8 Key Points from the ICCA-QM Task Force’s 2018 Third-Party Funding Report

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The Task Force’s 2018 Report on Third-Party Funding has finally been released. Here are comments on eight of the most interesting points.

1. **Third-party funding involves an entity, with no prior interest in the legal dispute, providing financing to one of the parties.**

One of the trickiest issues regarding third-party funding (TPF) has been defining it. Chapter 3 is dedicated to the challenges in reaching a definition. When reading the rest of the Report, keep in mind the scope of this definition (which excludes before-the-event insurance and maritime arbitrations by P&I clubs).

The Report presents extensive research on the history of TPF. For basic answers to “what is dispute funding?”, “why is funding sought?” and “how does the funding process work?”, read Chapter 2 for explanations which are fundamental to any meaningful debate on TPF.

What alternative funding models *currently* exist? The Report has done a formidable job in setting these out. There are: insurance, loans, corporate financing, equity-based and inter-corporate funding, and the most problematic—attorneys as funders.

It also explains the economics, return structures, risk alignment, and basic funding terms, including what is a 'waterfall' agreement:

> A document [that] will usually require execution by all "stakeholders" (i.e., those entitled to a share or contingent payment from any recovery, typically including the claim holder, the funder, the law firm and any insurer providing coverage for fees, costs or an adverse costs award).

The waterfall agreement will set out how the claim proceeds are to be divided between the stakeholders.

2. **Future funding arrangements could go *beyond* funding legal costs.**

And what about development of funding in the future? Potential directions for development are: portfolio funding; providing working capital, funding to discharge pre-existing liabilities or an advance on claimed damages; equity financing; assignments or sales of entire of part of claims; sale of awards; and enforcement financing.

Most interestingly, the Report predicts growth in portfolio financing, in particular two major types of arrangements:

(1) finance structured around a law firm, or department within a law firm, where the claim holders may be various clients of the firm; and

(2) finance structured around a corporate claim holder or other entity, which is likely to be involved in multiple legal disputes over a relatively short period of time.

Warnings are sounded regarding situations where clients enter funding agreements with the funder, but its terms or the financing process is dictated by the law firm's wider relationship with the funder. If the funder's return is dependent upon the overall net financial performance of the portfolio, as opposed to the outcome of each claim, this raises ethical issues.

Equity financing is highlighted as a creative way to enable the funder to take greater or total control over the litigation without running afoul of champerty restrictions. Owning a stake in the claim holder may also bring the funder within the circle of legal privilege.

3. **Disclosure of the existence and identity of funders is necessary so arbitrators can make decisions on conflicts of interest.**

Arguably, revealing the connection between the funder and arbitrator *creates* the potential for bias, where there was none before.

Instead of keeping the arbitrator in the dark however, the Report cites the results of the 2015 QM survey in which 76 percent agreed that disclosure of the existence of TPF should be mandatory. It recommends an "affirmative duty for arbitrators to investigate potential conflicts".

What conflicts of interest are we guarding against? Helpful examples of conflicts of interest are illustrated: if the arbitrator sits as a director of that funder; if an arbitrator is a partner at a firm that received significant financing from a funder based on a portfolio of the firm's cases; or has been re-appointed in numerous funded cases. These might prove fertile ground for future arbitrator challenges.

Recall that the 2014 IBA Guidelines, Rule 6(b) applies equally to funders:

> If one of the parties is a legal entity, any legal or physical person having a controlling influence on the legal entity, or a direct economic interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration, may be considered to bear the identity of such party.

The Task Force recommends that the IBA reconsider its definition of "direct economic interest" to take into account portfolio financing.

4. **Law firms should maintain their distance from funders.**

The Report touches upon a sensitive topic for some practitioners—the relationships between funders and law firms. It gives the example of a law firm's introducing funders to a client, and suggests that some law firms *rely* upon the funder for financing across a portfolio of matters. What happens when a disagreement arises between the funder and one of the funded clients in the portfolio? It might be difficult to avoid or manage those conflicts of interest.

