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Third-Party Funding as Exploitation of the Investment Treaty System

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I Introduction

TPF represents a profound challenge to the fairness and legitimacy of the international investment regime, which if not addressed effectively will further compromise not only the public’s faith in this system (already undermined), but the viability of the system for states and other stakeholders. Whatever its merits in traditional litigation and commercial arbitration (and this paper takes no position on that), third-party funding has no place in investment arbitration. At best, TPF works an uncompensated wealth transfer from the citizens of respondent states to TPF investors, which is a distortion of the BIT/ISDS system and a threat to its legitimacy. At worst, TPF constitutes the exploitation by speculative finance of a system many have come to view as long as fundamentally flawed, at a significant cost to the citizens and stakeholders of respondent states.

Even proponents of the current BIT/ISDS regime recognize the system’s flaws with respect to traditional rule of law desiderata such as transparency, predictability, coherence and accountability.[1] Moreover, there is growing concern among scholars, civil society and even some within the investment community that

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[1] *See* Garcia et al., *Reforming the International Investment Regime: Lessons from International Trade Law*, 18 J. INT’L ECON. L. 861 (2015).

bilateral investment treaties and ISDS, in their current form, are no longer justifiable, even granting *arguendo* that they may have been when invented. Their asymmetric allocation of rights, together with the many rule of law deficits in ISDS today, have proven not only inadequate in the face of the number of stakeholders and complex social policy issues implicated in foreign investment, but potentially damaging to states' right to regulate and responsibility for the well-being of their citizens.[2]

The simplest and strongest policy reason to ban TPF from ISDS is that within the BIT/ISDS system as currently configured, TPF 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. The TPF funding model is perfectly designed to capitalize on the asymmetry in BIT rights and the rule of law defects of the ISDS system for the benefit of speculators, who can realize in excess of 700% ROI for a relatively modest investment.[3]

Under such circumstances, allowing speculative finance a stake in the outcome, and a voice in the determination of which cases to bring, which arbitrators to choose, and which cases to settle, amounts to nothing less than a deliberate exploitation of the flaws in the BIT system for the benefit of capital and at the cost of

[2] *See* Garcia et al., *supra* note 1.
[3] *See* BURFORD CAPITAL, 2017 ANNUAL REPORT 23 (2017) *available at* http://www.burfordcapital.com/wp-content/uploads/2018/03/BUR-28711-Annual-Report-2017-web.pdf. An appeal is currently pending in *Teinver v. Argentina* following an arbitration tribunal award in excess of $325 million. *Id.* at 23. Burford Capital invested approximately $13 million in the matter and sold their interest on the secondary market for $107 million for a gain of $94.2 million. *Id.*

respondent states, their taxpayers and citizens.[4] These benefits come at a great cost to the public, when one considers that states either lose or settle in two-thirds of all investment disputes,[5] that it has been estimated to cost states an average of $8 million dollars to defend even a spurious claim,[6] and that funders deliberately consider a respondent state's development status when deciding on whether to invest in a claim.[7]

For these reasons, states should consider banning TPF entirely, at least until the international investment regime can be reformed towards more balanced agreements.

II. TPF Must Be Evaluated in the Context of its Operating Environment

TPF must be evaluated in its context, by which I mean 21st century international economic law and governance in general, and 20th century paradigm for investment treaties in particular. This means TPF cannot be fully evaluated without reference to larger structural and institutional questions in investment law, and to the fairness of the global economic system as a whole.

A fundamental premise underlying this paper's view on TPF is that the current BIT-based international investment regime is fundamentally unbalanced in terms of norms and dispute resolution, offering investors a wide range of

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[4] *See* PIA EBERHARDT & CECILIA OLIVET, PROFITING FROM INJUSTICE: HOW LAW FIRMS, ARBITRATORS AND FINANCIERS ARE FUELING AN INVESTMENT ARBITRATION BOOM (2012).
[5] U.N. Conference on Trade & Dev., *Recent Trends in IIAS and ISDS*, U.N. Issues Note, No. 1, at 8 (February 2015).
[6] U.N. Comm'n on Int'l Trade Law, Rep. of Working Grp. III (Investor-State Dispute Settlement Reform) on the work of Its Thirty-Fourth Session, U.N. Doc. A/CN.9/930 (Dec. 19, 2017).
[7] Round Table Discussion on Third Party Funding in Investor-State Dispute Settlement with ICCA-Queen Mary Task Force on Third-Party Funding in International Arbitration, Columbia Ctr. for Sustainable Inv., in N.Y.C., N.Y (Oct. 17, 2017).

protections while offering states no meaningful basis for claims or counterclaims. Indeed, Prof. Alessandra Arcuri has recently referred to this unbalance as "The Great Asymmetry" in international investment law.[8]

While there may be valid historical reasons for this asymmetry,[9] and the risks to the viability and security of foreign investment continue to be real, this asymmetry represents today a fundamental flaw in the investment regime from the perspective of both governance and fairness, the two parameters critical to both resolving the current legitimacy crisis and shaping a more effective investment law regime for the 21st century.

