to be noted that insurance industry is already regulated at the national level but there is no similar regulation for third party funding providers. Potential benefit of such prudential regulation for third party funding could be to ensure that those providers adequately control risks and hold adequate capital. This, of course, leads to the issue of the nature of third party funding: is it a "proper" financial service (like a bank loan, leasing etc.) that requires appropriate regulation? Even if one concludes that it is a proper financial service, the question that arises is how it should be regulated and whether principles of third party funding in international arbitration should deal with that or it should be rather left to national sector-specific law. This issue seems to be missing in the Draft Report, *i.e.*, whether third party funding is a financial service, and if yes, what impact it has on the dynamics of resolution of a particular dispute.

Given the above, EFILA supports a definition which is neither too broad, not too narrow, *i.e.*, one which covers the most common arrangements of third party funding, but at the same time does not try to account for all possible forms of providing external finance to disputing parties. As the reliability of the funding source seems to be an issue often raised in the debate, the question also to address is whether or not imposing some regulatory requirements on the providers of funding to ensure they have a proper financial standing could be desirable.

Regarding the above proposed definition, EFILA suggests to replace the wording "donation or grant" with "**non-recourse facility**" (as already marked in red and consistently applied with respect to principles that follow), as it is a more neutral and commonly accepted term within the third party funding practice and contains a functional description whereas the terms 'grant' and 'donation' have a specific meaning that is commonly used in other settings. Another suggested change in the wording of the proposed definition has been also marked in red by EFILA.

As a more general comment, EFILA would like to point out desirability of articulating the principle of "**reciprocity**" with respect to all principles that follow in the Draft Report to arrive at balanced solutions. This means is to assess whether a given principle proposed by the Task Force places a "one way"-burden (*i.e.* only on the claimant) and if yes, try to figure out what the matching obligation of the defendant could be. In this respect, regarding the definition of third party funding, EFILA would suggest providing a clarification that also the defendant might by funded via a portfolio financing construction of the agreement.

Disclosure and conflicts of interest (Chapter 4)

The Task Force proposes the following principles (Draft Report, pp. 65-66) (suggested amendment added):

> "[ALTERNATIVE A]:
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> 1. A party should, on its own initiative, disclose the existence of a third-party funding arrangement and the identity of the funder to the arbitrators and an arbitral institution or appointing authority (if any), either as part of its first appearance or submission, or as soon as practicable after funding is provided or an arrangement to provide funding for the arbitration is entered into.
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> [ALTERNATIVE B]:
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> 1. Arbitrators and arbitral institutions have the authority to, during the selection and appointment process, expressly request that the parties disclose whether they are receiving support from a third-party funder and, if so, the identity of the funder.
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> [ALTERNATIVE A]:
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> 2. For the purposes of the Principles in Chapter 3, the term "third-party funder" is defined as follows:
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>> *For the purposes of assessing potential conflicts of interest, the terms 'third-party funder' and 'insurer' refer to any natural or legal person who is not a party to the dispute but who enters into an agreement either with a disputing party, an affiliate of that party, or a law firm representing that party, in order to finance part or all of the cost of the proceedings, either individually or as part of a selected range of cases, and such financing is provided either through a non recourse facility or in return for remuneration dependent on the outcome of the dispute.*
>
> [ALTERNATIVE B]:
>
> 2. For the purposes of the Principles in Chapter 3, the term "third-party funder" is defined as follows:

For the purposes of assessing potential conflicts of interest, the terms 'third-party funder' refers to any natural or legal person who is not a party to the dispute but who enters into an agreement either with a disputing party, an affiliate of that party, or a law firm representing that party, in order to finance part or all of the cost of the proceedings, either individually or as part of a selected range of cases, and such financing is provided either through a donation or grant or in return for remuneration dependent on the outcome of the dispute. This definition does not extend to agreements that provide insurance or to persons who provide insurance.

