The Regulation of Third Party Funding: Gathering Data for Future Analysis and Reform

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It might be equally true, that a person in possession of a good fortune will seek new ways to grow that fortune. The Financial Crisis dried up certain financial markets for a time, leaving some corporations and investors to seek new avenues for building wealth, both for themselves and for their shareholders. One such avenue is commonly called third-party funding (TPF), in which an individual or corporation outside of a legal dispute provides financing to one of the parties – usually the claimant. In return, the non-party may receive a return on the amount of the claim recovered, if any (ICCA-QMUL 2017). What began in the context of domestic litigation, first in Australia, then in the United States and Great Britain, has taken root in other jurisdictions around the world – such as Singapore and Hong Kong, as well as certain countries in Latin America and Europe. It has also burst from the narrow context of domestic litigation and arbitration, into the realm of international commercial and investment arbitration.

The growth of TPF may be due to both demand-side and supply-side forces. In addition to the rising costs of litigation, there has been a shortage of capital through more traditional forms of lending for litigation (Flake 2015, citing Beisner, et al., 2009). Likewise, investors gained an interest in “alternative capital outlets, where returns would not be correlated to traditional markets” (ICCA-QMUL 2017). Through pressure from potential funders and (possibly) an increased demand for additional funding opportunities from claimants, some common law jurisdictions introduced statutory reforms permitting (and regulating) TPF.

On first glance, the availability of TPF (almost) uniquely to the claimants in any case, seems to place a thumb on one side of the scales of justice. In domestic litigation and arbitration, and even in international commercial disputes, it might not be quite that straightforward. In those cases, individuals and corporations may be on any side of the dispute. And even if they are brought before a tribunal on a contract claim, they may also have access to TPF for any related counterclaims in the case. In short, private disputes do not only have a claimant and a defendant, but often two claimants and two defendants, affording both parties access to this funding opportunity.

The one unique context in which this presents a problem is international investment arbitration. In international investment treaties, as I discuss in more detail below, countries are bound by rights and responsibilities while private investors have only rights. In that way, there is no room for counterclaims by respondent States and TPF is truly only available to one side of the system. This creates distinctive challenges for the states involved. Frank Garcia argues that such an asymmetry “constitutes an unjustifiable wealth transfer from respondent host states (frequently developing countries) and their citizens in favor of speculative finance, amounting to a deliberate exploitation of the system” (Garcia 2018). Others are concerned that banning TPF altogether would create barriers to justice and unnecessarily discriminate against legitimate dispute funding. I contend that the system as it stands lacks data with which to determine the costs and benefits of third-party funding in investment arbitration. This paper begins with a thorough look at the available empirical analysis on the claims and outcomes in investment arbitration. From that, I show that third-party funding suffers from a severe lack of access to information, that is, from a severe lack of transparency. Although the practice is currently permitted, we ought to seek expansive disclosure of third-party funding arrangements in the International Investment Arbitration context. Second, briefly, I argue that we ought not to stop at
that, but instead we should use the information gathered from that expansive disclosure to push against the status quo inasmuch as the data shows that TPF is not serving the goals of international investment agreements, or is resulting in unexpected side-effects.

I. Unequal Opportunities In An Imbalanced System: The role of TPF in Investor-State Dispute Settlement

Third-party funding is problematic largely because of its presence in an already imbalanced system. Investor-state dispute settlement (ISDS) has been a staple of international investment disputes since the Germany-Pakistan Bilateral Investment Treaty (BIT) in 1959. In 1966, the World Bank created the International Centre for the Settlement of Investment Disputes, an institution established specifically for the resolving of these investor-state conflicts outside of the domestic court systems. In those early years, the system acted as a much-needed protection for foreign direct investors providing capital, employment and infrastructure to the developing world. Its value lie “in its role as a restraint against unjustified expropriation or unfair treatment when governments changed political direction” (Schultz and Dupont 2015). As Gus Van Harten has pointed out, many of the earliest arbitrations “followed in the wake of foreign invasion or occupation” (Schultz and Dupont 2015, quoting Van Harten 2007).

