A Critical Perspective of Third-Party Funding in ISDS

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Outline

- Defining Third-Party Funding (TPF)
- Who are Funders?
- How do we evaluate TPF in ISDS?
- What is the case for TPF?
- How is TPF used in ISDS?
- Potential impacts of TPF in ISDS
  - On investors' decisions
  - On state conduct
- What are potential policy responses

Defining Third-Party Funding

- An agreement by an entity that is ***not a party to the dispute*** to provide a ***party***, an ***affiliate of that party***, or a ***law firm*** representing that party,
  - (a) ***funds or other material support*** in order to finance part or all of the cost of the proceedings either individually or as part of a specific range of cases, and
  - (b) such support or financing is either ***provided in exchange for remuneration or reimbursement*** that is ***wholly or partially dependent on the outcome*** of the dispute, or provided through a ***grant*** or in return for a ***premium payment***.
    - **ICCA Queen Mary Task Force on Third Party Funding in International Arbitration**

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Who are Funders?

Funders: an overview

- Third-party funders are investment funds. ISDS claims are assets. Funders invest in the asset to generate a financial return.
- Some funders are public, some are private, but all have profit-focused fiduciary obligations to their shareholders
- Some investors look to litigation funding as a way to diversify their investment portfolio away from other investable assets (e.g. stock market)

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How do we evaluate TPF in ISDS?

- **Does funding advance the object and purpose of investment treaties?**
  - **Purpose: [Sustainable] Economic Development**
    - US – Argentina (1994): Recognizing that agreement upon the treatment to be accorded such investment will stimulate the flow of private capital and the economic development of the parties
    - Switzerland – Egypt (2012): Recognizing the need to promote and protect foreign investments with the aim to foster the economic prosperity and sustainable development of both States
- **What are the costs vs. benefits of TPF?**
- **What are desirable and appropriate policy responses?**

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What is the case for TPF in ISDS?

Access to Justice

Creating Market Efficiencies = leveling the playing field to achieve more socially just outcomes

What is the case for TPF in ISDS?

- **Access to Justice**
  - E.g. the case of the expropriated small enterprise and the jailed and bankrupt business owner
- What do we mean by “access to justice”?
- Are other procedural remedies unavailable?
  - E.g. outside of claims for denial of justice after domestic exhaustion of remedies, in what cases have procedural remedies been denied?
- Are other financing methods that may have fewer costs available?
  - E.g. Claimant purchased political risk insurance?

What is the case for TPF in ISDS?

"Access to Justice" is usually not the reason for seeking funding

- Claimants are often not impecunious
- Well-resourced and sophisticated claimants seek to:
  - Manage risk
  - Move legal risk off-balance sheet
  - Reduce legal budgets or "turn legal departments into profit centers"
  - Take advantage of financing that may be on more attractive terms than elsewhere
  - Take advantage of funders "management consultancy" role

What is the case for TPF in ISDS?

Creating market efficiencies = leveling the playing field

- Funders create a market for legal risk where there wasn't one
  - they permit parties to transfer risk to the funder, who then has a right to the financial upside
- Funders can help to achieve socially efficient dispute outcomes
  - They "level playing fields" by aligning the risk tolerance, and bargaining power, of parties
  - This can ensure settlement that is based on merits rather than risk tolerance
- **But… is this the case in ISDS?**

What is the case for TPF in ISDS?

- Respondents in ISDS are, in many cases, not in positions of strong bargaining power
  - Access to information and legal counsel matter
  - Filing of claims are damaging to respondent states
  - Risk tolerance in standards-based systems is reduced
- Respondent funding is frequently unavailable
- TPF in ISDS thus acts to exacerbate differences in bargaining power in situations where the respondent is not in a position of strength
  - Vast majority of respondents are low-, lower-middle, and upper-middle income countries
  - Vast majority of claimants are large and well-resourced enterprises

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How is TPF used in ISDS?