It is a governance issue, because the investment treaty regime can no longer simply be considered as treaties granting private parties legal rights. The evolution of investment law and in particular the expansive trend in the interpretation of Fair and Equitable Treatment has resulted in a much more intrusive regime whose domestic regulatory reach raises basic questions of legitimacy. States face un-appealable arbitration awards whose scope directly impacts a range of unrepresented stakeholders, in a setting that affords their State-as-agent no substantive rights. As has been the case with international trade law, which also came from a background of limited "functional" treaties, the regulation of foreign investment has grown into an important element of what we now consider global economic governance, a set of institutions from which we expect more than one-

[8] *The Great Asymmetry and the Rule of Law in Trade and Investment Agreements*, *in* YEARBOOK ON INTERNATIONAL INVESTMENT LAW & POLICY (forthcoming 2018).
[9] *See, e.g.*, Garcia et al., *supra* note 1.

sided private rights.[10] We expect that regulatory structures and decisions that affect a range of transnational and national stakeholders be made according to norms of participation, accountability, transparency, due process and the rule of law. In these respects, the current international investment regime is sadly lacking.

More to the point of this paper, TPF is also a threat to economic fairness, insofar as—by design—TPF exploits this asymmetry in ways that further undercut the investment regime's capacity to satisfy even basic norms of distributive justice.

III. TPF as Economic Exploitation

Whatever the risks and merits of TPF in commercial arbitration, TPF within a system as unbalanced as the investment law regime is, to put it bluntly, an exploitation. This is so because TPF is explicitly designed to take unfair advantage of the asymmetric structure of the investment regime today, for the benefit of speculative finance. TPF does so by further concentrating economic power in the hands of investors, the privileged class of claimants (indeed the only class of claimants) in the current regime, through opening the system to the resources (and priorities) of speculative investment.

This is exactly the risk that traditional common law doctrines of maintenance and champerty were designed to mitigate, and thus reflects (even intensifies) the reasons investment treaties are under such serious legitimacy challenges today. More importantly, this pattern of behavior dramatically illustrates what we have come to call exploitation in economic relationships.

[10] Garcia et al., *supra* note 1.

A. Economic Exploitation as Unfair Advantage-Taking

The unfairness that constitutes exploitation "…is not the sort of thing that can be assessed by means of any precise formula."[11] Consequently theorists seeking to characterize a situation as exploitative offer a number of accounts of what makes an economic arrangement so unfair as to be exploitative. What the various accounts share in common is the notion of unfair advantage-taking.[12] This occurs when there is a flaw in the circumstances of the transaction—Risse and Wollner call it a moral defect in a distribution and its history[13]—that, whether due to an injustice in the background conditions, a vulnerability,[14] a rights violation, or some other form of disrespect, results in one apparently free party seemingly inexplicably accepting a bargain that is not *fair*, but without evidence of direct coercion.[15] We take the party benefitting from the flaw to be exploiting the situation, and the vulnerable party as the exploited party.

B. Why TPF in ISDS is an Exploitation

TPF is an exploitation, because it constitutes a case of unfair advantage-taking in the context of the current BIT/ISDS system. First, TPF is designed to take advantage of an unbalanced BIT/ISDS system. The funding model assumes a system in which states have no substantive rights under the treaty, claimants have a direct

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[11] Matt Zwolinski, *Structural Exploitation*, 21 SOC. PHIL. & POL'Y 154, 178 (2012); *accord* Mathias Risse & Gabriel Wollner, *Three Images of Trade*, 1 MORAL PHIL. & POL. 201, 216 (2014) (favoring an ecumenical approach to diverse competing accounts of exploitation).
[12] ALAN WERTHEIMER, EXPLOITATION (1996); Zwolinski, *supra* note 11; Risse & Wollner, *supra* note 11, at 214.
[13] Risse & Wollner, *supra* note 11, at 215.
[14] Vulnerability is a useful term to describe the situation that makes one ripe for exploitation, whether an individual or a state. *See* Robert E. Goodin, *Exploiting a Situation and Exploiting a Person*, *in* MODERN THEORIES OF EXPLOITATION 166 (Andrew Reeve ed., 1987).
[15] Zwolinski, *supra* note 11, at 158–61.

voice in the selection of adjudicators and arbitration rules, there is no right of appeal, and the global investment climate makes ignoring an arbitral award a very risky course of conduct for any responding state concerned with its investment rating. TPF thus gives an advantage to claimants against a responding party with limited substantive rights and no appellate rights, a party that is burdened by competing sovereign budgetary responsibilities to many stakeholders, and that holds a monopoly on the taxing power.