The system did not gain much traction, however, until the mid-1990s, when the number of BITs and modern free trade agreements (containing investment commitments) began to boom. In addition to investor protection, investment treaties became a signal, a “welcome mat”, that developing countries could put out indicating that they were open for business. Including ISDS helped governments “credibly commit to allow foreign investors to operate on their soil without undue interference” (Wellhausen 2016). Corresponding to the increase in the number of investment treaties, the average number of claims filed per year skyrocketed from under 5 (before 1994), to between 30 and 50 after the year 2000 (Schultz and Dupont 2015).

Structural imbalance.

Many people today argue that the presence of ISDS “tilts the scales too far” in favor of the investors (Wellhausen 2016). Structurally speaking, investment treaties are simply treaties – contracts between states that impose obligations on those states. The citizens of each state stand only as third-party beneficiaries and cannot be bound by obligations directly under the treaty. The preambles of many treaties highlight this tendency. In fact, investor-state arbitral tribunals have, in a number of instances, relied on the preamble to conclude that “the sole purpose of the treaty is the protection of the investor in order, presumably, to attract higher levels of investment” (SADC Model BIT). The substantive language of the treaty is also one-sided – protecting investors without safeguarding the host state (Schultz and Dupont 2015).

Consequently, in ISDS, investors are always the claimants and states are always the respondents. While, by itself, “this is a significant element of asymmetry in the system,” some argue that the asymmetry is “not terribly relevant” (Schultz and Dupont 2015, quoting Alvarez 2011). If we assume that the investor is incredibly vulnerable under the domestic legal system of the host state, then ISDS is “nothing but the reverse mirror image of the investors’ exposure to the host state’s [sovereign regulatory power]” (Schultz and Dupont 2015, quoting Alvarez 2011).

That asymmetry becomes increasingly relevant, however, in the context of TPF. Where large sums of money are available only to one side of a balanced system, the balance can be thrown off. Furthermore, as some research has shown, filing matters. Even states that ultimately
win the arbitration, experience the negative consequences of being involved in the system, such as a decrease in foreign direct investment and in the sovereign bond market (Wellhausen 2016). If TPF increases the likelihood that an investor will bring a case under the investment treaty, states are more vulnerable to these consequences. Finally, even if state parties won a vast majority of the time, the cost of arbitration is a particular concern for lower income countries who have become the target of an investor-state dispute. The rise of TPF and other funding sources for investment arbitration has risen concurrently with the costs of these cases, and the impact of such cash flow has not yet been studied empirically in this context.

A number of studies have examined the outcomes in investment arbitration and determined that the results are split approximately 3 ways – 1/3 of states win, 1/3 of states lose and 1/3 of states settle (Sweet, et al. 2017, Wellhausen 2016, Schultz and Dupont 2015). Researchers disagree about how to treat settlements, however, as the settlement agreements are not available to the public and it is not immediately clear which party benefits the most from such a result. On the one hand, settlement could be viewed as a loss to states, since they still have to pay the investors some amount for the alleged treaty violation. On the other hand, the cost to settle is likely much lower than the cost to go through with the suit, especially if the state thinks it will lose. This initial glance, in any case, does not seem to clearly prefer investors’ claims over states’ interests.

Practical North-South imbalance.

Although the overall average numbers do not point to the ISDS outcomes strongly favoring investors, further research shows that, for those very countries most vulnerable to the high costs of investment arbitration, those global trends obscure the true story. First of all, a vast majority of all claimant investors are from high income countries (88%). While respondent countries are more diverse than the home states of the claimants, the bulk of all claims are filed against states that are upper middle or middle income countries. Additionally, from 1998-2010, 46 percent of high income respondent states prevailed, but only 27 percent of low income states won (Schultz and Dupont 2015). Another study showed that, by the end of 2014, OECD states won 55 percent of the time, which is well above the 33 percent average (Wellhausen 2016).