- What and when does funding occur?
  - Some funders fund only a portion of costs, some all
  - Funding can come in early or later in the process
- Role of funder varies:
  - Some will require influence or decision-making over the management of the claim (e.g. decisions to settle)
  - Some will take a hands-off approach

How is TPF used in ISDS?

- Claimant funding
  - Money placed into a “special-purpose vehicle”
  - Funding Agreement between funder and claimant
  - Secured interest in portion of outcome of claim
  - Termination rights
  - Sometimes rights to:
    - Information
    - management of claim

How is TPF used in ISDS?

- Factors considered by funders:
  - demonstration of healthy claim
  - margin of recovery somewhere higher than budget for funding
  - the value of the claim
  - the amount required to be advanced
  - jurisdictional obstacles
  - available defenses
  - the nature, length and type of the proceeding
  - the possibility of settlement
  - the creditworthiness of the client
  - the creditworthiness of the Respondent (collectability of award)
  - Respondent's development level, quality of counsel, legal budget
  - counsel that has been selected and how counsel will be compensated
  - any other obstacles to recovery of an award

How is TPF used in ISDS?

- Respondent funding
  - Very different from claimant funding because there is no financial upside
  - Can be similar to after the event insurance
    - Requires agreement on forseeable outcome/liability (i.e. how will tribunal apply law to facts and what will award be?)
    - Permits risk limitation but not elimination
    - Respondent will pay a deductible for agreed amount, and higher amounts will be compensated by funder (and may be shared in some combination between funder and respondent
  - May also be collateralized by other claims
- But: Under what circumstances can (or will) governments enter into arrangements that grant control of claim to funder?

How is TPF used in ISDS?

- Portfolio funding = financial interest in a basket of claims
  - Around a single claimant
  - Around a law firm
- Permits risk diversification for funder
- Can result in lower cost of funding for claimants
- Permits secondary market for institutional investors
  - Not robust right now, but starting to exist

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Potential impacts of TPF in ISDS

- Impacts on:
  - The number and kind of ISDS cases
  - Select respondent states
  - The quality of cases: frivolous and marginal claims
  - The substantive development of investment law
  - The outcome of disputes and decisions to settle claims
  - The retention of foreign direct investment
  - State conduct: regulatory chill

Potential impacts of TPF in ISDS

- ISDS is a system of standards, and not rules
  - The party whose behavior is expected to conform to the vague standards generally bears the cost
- Standards-based legal systems can work
  - precedent or appellate mechanism can inform, ex ante, what behavior is expected
  - ISDS does not have these features
- ISDS awards are rarely set aside, are not subject to appellate
- TPF tends to exacerbate the asymmetry of ISDS

Potential impacts of TPF in ISDS

Impacts on the number and kind of ISDS cases

- Funders claim they only fund 10% of claims presented to them
- **Bigger concern: Are some kinds or sectors of cases being funded more than others?**
  - 60% of cases registered at ICSID are infrastructure and extractives
  - High damages awards, expectation damages possible
  - Extensive social and environmental complications in these sectors
  - Controversial claims because they often stem from complicated balancing of competing interests among different stakeholders

Potential impacts of TPF in ISDS

Impacts on select respondent states

- Are certain countries, or country profiles bearing an outsized burden of funded claims?
  - E.g. developing and middle income countries?
  - E.g. countries reliant on resource extraction?
- International investment law already has an outsized impact on developing states?
  - Primary targets of claims (relative to GDP)
  - Have paid more in damages than advanced economies
- **What does this mean for inequality and the ability of these states to regulate and take steps in the public interest?**

Potential impacts of TPF in ISDS

Impacts on the quality of cases: Frivolous and Marginal Claims

- ISDS is a standards-based legal system: claims are rarely declared frivolous
  - Arbitrators also have systemic incentives to accept jurisdiction
- **Bigger concern: Marginal claims intended to push the boundaries of the law**

