Kluwer Arbitration Blog

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

Jean Kalicki (Independent Arbitrator) · Wednesday, March 14th, 2012

Yesterday's post set the stage by describing the main provisions of a new voluntary Code of Conduct for "funding of resolution of disputes within England and Wales," released in November 2011. Today's post examines criticisms of that initiative from several corners, and notes important questions that persist in the arbitration arena, including issues surrounding the obligations of disclosure.

Despite the novelty and best intentions of the U.K. initiative, the Code has been strongly criticized both for its non-binding character and its lack of detail. Both the U.S. Chamber of Commerce's Institute for Legal Reform ("ILR") and the European Justice Forum ("EJF") have expressed concern that the Code is not a sufficient replacement for the development of binding, official regulation of third-party funders in litigation. While these critiques focus mostly on ramifications of the Code for litigation funding, the concerns they raise also have implications for international arbitration, where third-party funding increasingly is in use.

In a report issued on 22 December 2011, just one month after the Code was released (available at https://www.instituteforlegalreform.com/doc/ilr-comments-on-the-code-of-conduct-for-litigation-funders), the ILR expressed concerns about (1) the voluntary and self-regulatory nature of the Code; (2) the potential conflicts of interest for counsel raised by funding, including the degree of control a Funder may directly or indirectly exert over the litigation; and (3) the lack of protection for potential defendants. The ILR enunciated a preference that "litigation funding should be discouraged in all circumstances," but urged that if allowed to occur at all, funding should be strictly regulated through official channels (ILR Comments at 9).

The ILR criticism of the Code centers on the belief that its self-regulating nature undercuts its efficacy. In particular, the ILR points to the lack of any disciplinary mechanism in the Code as a barrier to its effectiveness as a regulatory tool (ILR Comments at 2). Additionally, the ILR argues that the Code's definition of "Funder" is under-inclusive and creates the potential for abuse (ILR Comments at 2-3). At the least, the ILR urges a cap on the fees that a third-party funder may charge and a requirement that all litigation funding agreements ("LFAs") be in writing to protect litigants who use third-party funding (ILR Comments at 4, 8).

The European Justice Forum issued comments on 26 February 2010, before the final version of the U.K. Code of Conduct was released (*see* https://europeanjusticeforum.org/faq/current-issues/costs-of-litigation.html). Nonetheless, the EJF

Comments reflect some of the same discomfort with the voluntary nature of effort at self-regulation voiced by the ILR. In their criticisms of the Code, the ILR and EJF both emphasize the potential for conflict of interest created when legal counsel develops close relationships with third-party funders. Thus, while the Code requires the "Funder" to ensure that the "Litigant" receives outside legal advice regarding the terms of an LFA, its critics note that such a legal advisor also may have a pecuniary interest in the funding of the claim. This is particularly problematic if the same advisor is also counsel to the Litigant in the underlying dispute and thus dependent on funding to be arranged in order to earn prospective legal fees from the representation (ILR Comments at 4, 8; EJF Comments at 11).

The ILR also notes that the Code does not address the issue of referral fees between Funders and attorneys and strongly urges a ban on such fees. In fact, both the ILR and EJF argue that the Funder should have no contractual relationship with the Litigant's counsel and that all LFAs should be strictly between the Funder and the Litigant in order to reduce the risk that the Funder and counsel would collude to "maximize their own profits" (ILR Comments at 8; *see also* EJF Comments at 11). Along this same line, the ILR would prohibit Funders from owning or being owned by law firms, a practice which apparently already is occurring in England (*see, e.g.*, https://www.cdr-news.com/litigation/109-articles/1132-barristers-join-third-party-litigation-funding-bandwagon). These proposed measures seek to delineate guidelines that are not expressly contemplated by the Code for interactions between Litigants, Funders, and outside counsel.

The ILR also expresses concern over the lack of protection for defendants in the Code (ILR Comments at 5-6). While the Code ensures that the funded Litigant is informed about the terms of the agreement and is funded by a party with adequate financial resources, it does little to protect the potential defendant from frivolous or unsubstantiated litigation brought in order to increase leverage for a settlement. In particular, the ILR argues that without a prohibition on funding of collective actions, the Code leaves potential defendants exposed to the threat of large collective suits which may prove lucrative for attorneys and funders by increasing pressure for settelements, even if the underlying claims ultimately lack legal merit (ILR Comments at 7). The EJF likewise has expressed concern over the potential for one-way cost shifting in collective claims (EJF Comments at 3).

Even aside from collective claims, the ILR points out that a defendant seeking to recover an award of adverse costs may be unable to do so, because the Code does not require Funders to support Litigants' liability for cost awards. Indeed, the Code stipulates only that any liability of the Funder for such costs must be stated in the LFA (Code, clause 8). Since Funders may decline to guarantee payment of an adverse cost award, the ILR asserts that a potential defendant is left vulnerable not only to being dragged into a frivolous claim that might not have been pursued in the absence of third-party funding, but also to being unable to recover the costs it would incur defending such a suit, even if the adjudicator ultimately rules in the defendant's favor and awards costs against the impecunious claimant.

The concerns highlighted by the ILR and EJF center on litigation, but recent debates through *Global Arbitration Review*, on OGEMID and in other fora have drawn attention to persisting questions about the Code's applicability in the context of international arbitration as well. In particular, it is unclear whether a litigant would be required to disclose the existence of a third-party funding arrangement to the adverse party, the administering institution, or potential arbitrators. This uncertainty, creates the possibility of undisclosed conflicts that could threaten the fairness or enforceability of awards down the road. In some cases, disclosure may proceed

transparently and thus lessen the probability of conflicts surfacing only late in the case. This occurred recently in the investment arbitration *Oxus Gold PLC v. Republic of Uzbekistan et al*., conducted under the UNCITRAL Rules. Nonetheless, the Code is silent on the issue of disclosure, leaving it entirely to the discretion and judgment of the parties concerned.

Indeed, during the recent *Global Arbitration Review* roundtable discussion on third-party funding, one third-party funder expressed concern that transparency could have negative consequences, including the risk that the opposing party's knowledge of financing arrangements could lead it to raise abusive arguments aimed solely at extending the length and increasing the costs of the case. Others in the arbitration community have suggested that knowledge of an opposing party's use of outside funding could influence a party's evaluation of the reasonableness of settlement offers. Concerns about disclosure have also touched on the possibility that tribunals themselves could be influenced by this information with respect to whether to order security for costs during the course of an arbitration, or to assess liability at the close of proceedings against an unsuccessful litigant for the prevailing party's costs. The third-party funder, of course, will not be subject to the tribunal's jurisdiction, and not liable to fund an order for costs, absent voluntary agreement to do so in the LFA it negotiated with the litigant at the outset of its involvement.

In short, while the U.K. Code may be a welcome first step in attempting to impose some voluntary order on a process and set of relationships that heretofore have been entirely unregulated, many questions remain. It remains to be seen how the practice will evolve in the arbitration arena, in the wake of both the Code and increasing public attention and debate. One thing is certain however: whether regulated or not, the use of third-party funding in major arbitration cases is a development that is here to stay. The genie is out of the bottle, and no one in the arbitration community has suggested that it ever may be persuaded to return.

By *Jean E. Kalicki, Amy Endicott and Natalia Giraldo-Carrillo*

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