3. In light of any disclosures made pursuant to Principle 1, above, arbitrators and arbitral institutions should assess whether any potential conflicts of interest exist between an arbitrator and a third-party funder, and the need to make appropriate disclosures or take other appropriate actions that may be required under applicable laws, rules, or Guidelines."

EFILA's comment

The first question that arises is whether the disclosure should be required in every case [Principle 1, Alternative A] or based on a request for disclosure by arbitrators and arbitral institutions [Principle 1, Alternative B].

EFILA supports the Alternative A, being of the view that disclosure should be automatic to provide transparency as to the relative positions of disputing parties (*i.e.* how deep their pockets are) and ensure the level playing field between them. It is beyond doubt that a party having a financial institution behind approaches a dispute differently than a party not having such a backup. This means that a potential third party funding on both sides (also via portfolio financing) should be disclosed. Of course, the question is how to ensure compliance with such a duty to automatically reveal the existence of external funding.

The second question is the definition, *i.e.,* to what types of funding the principle on disclosure and conflicts of interests should apply, assuming that some types of funding (e.g. insurance) already have specific rules in this regard. This seems to be a secondary question from the perspective of this consultation. It is, though, relevant, but would require comparison of third party funding as defined by the Task Force with other – already regulated – forms of funding disputes.

Privilege (Chapter 5)

The Task Force proposes the following principles (Draft Report, p. 93) (suggested amendment added):

"1. Generally, the existence of funding and the identity of a third-party funder is not privileged information.

> 2. Generally, the specific provisions of a funding agreement will include privileged information, and production of it should only be ordered in exceptional circumstances.
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> 3. For information that is determined to be privileged under applicable laws or rules, tribunals should not treat that privilege as waived solely because it was provided by parties or their counsel to a third-party funder for the purpose of obtaining funding or supporting the funding relationship.
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> 4. If the funding agreement or information provided to a third-party funder is deemed to be disclosable, the tribunal should generally permit appropriate redaction or take appropriate measures and limit the purposes for which such information may be used."

EFILA's comment

EFILA supports the above four principles on privilege. Although there is some piecemeal regulation of this issue, as also discussed in the Draft Report, there is relatively limited guidance or case law on how issues of privilege are determined in third party funding scenarios.

EFILA also notes that in order not to discourage the use of third party funding, bearing in mind that for some potential claimants, in particular SMEs, third party funders may be the only option for getting access to ISDS and thus compensation, providing information and documents to funders should not result in a waiver of privilege and confidentiality with the (unfair) result that the information could become the subject of disclosure requests by the other side in the arbitration.

Regarding the suggested amendment, EFILA is of the opinion that the tribunal should also have the authority to order other measures than just a redaction, for example, that only parties' lawyers or a third neutral party reviews the clause/relevant parts.

Costs and security for costs (Chapter 6)

The Task Force propose the following principles (Draft Report, pp. 114-115) (emphasis added):

> "Final award (allocation) of costs:
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> 1. Generally, at the end of an arbitration recovery for costs should not be denied on the basis that a party seeking costs is funded by a third-party funder.
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> 2. When recovery for costs is limited to costs have been "incurred" or "directly incurred," the obligation of a party to reimburse the funder in the event of successful recovery is generally sufficient for a tribunal to find that a funded party comes within that limitation.

3. In the absence of exceptional circumstances, the cost of funding, including a third- party funder's return, is ordinarily not recoverable as costs.

4. Generally, a tribunal lacks jurisdiction to issue a costs order against a third-party funder."

"Security for costs:

1. Applications for security for costs should be determined irrespective of any funding arrangement and on the basis of impecuniousness or bad faith concerns.

2. In the first instance, the burden is on the moving party; no party should have to defend a motion for security unless and until the moving party makes a prima facie showing of impecuniousness or bad faith concerns.

3. If a party is found to be impecunious or giving reason for bad faith concerns, that party should be given the opportunity to present additional evidence of funding or have a security for costs award imposed.

