Columbia Center on Sustainable Investment

A JOINT CENTER OF COLUMBIA LAW SCHOOL AND THE EARTH INSTITUTE, COLUMBIA UNIVERSITY

CONCERN:

THIRD PARTY FUNDING

Increasingly, investors suing governments in ISDS are turning to third parties to finance their litigation. Funders and law firms are also reportedly working together to identify and pursue cases. These trends in the rise of third-party funding have given rise to various concerns, which have been identified by WGIII as issues meriting reform. This note outlines some of the concerns and reform options.

What is meant by "third party funding"

- Third party funders are investment funds; the ISDS claim is the "asset."
- In exchange for covering all or part of the expenses that a party incurs in a claim (such as legal fees) and in subsequent enforcement actions or appeals, the funder takes an interest in the financial outcome of the claim.
- The contractual agreement(s) between the funder and the funded party sets forth the rights and obligations of each of these parties; it includes a description of the funder's financial interest and may grant the funder other rights of access to information or input into or decision-making with respect to how the claim is managed (e.g. when, under what circumstances, and/or whether to settle).
- While third party funding can also compete with (or be combined with) other forms of financing an arbitration, such as lawyer contingency fees, pro bono legal services, litigation loans, and various forms of insurance (liability, political risk, before-the-event, after-the-event, etc.), the focus of current regulatory discussions is on financing that is motivated by a financial interest in the outcome of the dispute, and generally excludes financing that is regulated through other legal regimes (e.g. lawyer contingency fees).

How it works: Claimant funding

- When considering whether to invest in a claim, funders consider (the respective importance of which will vary by claim and by funder): (1) demonstration of healthy claim (2) margin of recovery somewhere higher than budget for funding (3) the value of the claim (4) the amount required to be advanced (5) jurisdictional obstacles (6) available defenses (7) the nature, length and type of the proceeding (8) the possibility of settlement (9) the creditworthiness of the client (10) the creditworthiness of the opposing party (with a view to being able to collect on the award) (11) counsel that has been selected and how counsel will be compensated (12) any other obstacles to recovery of an award.
- While funders can invest in individual claims, in order to diversify risk to the fund they are increasingly investing in "portfolios" of claims of a particular party or a particular law firm.

How it works: Respondent "funding"

- Respondent "funding" is not currently understood to be widespread or scalable in ISDS.
- Claimants can sue states but states cannot sue or counterclaim (generally) against claimants, so the best a respondent can hope for is an award for costs, meaning that there is not a financial upside that would attract third party investors.
- Respondent "funding" can take the form of after-the-event insurance, whereby the respondent and funder agree on the anticipated liability of the claim, and the respondent can offload all or part of liability above that amount to the funder, for a price.

Issues of concern surrounding third party funding:

- **Conflicts of interest:** Conflicts between arbitrators (in particular, but also experts) and funders (e.g. where an arbitrator acts as an advisor to a funder, or when an arbitrator's law firm has a recurring relationship with a funder) goes to issues of enforceability of awards, but also the legitimacy of ISDS itself.

- **Control and influence over management of the claim:** Concerns over whether and in what circumstances a third party funder should be able to influence a party to the proceedings, including with respect to when and under what circumstances a party may agree to settle a claim. Domestic laws differ in their approach to how much influence funders may exert. Notably, funders do not have ethical/fiduciary duties to the funded party, but to their own shareholders. Decisions to settle based on the funder's interest (e.g. during a particular fiscal year, or only for a certain amount) may not align with funded party's interest (e.g. in preserving a relationship with a host state).

- **Confidentiality and legal privilege:** Confidential information must generally be shared with the funder in order to obtain funding which leads to concerns about whether disclosure to a funder renders the information susceptible to disclosure requests in arbitral proceedings. Furthermore, funders are not bound by confidentiality agreements and are not prohibited from using information obtained elsewhere.

- **Costs and Security for Costs:** There are questions surrounding whether: (1) costs of obtaining third party funding (legal fees, etc) are recoverable costs in an arbitration proceeding, (2) a funder should be ordered by an arbitral tribunal to pay adverse costs if a claim fails or the respondent prevails, (3) a tribunal has jurisdiction to order costs against the funder, who is not a party to the arbitration proceedings, (4) under what circumstances a tribunal should take the existence of a third party funder into consideration when ordering security for costs.

- **Which claimants use third-party funding:** While third party funding is often claimed to facilitate "access to justice," it is increasingly the case that well-resourced, multinational corporations turn to third-party funders as one method of financing litigation, which determination is one of balance sheet management and not impecuniosity.

