



## Columbia FDI Perspectives

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Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Managing Editor: Shawn Lim (shawnlwk@gmail.com)

### **Cost allocation in investment arbitration: Forward toward incentivization**

by

James Nicholson and John Gaffney\*

In their contribution to the *FDI Perspectives* series, Baiju Vasani and Anastasiya Ugale drew attention to an emerging trend in favor of the so-called “costs follow the event” (CFtE) (or loser pays) approach, which is in contrast to the more “traditional” approach under which parties share the costs of arbitration equally, with each party covering its own legal fees.<sup>1</sup>

Vasani and Ugale suggested that, from a claimant’s perspective, “the traditional approach encourages arbitration” while “CFtE is largely a deterrent” to investment treaty arbitration and “makes arbitration less appealing to claimants (and would-be third-party funders), more risky and/or outright economically unviable.”<sup>2</sup> They concluded that “a default CFtE custom in the context of ICSID seems inapposite just at a time when [CFtE] appears to be gaining popularity”<sup>3</sup> and argue that a harmonized approach to cost allocation between ICSID and commercial forums is likely inappropriate.

While we welcome that the authors have initiated a renewed debate on this issue, and note that they raise a range of other objections to CFtE in the context of ICSID, we disagree with their criticism of CFtE as a deterrent to claimants. We suggest that CFtE incentivises meritorious claims while discouraging frivolous or weak claims.<sup>4</sup>

If claimants act economically rationally, they will only bring claims that they see as being of greater value than the next best alternative, i.e. if they consider, explicitly or implicitly, that:

{ Probability of claimant winning *multiplied by* (award assuming a win *less* claimants’ costs assuming a win, if any)

*less*

(Probability of state winning *multiplied by* claimant’s costs assuming a loss) }

*is greater than*

zero, or the maximum value of any settlement offered.<sup>5</sup>

Parties are, of course, sometimes motivated by factors other than maximizing their economic position in a particular case. For example, they may be considering the wider strategic interests of their organization, or individual managers may be acting with regard to their own careers at the expense of their organization. These points largely lie outside the scope of this *Perspective*; however, we do consider that (a) economic incentives are an important motivating force for most organizations, (b) other motivating factors do not favor one costs regime over another, and (c) contingent fee and third-party funding arrangements, which are increasingly prevalent, are even more likely to introduce considerations of economic rationality into decision-making.

Under CFtE, confident claimants with strong claims are more likely to come forward than they would under the more traditional approach, especially if they have a smaller claim, because CFtE increases their payoff if they prevail; claimants with strong claims will necessarily accord less weight to the cost implications of losing. CFtE therefore increases the incentive for confident claimants to come forward with their cases. By contrast, less confident claimants with weak or speculative claims in smaller cases are likely under CFtE to give more weight to the proportionately more significant effect of costs if they lose, and therefore be less likely to pursue a claim.

More generally:

Situation		Traditional approach	CFtE
1. Claimants are confident in their claims	a. <i>Relative incentive effect on claimants</i>	<i>Stronger deterrent</i>	<i>Weaker deterrent</i>
	b. <i>Is the effect desirable?</i>	<i>No</i>	<i>Yes</i>
2. Claimants are not confident in their claims	a. <i>Relative incentive effect on claimants</i>	<i>Weaker deterrent</i>	<i>Stronger deterrent</i>
	b. <i>Is the effect desirable?</i>	<i>No</i>	<i>Yes</i>

Note: the deterrent effect is more pronounced when claims are small relative to anticipated costs.

We thus consider that Vasani and Ugale’s conclusion that CFtE is largely a deterrent to claimants in investment treaty arbitration, while the traditional approach encourages arbitration, is incorrect when claimants are confident in their claims (situation 1). A costs-allocation regime is less important when claims are large relative to the anticipated costs of bringing them (situation 2, when claim is large relative to costs). However, we do agree with Vasani and Ugale’s conclusion that CFtE deters potential claimants in cases in which claimants are not confident in their claims and the claims are small relative to the anticipated costs (situation 2, when claim is small relative to costs). Similar arguments can be made about counter-claims by states.

We consider each of these incentive effects of CFtE to be more desirable than the effects of the traditional approach. Moreover, CFtE also increases the incentive for respondent states to settle strong claims and to dispute weak ones, which we also

consider desirable, both from the point of view of the specific parties as well as in relation to broader incentive effects.

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\* James Nicholson ([james.nicholson@fticonsulting.com](mailto:james.nicholson@fticonsulting.com)) is a Senior Managing Director in the International Arbitration team of FTI Consulting, based in Paris; John Gaffney ([J.Gaffney@tamimi.com](mailto:J.Gaffney@tamimi.com)) is a Senior Associate at Al Tamimi & Company, based in Abu Dhabi. The authors are grateful to Andrea Bjorklund, Mark Kantor and Baijiu Vasani for their helpful peer reviews. **The views expressed by the authors of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* (ISSN 2158-3579) is a peer-reviewed series.**

<sup>1</sup> Baiju S. Vasani and Anastasiya Ugale, “Cost allocation in investment arbitration: Back toward diversification,” *Columbia FDI Perspectives*, No. 100, July 29, 2013.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> We assume that CFtE will be implemented by tribunals with careful consideration on an issue-by-issue basis, rather than, e.g., necessarily awarding all costs to the prevailing party.

<sup>5</sup> Where “costs” = tribunal/ institution costs; lawyers’, experts’ and other advisers’ fees; internal disruption and diversion of management attention; and impact of the dispute on other aspects of the claimant’s business (e.g., other activities with respondent, reputational impact (positive or negative)).

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For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Shawn Lim, [shawnlwk@gmail.com](mailto:shawnlwk@gmail.com) or [shawn.lim@law.columbia.edu](mailto:shawn.lim@law.columbia.edu).

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