Proponents of ISDS credit the “good behavior” of countries like the United States, contrasted with the “fast and loose behavior” exhibited toward foreign investors by countries like Argentina (Hufbauer 2015). Others argue, however, that “a systematic prevalence of stronger parties . . . is taken [indicate that] the rule of law is pursued less diligently” (Schultz and Dupont 2015). By looking at the nationality of the home states of the investors, for example, one study showed that investors from the wealthiest countries were less likely to have their claims dismissed on jurisdictional grounds (McArthur & Ormachea 2009).

Most of these trends point toward some fundamental imbalances within the ISDS system – both structurally between investors and states, and, in practice, between developed and developing countries. Introducing TPF, an inherently one-sided funding opportunity, into such a  

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1 Unfortunately, we cannot measure the number or percentage of awards that they investors or states should have won, as it would require second-guessing the facts and legal arguments of hundreds of investment cases (Schultz and Dupont 2015). On average, claimants who won their case, were only awarded 30-40 percent of the amount initially claimed (Wellhausen 2016). One could argue that claimants inflate awards requests, knowing that they will get a small percentage of that, or that tribunals do a good job of constraining damage claims against states (Wellhausen 2016). Ultimately, however, we do not know.
system could create a wealth of unknown impacts. It has the potential, certainly, of increasing the number of cases against vulnerable states and driving up the costs of arbitration through supply-side pressure.

II. New Regulation: Expansive Disclosure

As amply demonstrated, ISDS is rife with asymmetry. Given the financial vulnerability of states in investment arbitration, the regulation of third-party funding must seek to not exacerbate such imbalances. I argue that, in order to do that, we need mandatory, expansive disclosure of third-party funding agreements. This, primarily, for three reasons: to avoid conflicts of interest, to align with arbitration’s institutional movement toward transparency, and to provide information for on-going empirical research.

Disclosure and Confidentiality Concerns.

Currently there is no widespread requirement to disclose the presence or identity of third-party funders. The Canada-EU Trade Agreement, Article 8.26, for example, does include mandatory disclosure of the presence and identity of the funder, while the Singapore Investment Arbitration Commission (SIAC), Article 23(1) gives the tribunal power to order disclosure of the funder and details of the agreement, but it is not mandatory. In many jurisdictions, TPF is left unregulated.

Admittedly, there are competing interests when it comes to disclosure and confidentiality. In this case, both parties have a strong interest in a determination by an unbiased tribunal as well as in a swift and final resolution of a dispute. Meanwhile, the claimant has some interest in keeping the funding relationship confidential, for fear of how it will affect other procedural issues in the case. In a few instances, respondents have viewed the presence of a third-party funder as evidence that the claimant will be unable to pay costs at the end of case, should the tribunal shift costs. A request for security for costs can result in a delay of the process, as well as driving up the actual costs of the arbitration. Claimants and funders alike view this outcome as unnecessarily punishing claimants for using outside funding.

The high likelihood of accidental or delayed disclosure, as well as the high cost to both parties of accidental or delayed disclosure in the event that an award is set aside, however, suggests that interests in disclosure substantially outweigh those in confidentiality. As a result, the growing consensus is that both the existence and identity of a third party funder should be disclosed. But this is not enough. Funding agreements often contain the same main components. One the most important pieces is the control that the funder might exercise over litigation decisions. It makes sense that funders would have an interest in whether and when a claimant would decide to settle as opposed to pushing for an arbitral win. However, that makes the claimants extraordinarily vulnerable to the underlying profit-based incentives motivating the funder.

Funding agreements also lay out the return structure of the arrangement (how much the funder will make in the event of a win), the priority agreement (who gets the money first) and a risk alignment section (who bears the risk of increased costs and fees over initial predictions). All of these components are helpful in determining whether the funder is undertaking an appropriate amount of risk in the claim, and where the incentives lay for the claimant, the funder and the lawyers.
Expansive disclosure, or total disclosure of TPF agreements could address many of the concerns, both on the side of the respondent and the claimant. On the one hand, it could alleviate concerns that delayed or accidental disclosure would lead to an award set aside or a miscarriage of justice for the claimant and respondent. On the other hand, mandatory disclosure could normalize TPF, leading to fewer orders of security for costs and less discrimination or undue arbitration delays.

