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European Parliament Resolution On Third-Party Funding: A Step Too Far?

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International arbitration proceedings typically involve fact-sensitive and technically complex transnational disputes, and usually require large legal teams, multiple expert and fact witnesses, making the costs skyrocket. In this scenario, a party lacking the necessary funds might decide not to pursue a legitimate claim. This limited access to arbitral justice is concerning from a policy standpoint, especially in jurisdictions where the difference with the costs of court proceedings is particularly noticeable.

This is one of the main reasons the phenomenon of third-party funding ("TPF") has progressively gained a central stage in debates about international arbitration. Typical TPF is a form of non-recourse financing in which a funder undertakes to bear the costs of a party to a dispute. If the funded party prevails, the funder makes a profit usually consisting of a percentage of the award or a multiple of the funds provided, whichever is higher. Critically, in case of defeat the funder's investment is lost.

Although obviously beneficial to the funded party, who gets the chance to adequately pursue its claim, the involvement of an "*anarchic*" player (which is not a party but nonetheless has a direct economic interest in the dispute) has raised numerous concerns around the potential side effects of TPF in various aspects of an arbitration. This has spurred an intense – and currently unsettled – debate over the regulation of TPF.

A number of arbitral institutions have addressed TPF in their institutional rules (the 2022 ICSID and 2021 ICC arbitration rules are among the most recent examples). Despite some differences (which I have addressed in a previous post), the general approach is light touch regulation mainly consisting of disclosure obligations regarding the involvement of a funder in the arbitration and the funder's identity.

The European Parliament, on the other hand, proposed to adopt a far stricter regime in the European Union (the "EU") in its resolution dated September 13, 2022 (the "Resolution"). The Resolution – and the proposed EU Directive annexed thereto – envisage *inter alia* to:

1. create an authorization system for funders intending to operate in the EU, including capital adequacy requirements and the set-up of dedicated supervisory authorities (Articles 4 and 6 of the draft Directive);
2. introduce a fiduciary duty for the funders *vis-à-vis* their clients (Article 7 of the draft Directive);

3. set up minimum mandatory requirements for the funding agreements (Article 12 of the draft Directive);
4. prohibit influencing the management of the dispute (Article 14(2) of the draft Directive);
5. set a cap on the funder's profit at 40 percent of the award (Article 14(3) of the draft Directive);
6. prohibit funders from contractually limiting their liability regarding adverse costs (Article 14(5) of the draft Directive); and
7. create an obligation to disclose *inter alia* a "*complete and unredacted copy*" of the funding agreement upon request of the court/tribunal or the opposing party (Article 16(1) of the draft Directive).

It is now up to the European Commission to submit the text of the Directive (in its current or amended version) to the European Parliament and the EU Council for their vote. If the Directive is eventually approved and enters into force, the EU Member States will be bound to align the respective legal systems to the above-mentioned principles, thereby creating a uniform regulatory framework that might deeply affect the future of TPF in Europe.

The Resolution undoubtedly has some promising aspects. Introducing a structured regulatory framework at a stage at which TPF in Europe is, using the words of the Resolution, "*virtually non-existent*" may allow to benefit from the experience of jurisdictions where the TPF industry is more mature (USA, UK and Australia in particular) and prevent distortions observed elsewhere from happening in the EU. In particular, imposing mandatory clauses to be included in the funding agreement and limiting the funder's contractual power aims to protect the funded party against predatory conducts through which funders might pursue their interests at the expense of their clients, including lack of transparency, excessive control over the management of the claim, and arbitrary termination. The Resolution also intends to shelter the non-funded party, making sure that the funder takes responsibility for adverse costs awards in case the funded party is impecunious.

However, some of the proposed provisions are not ideal and are possibly counterproductive.

First, providing the non-funded party with the right to request and obtain a "*complete and unredacted*" copy of the funding agreement seems unjustified because such contract is likely to contain confidential and commercially sensible information. It would be advisable to follow the example of certain arbitral institutions, which have sought a balance between transparency and secrecy by expressly identifying specific clauses that have to be disclosed, such as the funder's obligations to cover adverse costs (this is, for instance, the case of the BAC investment arbitration rules). Another viable approach is the one adopted by the 2022 ICSID arbitration rules, which grant the tribunal – not the funded party – the power to order the disclosure of "*additional information*" (not necessarily the entire unredacted agreement) about the funding agreement.

Second, capping the funder's profit to 40 percent of the award constitutes a visible, and arguably excessive, interference in party autonomy and, more specifically, in the assessment of the risks associated with a claim. Put differently, the cornerstone of the TPF business is the ability of the funder to analyze the strengths and weaknesses of a claim, identify the probability of victory to the maximum extent possible, and absorb the risk of loss by inserting such claim in a portfolio of diversified investments. This peculiar expertise allows funders to invest in relatively risky claims and their profit is thus proportional to the level of risk they are willing to accept. Capping such profit can consequently limit the range of cases that funders can invest in.

Some argue that the funders' ability to "bet" on riskier (*i.e.*, weaker) claims incentivizes frivolous litigation. On this basis, capping the profit might limit this effect, forcing funders to focus on strong cases. I have never been fond of this argument. The only way for funders to make profit is having the claims they invest in succeed: it follows that they have no reason to support lost causes, especially since in case of loss they do not recover their investment.

Third, introducing such rigid regulatory framework in the EU – where the TPF industry is still at an embryonal stage – is likely to push funders to move their investments to less regulated jurisdictions, to hamper the growth of this industry in the EU and, ultimately, to prevent its beneficial effects on access to justice.

In light of the above considerations, while the initiative of the European Parliament is to be praised, it seems necessary to partially revise the text of the proposed Directive, in order to create a regime that addresses the criticisms related to the TPF industry and, at the same time, allows it to flourish and foster access to arbitral justice in the EU.

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This entry was posted on Thursday, February 16th, 2023 at 8:14 am and is filed under EU Law, Third party funding
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