5. **If the claimant is financially reliant upon the funder, this may amount to powerful indirect control.**

The extent to which the funder has the power to assert control over the arbitration is often the most controversial. In many jurisdictions, especially common law ones where doctrines of maintenance and champerty still exist, a third-party funding agreement could be illegal.

The Task Force has found that in reality, the vast majority of third-party funding arrangements are structured carefully to ensure that the funder does not have

control over the case, but notes that the funder may still play a *highly active role*, attending client meetings and/or hearings, being copied on correspondence, and providing strategic input.

6. **Provide expressly in the funding agreement how to resolve differences of opinion concerning conduct of the case.**

What happens when the funder, the party, and counsel disagree over whether to accept a settlement offer or to add additional claims? Who has control of the case should be carefully negotiated and expressly set out. There are competing concerns—TPFs may pressure the funded party to accept short-cuts to save costs, overriding the rights of actual the party to the arbitration, but on the other hand, the risk-averse behavior of TPFs might actually introduce a desirable regulating influence over the arbitration.

7. **In a security for costs application, a key consideration is the financial situation of the party against which security is requested.**

Based on an extensive survey of various investor-state cases, the Report correctly distills the conclusion that the solvency of the claimant is a key focus in a security for costs application. It refers to the most recent cases, *Eskosol S.P.A. v. Italy* and Garcia *Armas v. Venezuela*, in which the tribunals considered evidence on the solvency of the claimants.

On the other hand, the Report's discussion of commercial arbitrations was more limited, despite pointing to a rising concern that commercial parties are increasingly applying for security for costs as a tactic to delay arbitrations.

In a 2012 ICC commercial arbitration, the tribunal imposed a test of "a fundamental change of circumstances". This test underlies the bargain struck between the commercial parties, which is hardly applicable in investor-state arbitration 'without privity', where the state does not know in advance which investor will accept its treaty offer to arbitrate.

Ironically, most investor-state tribunals so far have rejected security for costs applications. The Report notes that "tribunals in [investor-state] arbitration tend to adopt a stricter test", and suggests that "it is questionable whether such a high threshold is warranted".

8. **Use the Principles 'codified' in the Appendix and Due Diligence Checklist**

The Task Force drafted a helpful Appendix containing Principles regarding:

1. Disclosure and conflicts of interest;
2. Privilege and professional secrecy;
3. Allocation of costs; and
4. Security for costs.

The Appendix might be adopted by arbitrating parties in their arbitration agreement, institutions as guidelines in their rules, or even investment treaty-drafters. However, these Principles might not be suitable for *all* arbitrations and should be carefully considered before adoption.

For instance, security for costs should be determined "without regard to the existence of any funding arrangement" which reflects a burgeoning international consensus. There is some tension between this principle and the next. Principle D.1 takes the position that:

> The terms of any funding arrangement […] may be relevant if relied upon to establish that the claimant (or counterclaimant) can meet any adverse costs award.

A tribunal is simultaneously directed to disregard the funding arrangement and asked to apply its knowledge of the terms of that funding arrangement to determine if the claimant can meet an adverse costs award.

How could the tribunal be certain that an adverse costs award will be met? The Report acknowledges that given the typical arm's length commercial relationship and the lack of corporate links between a funder and the funded, nor any involvement in the underlying contract, it would be difficult to bring a funder within a tribunal's jurisdiction.

The Task Force has also drafted a useful Due Diligence Checklist containing a series of questions to ask before seeking TPF, relating to the funder's capital structures, the scope of funding, and terms of the agreement.

Future of TPF

The Task Force's Report is currently the most significant and comprehensive contribution to the development and regulation of arbitration funding. Reading it is a prerequisite to any meaningful future debate about TPF in international commercial and investment arbitration.

Most importantly, the Report also flags issues we have yet to resolve regarding the ideal level of control a TPF would exercise over the case, disclosure obligations under different rules and legislation, and shines the spotlight on portfolio financing.

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