_Institutional Transparency and Long-term Legitimacy._

In the past decade, institutions governing international investment arbitration have begun to transition toward greater transparency in all their proceedings. Both ICSID (in 2006) and UNCITRAL (United Nations Commission on International Trade Law) (in 2013) modified their arbitration rules to increase transparency. In view of that trend, third-party funding should be treated with more transparency to align with the current institutional framework.

In addition to the current institutional needs of international investment governance, we ought to have a long-term investment in the legitimacy of these institutions. In order to support that, however, we need to provide on-going research into the role of third-party funders. Since third-party funders are relatively new to this context, we do not know much about the direct and indirect impacts, about which kinds of cases will be funded and what the outcomes will be. While proponents speculate that TPF will promote greater (much needed) investment in developing countries because investors will feel more comfortable that their rights and interests will be preserved. Critics speculate on the other side that it will increase both the cost and amount of litigation, leading to draining State balance sheets and ultimately a regulatory chill. However, until we have data, we cannot know the truth of either statement. And in order to gather this data, we need expansive disclosure: disclosing not only the existence and identity of third party funders, but also the general structure of these funding agreements, the financial situation of the funded party, the expected return on the investment, as well as the control, priority and risk alignment provisions.

One way to approach this is to incorporate third-party funding rules into new trade agreements, as Canada and the European Union have done. This would work well for new treaties, but would be time consuming and costly for older treaties that have been in place for decades. Another option, which could provide a more rapid change throughout the system, would be to modify arbitration rules for institutions like ICSID and UNCITRAL. In either case, language which combines the mandatory disclosure of the CETA Article 8.26 with the expansive disclosure of SIAC Article 23(1) could accomplish the goal.

_Concluding Thoughts: Rorschach Tests and Real Data._

Rusty Park said that third-party funding, like ISDS acts as a bit of a Rorschach test for researchers looking into this. He said that our conclusions say more about the researcher than about the process itself (Park 2017). Assuming that TPF represents just another market for investors to grow their capital and ISDS is just another international legal process, what should keep a corporation from making a corporate decision to get a “loan”, so to speak, in order to bring a lawsuit? What if that loan is a very special kind of loan where the lender recovers only if the plaintiff succeeds? In a place where the freedom to control one’s own property (and not to have a government interfere with its use or value) is held in high esteem, it seems that third-party funding is nothing over which we should lose sleep.
But some jurisdictions have begun to recognize that there are a few additional factors playing a role here. First of all, ISDS is a very specific, and particular kind of international legal process. It represents a very specific exception to the rule of sovereign immunity – in which a country cannot be sued outside of its own state courts. States consent to the jurisdiction of these international legal institutions as a concession to investors who have had a historical difficulty seeking redress for economic wrongs in the domestic courts of the investor’s host state. Furthermore, respondent states in international investment arbitration are in a unique position given that many of the measures complained of are measures “of general public interest” – environmental laws, labor protections and other social and economic rights.

Despite the fact that Third-Party funding is currently accepted in the realm of international investment arbitration, and despite the fact that critics calling for it to be banned have been unable to “move the needle” in terms of making practical changes, as some experts have said, we ought not to give in and accept that Third Party funding is here to stay. The ISDS system itself has been in place for more than 50 years, yet even now, in light of empirical evidence demonstrating some of its weaknesses, countries are pushing back on the status quo. In 2011, Australia announced that it would no longer include ISDS provisions in its trade agreements. Bolivia, Ecuador and Venezuela have terminated several investment agreements and withdrawn from ICSID. If, at 50 years old, the investor-state dispute settlement can be re-examined (and in some cases discarded), then third-party funding can as well.

As with any legal practice or institution, we ought to welcome on-going scrutiny which pushes us to provide greater justice with greater transparency and consistency. Expansive disclosure could make this scrutiny possible.
References


