TPF regulation: how should third-party funders be regulated and why would that be a better solution than the status quo?

The last few decades have seen exceptional growth in the arbitration market[1]. However, this development has not escaped criticism, particularly given its high costs, which have been expressed as "arbitration's worst feature."[2] Due to its creativity and flexibility, the arbitration system has found a way to finance the increase in these costs: third-party funders.

Third-party funders finance litigation in exchange for a return or other financial interest in the outcome of a dispute, often accompanied by a contractual right for the funder to remain involved in, and potentially even control, the management of the claim.[3] Many prejudices exist about this practice, as often happens when money is at stake. These prejudices are built on the fact that third-party funders remain new to the arbitration system and have been brought to the forefront mostly for the wrong reasons, which assured them the name of "vulture funds."[4]

Such a lack of confidence is reflected in the existence of legislation preventing or limiting its use. However, practitioners wish for a more accomplished regulation. As demonstrated in the Queen-Mary and White & Case survey of 2015, 71% of people of the sector expressed they would like third-party funding to be more regulated[5].

The reflection will be focused on practical, and potentially innovative, solutions to improve the practice of funding. To determine (IV) the best possible regulation, it is necessary to look into (I) the relation third-party funders have with the outside world, (II) the potential impact of third-party funders on the tribunal, and (III) the internal functioning of these funds.

I – Third-party funding regarding the outside world

The first reflection on a potential regulation for a new entity on the arbitration market is to consider whether to make this entity known to the market. This awareness will pass through (A) the entity itself and (B) potentially the content of the contracts entered into.

A) A desire for transparency leading to the funder's disclosure

The idea is to determine if it is proper to seek the disclosure of third-party funders. The lawyer Laurent Lévy, for instance, gave his preference to ignorance, with the idea that revealing the existence of a third party can give the market a sign of the company's poor financial health. However, one can also support the opposite view that for considerations of fairness and good information of the litigants and the court, the disclosure is preferable. The practice tends to go toward transparency, as can be seen through new trade agreements (e.g. the Comprehensive Economic and Trade Agreement) or the ICSID rules reform that integrates the practice[6].

[1] W. Ben Hamida et T. Clay, L'argent dans l'arbitrage, Lextenso éditions, 2013.
[2] Queen Mary University of London, School of International Arbitration, 2015 International Arbitration Survey: Improvements and Innovations in International Arbitration, 2015.
[3] Report of the ICCA–Queen Mary task force on third-party funding in international arbitration, April 2018.
[4] Rebecca Lowe, Investment arbitration claims could be 'traded like derivatives,' International Bar Association.
[5] Queen Mary University of London, School of International Arbitration, 2015 International Arbitration Survey: Improvements and Innovations in International Arbitration, 2015.
[6] Proposals for amendment of the ICSID rules, Working Paper #3, August 2019.

French law is silent on the obligation to indicate the presence of a third-party funder in the procedure. Because of the arbitrator's obligation to disclose his direct and indirect links he may have with the parties, their counsel, or through their law firm, it seems desirable to push for disclosure. Similarly, Australia has required disclosure in principle by the parties of any agreement by which a third-party funder is required to pay or contribute to the costs of the proceedings[7]. The Singapore[8] and Hong Kong[9] laws also make mandatory disclosure of the existence of third-party funding and the identity of the funder involved.

By digging into this idea of transparency, other ideas can be supported. This could be the case of a national register to inform parties of such an opportunity and ensure good practices. Indeed, state accreditation could protect the litigants of an entity that shows itself as a funder but does not present the qualities and guarantees of this practice. In this respect, the law of Singapore put regulations prescribing specific eligibility requirements for funders. This framework could also ensure the capital adequacy. Hence, funders would be required to maintain adequate financial resources at all times to meet their obligations to fund all of the disputes they have agreed to fund.

Next to a national register, a rating could be envisaged. Following the example of rating agencies for government or corporate debt, it could also be considered for agencies to rate third-party funds according to their practice, source of financing, stability on the market, and overall quality. These reflections push for transparency and access to information, which may also be desirable concerning the contract itself.

B) Disclosure of the content of the contract to provide protection

The most recent agreements (the Transatlantic Free Trade Agreement or the UEEA-Vietnam agreement) include the obligation to disclose the presence of a funder, but not to disclose the contract that binds it to the party.