- **Who are respondent states in funded cases:** Anecdotal evidence suggests that third party funders consider the resources and talent states have available for the defense of a claim, and if strong (e.g. a developed state) view this negatively in considering prospective funding, and that they may not fund claims against highly impoverished states that will be unable to pay even a small fraction of an eventual award. It is important to know which states are respondents in funded claims and whether there is a disproportionate impact.

- **The number and kind of claims:** Funders operate on a high-risk, high-return funding model, and to the extent funding is more prevalent or increase the kind of cases with this financial opportunity (e.g. extractives investments) it may be cause for concern that a few sectors have a greater prevalence of funded cases than other sectors.

- **Frivolous and marginal cases:** Funders claim that funding frivolous cases is against their business interest, but critics suggest that marginal, not frivolous, cases are a concern. Investment law has vague standards and tribunals do not declare many cases to be frivolous. The concern is that funding may result in an increase in marginal cases that have the potential to bend the law in a more claimant- (and funder-) friendly direction.

- **Retention of foreign direct investment:** There are questions as to whether access to ISDS for expectation damages, facilitated and encouraged by third party funding, has a negative impact on investor retention as the financial incentive to manage long-term relationships with the host-state decreases in comparison to relocating and suing for potential lost profits.

- **Negative impacts on state conduct and regulation:** The introduction of third party funding may increase the overdeterrence that states already experience. As more claims are raised and states pay more and more to settle, the price of regulation increases.

<u>**Possible Solutions:**</u>

- **Ban it:** Effectively banning third party funding would require a multi-pronged approach**.** Consideration must be given to (1) arbitration rules (2) investment treaties (3) national law (i.e. that applicable to place of enforcement; seat of arbitration; regulation of legal counsel and/or funders).
    - **Costs:**
        - To the extent funding facilitates access to ISDS for impecunious claimants they would need to look to other sources of finance to bring these claims.
        - Well-resourced claimants view it as their own business interest how and with what funds they decide to finance a claim.
    - **Benefits:**
        - The asymmetrical nature of ISDS means that third party funding has more severe impacts (listed above) than it may have in other legal systems where counterclaims, and impleader of impacted parties, is possible. A ban eliminates those negative impacts.

- **Regulate it**: Various levels of and approaches regulation have been discussed:
    - A code of conduct/ethics binding on third party funders and/or counsel could prevent concerns surrounding how and in whose interest a funder approaches the management of or input into claims (if permitted).
    - Much of the discussion on regulation is focused on greater transparency. Various arbitration rules and treaties are including transparency provisions that require (1) disclosure of existence of funding and (2) disclosure of name/identity of funder, either to only the tribunal, or to the tribunal and the opposing party.
    - The sticking point over transparency seems to be whether and under what circumstances the funding agreement itself should be disclosed, and if so, what

information may continue to be confidential (e.g. confidential business information).

- Other discussions on regulation surround costs and security for costs, suggesting that funders may, in certain circumstances, need to provide escrow or other financial guarantees.
- **Costs:**
  - As a general matter, there seems to be recognition, even among funders, of the need or desirability for some form of regulation. Funders seek to limit transparency to the existence of funding and identify of funder and strongly oppose disclosure of funding agreements arguing, e.g. that this is proprietary business information and disclosure, if to the other side, would give a tactical advantage.
  - Funders oppose obligations for costs. Liability for costs can be, and sometimes is, included as part of the deal with the funded party. This is all a business transaction and comes at a cost. Just because funders have an upside interest there is no normative reason why they need to be responsible for downside risk.
  - Funders also oppose obligations to post security for costs. Tying up funds in escrow or a guarantee has a cost to the funder because these funds cannot be deployed to make a greater return elsewhere. This will increase the costs of funding to the funded party and in some cases make it impossible.
- **Benefits**:
  - Despite their very central role in an arbitration and impact on claims and how claims are managed, funders are beyond the jurisdictional reach of a tribunal. Many domestic jurisdictions carefully regulate the role of litigation finance to try to control its negative impacts while still permitting claimants to benefit in certain circumstances.
  - With respect to a transparency, conflict of interest concerns are very strong, and because they reach to the very legitimacy of ISDS, should be addressed.
  - With respect to transparency, regulation permitting disclosure of the funding agreement (either to the tribunal, to the other party, or publicly) would help to make clear which parties and which interests are driving the claim and management of the claim.
  - With respect to regulation of costs and awards for costs, states have difficulty collecting awards for costs (particularly when the claimant does not have assets or there are jurisdictional hurdles to enforcement). Bringing the funder into this context may make enforcement of cost awards easier for states. Some in favor also assert that it would disincentivize funding of frivolous or marginal claims claims as the funder may have a financial downside.