4. At that stage, a request for disclosure of third-party funding agreements should normally be accepted as the tribunal should be able to examine the relevant parts of the third-party funding agreement (in particular provisions on the funder's termination of funding rights and funder's obligation to cover adverse costs) in the context of the security for costs application against an impecunious party or a party acting in a way to give a reason for bad faith concerns. However, tribunals should limit disclosure orders to the provisions that are strictly necessary to assess the extent to which the funder may cover (or not) an adverse costs order.

5. If a tribunal decides that a security for costs order is warranted, it can order security for costs by way of a bank guarantee. Payment into a bank account may be ordered for security for costs in exceptional circumstances, and where there is no ATE or any other form of evidence of indemnification arrangements already in place.

6. In addition, an arbitral tribunal should consider indicating to the requesting party that, should the defence fail, it will be held liable for the costs reasonably incurred by the funded party in posting security. It should be for the funded party to substantiate the amount of costs it reasonably incurred in posting security.

EFILA's comment

EFILA supports the above-articulated principles on allocation of costs and security for costs. Regarding principle 5 on security for costs, EFILA submits that security for costs by payment in escrow account should be also permitted.

Regarding the bank guarantee, EFILA notes that it costs a lot of money; it might be preferable to stipulate that the default position is that evidence of indemnification arrangements with a credit worthy third party is sufficient. Only when that cannot be demonstrated, then a bank guarantee should be required.

EFILA notes that the solution proposed under principle 6 on security for costs is very important in order to discourage bad faith claims for security of costs by Respondent states. Accordingly, we have provided appropriate corrections (in red) to the proposed principles, relating "bad faith concerns" to defendants hiding their assets.

EFILA is in favour of explicitly stressing that claimant's decision to seek third party funding does not imply its financial problems and an inability to pay a costs order; the decision might have been taken for other legitimate reasons. It needs to be also stressed that one of the rationales behind third party funding is to ensure/enlarge access to justice, thus, by definition, in such scenarios one deal with claimants having financial problems and unable to pursue their legitimate claims who for that very reason look for funding opportunities.

EFILA also notes that one should bear in mind that a person who has provided funding in reality will obtain the benefit of the litigation. Thus, in certain instances it could be appropriate that a tribunal issues a costs order against the third party funder but there might be a jurisdictional obstacle as the third party funder is not a party to the arbitration.

Further, states should not be able to use applications for security for costs as a means of seeking to stifle legitimate claims, particularly where the assets expropriated represented an important part of the investors' business. If the mere existence of third party funding was sufficient for a security order, states could obtain such orders on a systematic basis, increasing the risk of blocking legitimate claims by investors.

Finally, financial impecuniosity should not in itself be a reason to permit security for costs, as all factors in a security for costs evaluation should be considered cumulatively. There is therefore a need to elaborate a list of such factors.

Best practices in third party funding arrangements (Chapter 7)

EFILA's comment

Collection of principles (articulated above) is welcome as it has a potential to harmonise the third party funding practice.

Due diligence checklist (Draft Report, pp. 154-156) is also welcome as it has a potential of helping parties seeking funding to identify a proper and reliable funding source. It seems also helpful for drafting a funding agreement.

Third party funding in investment arbitration (Chapter 8)

Regarding this chapter, the question is whether the principles articulated above should be equally applicable to commercial and investment arbitration disputes. EFILA submits that they should be applicable equally as it is difficult to see how the nature of the party

(state/non-state) could mitigate/aggravate potential risks (and benefits) that third party funding potentially involves. However, EFILA is aware that in ISDS cases this issue is more politically sensitive.

What is missing from the Draft Report?

Given that many funders engage also in funding of enforcement (*i.e.* funders "buy" awards at a discounted price and enforce them on their own), it could be advisable to include – if not a fully developed principle – at least a remark/comment on this service in the Draft Report. It goes back to the first question. Indeed, EFILA sees the funding of enforcement as a separate business than funding of initiating claims. Funding enforcement of awards or selling awards is simply a financial product like many others and does not have much to do with the encouraging ISDS claims.

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