The disclosure could be helpful to protect the litigants. The fact the agreement is a contractual relationship raises the same issues as traditional contracts. This idea has at its origin potential economic exploitation of a litigant who needs or has to resort to arbitration and will potentially accept an unconscionable agreement, creating a need for protection. Third-party funding agreements can be seen as credit advanced to a consumer and should be controlled because the agreement has the potential of containing abusive or unfair provisions that are unjustifiably harsh on the litigant.[10] Expansive transparency will also provide the much-needed data for future research into the benefits and harms involved in third-party funding and enable more effective regulation going forward.[11]

In a will to rationalize litigation, it seems necessary to be able to oversee the contractual content, but it is also necessary to see how funders can impact the tribunal.

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[7] Federal Court of Australia, Practice Note CM17 – Representative Proceedings Commenced under Part IVA of the Federal Court of Australia Act 1976, §3.6.
[8] Civil Law (Amendment) Act (Bill No. 38/2016).
[9] Third Party Funding (Amendment) Bill 2016 on 14 June 2017.
[10] Khoza MJ, Formal Regulation of Third-Party Litigation Funding, South African perspective.
[11] Frank J. Garcia, Hyun Ju Cho, Tara Santosuosso, Randall Scarlett, and Rachel Denae Thrasher, The Case Against Third-Party Funding in ISDS.

II – The impact of third-party funders on the tribunal

Once the importance of regulating the existence of the third party has been expressed, consideration must be given to the effect of a new entity in the dispute. This effect may be (A) regarding the cost of arbitration or (B) the jurisdiction of the tribunal.

A) The presence of a funder should create a presumption to ask for security for cost

Using a third party to enable access to arbitration leads to reflections about the impact of the third party. Assuming that the tribunal has the power to order security for costs, does the claimant's reliance on third-party funding constitute grounds for making such an order? Many commentators respond positively pointing out that, in the absence of security, the respondent will be unable to enforce a potential costs award against the claimant because it has no funds of its own, and will also be unable to enforce it against the third-party funder because it is not a party to the arbitration and is outside the jurisdiction of the tribunal[12]. Several tribunals in both investment and commercial arbitration have ordered security for costs based, at least in part, on the claimant's reliance on third-party funding[13].

One could argue that, once the claimant is relying on third-party funding, this constitutes *prima facie* evidence of the claimant's impecuniosity, and the claimant should then be required to provide positive evidence of its ability to comply with a costs award. Also, mandatory security for costs can help disincentivize funders from pursuing weak cases merely for their settlement value.[14]

B) The participation of a funder should not distort the jurisdiction of the tribunal

In investment arbitration, the transfer of an interest in the claim to a third-party funder may affect the tribunal's jurisdiction *ratione personae*. Even if the nature of the interest depends on the funding agreement, the funder's entitlement to receive a portion of any damages paid to the claimant may be deemed to constitute a *de facto* assignment. To address this issue, a principle of international law expresses that the beneficial owner, rather than the nominal owner, of a claim, is the proper party before an international tribunal[15]. This principle was applied by the ad hoc committee in Occidental v. Ecuador[16].

A similar reflection will apply to the question of nationality because tribunals can only adjudicate the claims of investors having the nationality of one of the contracting parties to a treaty. In Teinver v. Argentina[17], the tribunal found that the alleged transfer of the interest to a third-party funder that did not meet the nationality requirements could not affect its jurisdiction because it occurred after the case was initiated.

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[12] Maxi Scherer, 'Third-Party Funding in Arbitration: Out in the Open?', Commercial Dispute Resolution, May 2012.
[13] RSM v. St Lucia X v. Y and Z, ICC Case, Procedural Order dated 3 August 2012.
[14] Frank J. Garcia, Hyun Ju Cho, Tara Santosuosso, Randall Scarlett, and Rachel Denae Thrasher, The Case Against Third-Party Funding in ISDS.
[15] David J Bederman, 'Beneficial Ownership of International Claims', 38 International and Comparative Law Quarterly 935 (1989).
[16] Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador, ICSID Case No. ARB/06/11, Decision on Annulment of the Award dated 2 November 2015.
[17] Teinver SA, Transportes de Cercanías SA and Autobuses Urbanos del Sur SA v. Argentine Republic, ICSID Case No. ARB/09/1.

For reasons of legal certainty and predictability, it would be necessary to fix a solution regarding jurisdiction by ensuring that the participation of a third party does not distort the jurisdiction of the tribunal. The impact of the funder must be controlled regarding the tribunal, but also from the point of view of the management of the procedure.

