Kluwer Arbitration Blog

Third-Party Funding in Arbitration: Innovation and Limits in Self-Regulation (Part 1 of 2)

Jean Kalicki (Independent Arbitrator) · Tuesday, March 13th, 2012

The use of third-party funding for international arbitration has been growing for several years, and its potential benefits and risks have received increasing attention from the arbitration community. The November 2011 release in the United Kingdom of a Code of Conduct for funders has galvanized the debate. The Code is the first-ever attempt at voluntary self-regulation by litigation funders, and could apply not just to third-party funders based in England and Wales, but arguably also to other funders of arbitrations seated in those jurisdictions. The Code has been welcomed as an innovative attempt to impose restraints on funding practices that otherwise raise significant ethical concerns, but it also has been criticized as insufficiently stringent and lacking detail. Today's post (Part 1 of 2) summarizes the main provisions of the U.K. initiative, setting the stage for a following post (Part 2 of 2), which examines recent criticisms and identifies persisting questions, including the issue of disclosure.

Third-party funding is understood as a "nascent" but growing industry involving the funding of litigation or arbitration by specialized providers who are neither parties to the dispute nor closely connected with it, and whose sole interest is potential profit in return for providing financing. The potentially high awards in certain commercial and investment arbitrations have attracted funding providers. Claimants likewise have been drawn to third-party funding to provide access to justice where litigation costs otherwise might be prohibitive and obtain an early independent assessment of the merits of a potential claim.

It is not yet clear how workable the model will prove for respondents in arbitration. By definition, respondents would be required to reward funders for their investment in successful defenses, in exchange for hedging against the costs of unsuccessful proceedings. This proposition is unlikely to be attractive to sovereign State respondents who may have difficulty politically justifying State payments to foreign financing companies, particularly for frivolous cases. However, in the purely commercial context, funders participating in a recent Global Arbitration Review roundtable suggested that shareholders of some respondent companies have proven receptive to shouldering the higher costs of third-party funding, particularly as cases approach the later stages of arbitration.

The U.K. particular has experienced huge growth in the number of investment funds

willing to invest in both litigation and arbitration. While no country has developed an official binding system of regulation, funding providers in the U.K. have established an industry organization, the Association of Litigation Funders of England and Wales ("ALF"), which in November 2011 released a proposed Code of Conduct for its members (available at http://www.judiciary.gov.uk/about-the-judiciary/advisory-bodies/cjc/third-party-funding). Membership in the ALF is voluntary but requires compliance with the Code's "standards of practice and behaviour" for those who choose to join. Supporters of the Code have suggested that while membership and thus compliance with the Code remains optional, in practice most funders are likely to join because clients will likely hesitate to contract with funders that operate outside of the ALF and the industry standards it sets.

The Code consists of ten principles that regulate the formation, use and termination of litigation funding agreements ("LFAs"), which, once signed, are contractually binding for "funding of resolution of disputes within England and Wales" (clause 6). It is unclear whether this language refers solely to the location of the funder or the litigant being funded ("funding . . . within England and Wales"), or also to the *situs* of the dispute proceedings ("disputes within England and Wales"). This ambiguity raises the possibility that non-U.K. funders may feel pressure to join the ALF also, so that they can offer services to U.K. litigants or foreign litigants in arbitrations seated in the U.K.

The Code defines "Funder" as either an entity with immediate control over funds or an entity that acts as the exclusive investment advisor to a investment fund with immediate control over funds. These funds must be sufficient to enable each funded party (the "Litigants" as defined in the Code) to meet the cost of resolving their disputes in litigation or arbitration (clause 2). To this end, the Code requires a Funder to ensure that its funds are adequate to pay debts at all times and to cover funding liabilities under its LFAs for at least thirty-six months (clause 7(d)(ii)). The drafters added the thirty-six-month funding requirement in response to concerns raised about an earlier draft, which required adequate funding only for three months. The Code is vague as to how this "adequate funds" requirement is determined, since reasonable minds can differ about the value of aggressive but costly litigation strategies. The Code states that a Funder shall "not seek to influence the Litigant's solicitor or barrister to cede control or conduct of the dispute to the Funder" (Clause 7(c)), but this is unlikely to require the Funder to guarantee a "blank check" for any and all litigation strategies. Nor is the Funder required to meet any liability of the Litigant to provide security for the opposing party's costs, to pay premiums to enable that Litigant to obtain insurance against possible future awards of costs, or to finance such cost awards. To the extent the Funder agrees to assume such responsibilities, the extent of its liability must be recorded in the LFA (clause 8).

In return for funding a Litigant's claim, the Funder is entitled to a share of the proceeds if the claim is successful (clause 2(a)). By the same token, the Funder is prohibited from seeking payment in excess of the proceeds of a successful claim, unless the Litigant is in "material breach" of the LFA (clause 2(b)), a term which is not defined in the Code.