Potential impacts of TPF in ISDS

Impacts on the Substantive Development of Investment Law

- Defense of ISDS and TPF often focuses on upholding “the rule of law” = but most cases are less clear
  - E.g. good faith ban or moratoria on extractives projects
  - E.g. domestic common law patent protection is inadequate
- Many ISDS cases involve highly complex questions of public policies, preferences and competing rights and obligations
- But, only investors initiate claims
- Claims that are outside the intent of treaty parties but accepted at the jurisdictional phase are only likely to move the contours of investment law in a more investor-friendly direction and away from state-party intent
  - Australia: Chen found that TPF leads to more claims; claims raise riskier and novel issues and constantly push boundaries of law; these cases are cited more and have more impact on legal developments
- **Funders have long-term interests in shaping the contours of the law but there is currently no transparency around when they are involved or who they are**

Potential impacts of TPF in ISDS

Impacts on Outcomes of Disputes and Decisions to Settle Claims

- Funders financial interest may prefer settlement over seeing a claim through to an award
- Settlement raises public policy issues that are often regulated in domestic legal systems but not in ISDS:
  - Government accountability
  - Transparency
  - Rule of law
- **How does funding impact risk tolerance and bargaining position of states in settlement discussions? Should funders be able to influence or control settlement?**

Potential impacts of TPF in ISDS

Impacts on the retention of FDI

- FDI can help long-term development (e.g. commitments of capital, technology transfer)
- Investment treaties should help to attract and retain FDI
- No clear evidence that they attract FDI
- TPF may exacerbate concerns about ISDS
  - Damages often higher than under domestic law
  - May undermine long term contractual relationship with incomplete terms if investor can sue, (settle) and walk away

Potential impacts of TPF in ISDS

Impacts on State conduct: regulatory chill and overdeterrence

- Investment treaties go beyond other constraints on government powers
- They unduly discourage (or require compensation for) good faith actions taken by governments in the public interest
- Standards of investment law make it difficult for states to understand what actions will violate treaties
- TPF exacerbates situations of regulatory chill and overdeterrence of government behavior
- TPF eliminates claimant risk so permits more marginal claims to be advanced

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Potential policy responses

Questions that should guide policy-making:

- How and under what circumstances is TPF being used?
- Absent information, what assumptions should be made?
- Evaluated in light of economic development objectives:
  - What are costs of TPF in ISDS?
  - What are benefits of TPF in ISDS?
- Under what circumstances, if any, should TPF be permitted?
- What regulations should be in place to reduce costs and advance benefits?

Potential policy responses

Ban TPF in ISDS

- Whatever its merits elsewhere, TPF has no place in an ISDS system that is deeply asymmetrical and fundamentally flawed
- Permitting speculative finance to take a stake in the outcome of these cases, and to have a voice in or influence over critical issues (e.g. selection of arbitrators, decisions to settle) exploits deep-rooted flaws at expense of governments, taxpayers and citizens
  - Respondent state tax payers are residual risk-bearers, as opposed to in commercial arbitration where both sides bear risk of adverse judgments

Potential Policy Responses

Regulate TPF in ISDS

- There are a wide range of possibilities
- Regulatory response should address what the problem with third party funding is understood to be.
- E.g. **If conflicts of interests with arbitrators and/or experts is of concern**, disclosure of existence of funding and funder (including beneficial ownership) may be desirable.
- E.g. **If enforcement of awards for costs is a concern**, rules on security for costs may be desirable (particularly in the case of impecunious claimants), may wish to understand:
  - Whether funder has an obligation for adverse cost awards
  - What termination rights the funder has

Potential Policy Responses

- For concerns beyond conflicts of interests or enforcement of cost awards, more extensive policy responses may be desirable
  - Ethical rules
  - Tribunal supervision over funding relationship
  - Tailor securities regulation to address secondary markets in claims
  - Place a burden on claimant to demonstrate a prima facie valid claim and need for funding (e.g. demonstrate impecuniosity)

Potential Policy Responses

Practical steps to bans or regulation:

- A multipronged approach
  - Arbitration rules
  - Domestic jurisdictions
  - Treaties
- This may take time but can be accomplished
  - E.g.: Consider in context of multilateral investment court – include rules in organizing treaty

Thank you

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