III – Third-party funders regarding their own functioning

The litigants must stay in charge of the case. In this regard, (C) third-party funders should not be able to impact the procedure because of (A) the intrinsic conflict of interest of this financing relationship and (B) the diversity of models existing in the world.

A) Conflict of interest as intrinsic to the financing relationship

Current French law does not govern the internal regulation of the funder and lets the parties create their relationship through the financing contract. The necessity for a framework comes from an intrinsic problem in the relationship between the third party and litigant. A perfect alignment of interests is possible where everyone is looking for the maximum monetary compensation. However, it is not uncommon to see diverging interests between these two parties, e.g. the funder is looking for a return on its interest, whereas a litigant will have personal gain beyond the simple economic interest. Similarly, the litigant may wish to settle and the third party may object. Funders' and clients' interests, even if aligned at different stages of the arbitral procedure, are not the same and could jeopardize the good resolution of the dispute. As a result, various systems have been put in place to control the involvement of the third party.

B) A multitude of degrees of involvement of the funder

A regulation in French law would be salutary given the multitude of existing models in the different legal systems, and the problems that this relationship may encounter. The models represent different degrees of intervention by the third party in the procedure and its relationship with the litigant. In England, for instance, the doctrine of "champerty and maintenance" is applied and will block the possibility for the third party to exercise control or intervene in the management of the dispute[18]. This doctrine sets strict limits on what a third-party funder can do, i.e. the funder cannot decide on the identity of the lawyers, cannot decide on the strategy, cannot decide on the amounts of the transactions. In the United States, some states apply the doctrine of champerty and maintenance, others do not. In Australia, some judges had determined that by taking the risk, the third-party funder can make orientation on the trial and the amounts of the transactions. In the cases Fostif[19] and Mobil Oil Australia[20], the High Court of Appeal authorized financing by an investor with broad powers regarding the management of the lawsuit.

Due to this cultural difference throughout the world, it would be necessary to create a frame for French funder to determine their rights and obligations in a procedure. Indeed, in France, so far, only one case[21] confirmed the adoption of the practice of financing while the Council of the Paris Bar[22] expressed that the financing of arbitration by third parties is not contrary to French law. More need to be done to frame the involvement of the third party.

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[18] Arkin c/. Borchard Lines Ltd, [2005] EWCA (Civ) 655 (Eng.).
[19] Campbells Cash et Carry Pty. Ltd. c/. Fostif Pty. Ltd., [2006] HCA 41.
[20] Mobil Oil Australia Pty. Ltd. c/. Trendlen Pty. Ltd., (2006) 229 ALR 51 (Austl.).
[21] Cour d'Appel de Versailles, 12ème chambre section 2, arrêt n° RG: 05/01038 du 1 juin 2006.
[22] Council of the Paris Bar, meeting of 21 February 2017.

C) The need to avoid the involvement of the funder in the management of the case

The most suitable solution seems to be the abstention of the third party from the arbitral proceedings. The diversity of existing practices tends to find a minimum balance which would be abstention. By considering the funder as an investor, it makes sense not to give it the power to intervene in the strategy or resolution of the dispute. A risk analysis has been made upstream and once engaged in the dispute, the third party cannot take the lead and decide on the proper functioning of the procedure.

Once expressed what would be the best solutions to be taken to rationalize the funder-litigant relationship, it remains to be seen what form this regulation should take.

IV – Different types of regulation outside of state law

The expressed regulation seems necessary since it would be imposed over the existing vacuum. Indeed, various practices exist nowadays and uniformity would bring certainty and predictability for all stakeholders. Some commentators explain that national laws do not seem to be the best way for this clarification because it would lead to a fragmentation of regulations, creating inconsistency among jurisdictions, opening the door to forum-shopping.

A solution would potentially be for the practice to regulate itself. Different countries such as England[23] and the Netherlands have pushed the favor of self-regulation. Similarly, some institutions[24] have given guidance and insight for the proper functioning of third-party funding. Soft law and guides could provide a tailor-made framework. However, this can only be effective if all the parties concerned are taken into account.

In light of past economic crises and the expansion of arbitration, the third-party funder has become an important player whose practice needs to be streamlined. Such a framework would be beneficial to all stakeholders.

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[23] Code of Conduct of Association of Litigation Funders, 2016.
[24] SIAC: Practice Note on Arbitrator Conduct in Cases Involving External Funding.

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