The Code also loosely defines the role of the Funder, and the limits of its role.. The

Funder must refrain from taking steps “likely to cause” the Litigant’s attorney to violate his professional duties or to influence that attorney to cede control of the dispute (clause 7(b) and (c)). In referencing the professional duties of attorneys, the Code implicitly refers to U.K. ethics rules for solicitors and barristers that have specific regulations on fee sharing and referrals. It is unclear, however, whether and how this provision of the Code would apply to non-U.K. attorneys participating in arbitrations seated in England and Wales, or working with third-party funders and clients based in those jurisdictions. The Code also requires the Funder—who may insist on broad access to information in order to assess the merits of the claim and conduct of the litigation—to observe the confidentiality of all information as defined by relevant law and the LFA (clause 5) and states that the terms of the LFA shall control the extent of the Funder’s ability to provide input on the Litigant’s decisions in relation to settlement (clause 9(a)).

The Code also requires the LFA to state whether and how the Funder can terminate the agreement (clause 9(b)). If the LFA grants the Funder the right to terminate the agreement, that right is limited to three circumstances (clause 9(b)). First, the LFA may provide a method for termination if the Funder “reasonably” ceases to be satisfied with the merits of the dispute. Second, the LFA may provide a mechanism for termination if the Funder “reasonably” believes that the dispute is no longer commercially viable. Third, the LFA may allow the Funder to terminate it if the Funder “reasonably” believes the Litigant is in material breach. Though the Code offers no definition of a “reasonable” belief, it limits the Funder’s discretion to terminate to these grounds (clause 10). If the Funder nonetheless does terminate the LFA, it remains liable for all funding obligations accrued to the date of termination, unless termination arises from the Litigant’s material breach (clause 11(a)). In the event a dispute arises over termination of the LFA, the parties may obtain a binding opinion from a Queen’s Council (clause 11(b)).

Finally, the Code prohibits Funders from using any misleading or unclear literature to promote these agreements to potential clients (clause 4). Additionally, any Funder must take reasonable steps to ensure that the Litigant receives independent advice on the terms of the LFA. This requirement may be satisfied if the Litigant confirms in writing that it has taken advice from the solicitor instructed in the underlying dispute (clause 7(a)).

As the Code was released only in late November of 2011, much remains to be seen about its eventual use and interpretation in international arbitration proceedings, and the nature of any disputes that subsequently arise. While the international arbitration community has acknowledged the Code as an important first step towards fulfilling the potential of litigation funding to provide greater access to justice, concerns remain. The next post will discuss some of the criticisms of the Code—particularly about lack of detail and non-binding status—raised by the U.S. Chamber of Commerce Institute for Legal Reform and the European Justice Forum (the latter in comments on an earlier draft of the Code), as well as persisting questions about its applicability to international arbitration, including with respect to important issues of disclosure.

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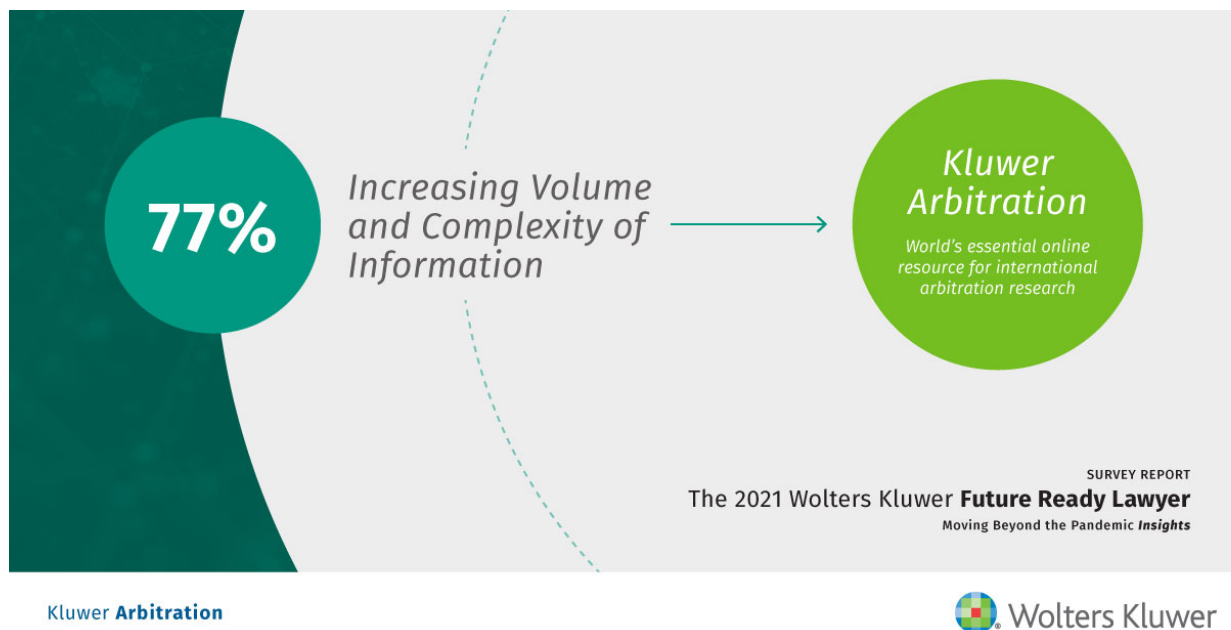

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