Second, TPF takes advantage in a way that is unfair. TPF is a threat to fairness because it intensifies the resources available to this privileged class of claimants. TPF gives a small class of investors even more resources to prosecute unbalanced claims against a constrained State. This advantage to a small privileged class comes at a significant cost to target countries and their citizens, since these claims will in a majority of cases ultimately be paid by a large underrepresented class of stakeholders (the public, who as tax payers are the "residual risk-bearers" in the current system). They will pay in the form of additional fiscal or welfare burdens since both losses and settlements are equally burdensome on the public fisc.[16]

TPF thus effects a significant, uncompensated and unjustified wealth transfer to TPF funders and their investors from the citizens of respondent states through the operation of the BIT/ISDS system. Such a transfer is problematic even when the respondent state is wealthy, but it is particularly egregious (and sadly more frequent) when it comes from the citizens of targeted developing and newly

[16] Moreover, regulatory settlements (e.g. waivers of environmental law requirements) can impose negative externalities on the public as well.

industrialized countries. Such wealth transfers turn generally accepted norms of fairness—and the basic investment principle of no expropriation without compensation—on their heads, amounting to an uncompensated taking from the less-favored many for the benefit of the wealthy few, with no social justification.[17] It is a mortal threat to the international investment regime to become a facilitation mechanism for such unfair extractions.

IV TPF Must be Banned

As a general rule and for good reasons, in the law we prohibit exploitation, we don't regulate it. As an exploitative mechanism for unjustified wealth transfers, TPF should be barred from all ISDS cases until the system is fundamentally reformed both substantively and procedurally. However, at present the TPF industry is in the midst of an aggressive world-wide lobbying campaign to increase the number of jurisdictions permitting TPF, as well as a "self-regulation" project which not only does not bar TPF, but in fact seeks to normalize it and facilitate its increased use. Together these efforts create serious risks for all stakeholders and contradicts sound public policy.

A. Regulation is Not Enough

The ICCA/Queen Mary Draft Report, while offering useful recommendations for addressing important ethical and professional issues raised by TPF, almost

[17] The "access to justice" rhetoric so central to TPF's public campaign is at best disingenuous, and at worst so cynical as to be obscene. *See* Tara Santosuosso & Randall Scarlett, *Third-Party Funding in Investment Arbitration: Misappropriation of Access to Justice Rhetoric by Global Speculative Finance* (Bos. Coll. Law Sch. Law & Justice in the Ams. Working Paper Series, Paper No. 8 2018), http://lawdigitalcommons.bc.edu/ljawps/8/.

entirely sidesteps this fundamental, even existential issue. For this reason, the Draft Report risks doing more harm than good in the area of TPF, because it normalizes exploitation under the guise of regulating it.

The Draft Report adopts a disclosure-based regime with conflict of interest rules. This is not an unprincipled view in itself and represents an improvement over the status quo. However, given the stakes involved, the exploitative nature of TPF in ISDS, and the costs to respondent countries' taxpayers and citizens, it is not enough in itself as a regulatory response. Certainly, it is a step in the right direction to know who is exploiting the Great Asymmetry, how much, and for whose benefit, but in light of the fundamental inequities described above, it cannot be considered an adequate response. The Queen Mary approach amounts to a call for regulated exploitation, without even acknowledging the underlying exploitative pattern.

Moreover, at a rhetorical and strategic level, the approach of the Draft Report itself implies that the *presence* of TPF in ISDS is beyond regulation or review, that there will be no further public consideration or regulatory response except to moderate some of its effects. One can see in the careful wording of Chapter Eight, for example, that the Task Force had to contend with strong differences of opinion on this question. Nevertheless, there is reason for concern that by its omissions and elisions the ISDS portions of the Draft Report will be read more as a ratification of the status quo with respect to TPF, than as the opening contribution to a searching and public-minded regulatory conversation on TPF and investment arbitration that the Draft Report ostensibly seeks to be.

For these reasons, this paper advocates the strong position that TPF should be barred from all ISDS cases until the system is fundamentally reformed both substantively and procedurally. Simple disclosure is not, in this view, an adequate remedy when the structural defects of the system are so basic and so prone to exploitation. Allowing TPF to operate within ISDS—even under an enhanced disclosure regime—reduces an institution designed to protect and incentivize allocations of development capital, address injustice (albeit imperfectly), and maintain order, into a mere speculative investment opportunity. This is the kind of economic distortion of dispute resolution that traditional prohibitions on maintenance and champerty were designed to prevent.

This pattern—de-regulating traditional safeguards in order to facilitate speculative finance's exploitation of a substantive legal regime for extraordinary short-term gain—bears uncomfortable similarity to the regulatory decisions taken in the U.S., such as the elimination of the Glass-Steagall Act, that gave speculation an increased role in home mortgage finance,[18] creating tremendous wealth for a few but also unleashing the greatest global economic recession since the 1920's. Granted, the systemic risks from TPF in ISDS may not be as great as the systemic risks created by mortgage-backed securities, but for citizens of targeted countries the threat to wealth, savings, public goods and public welfare are equally great, as is the uncompensated wealth transfer which TPF effects from the needy many to a privileged few.

[18] KATHLEEN C. ENGLE & PATRICIA A. MCCOY, THE SUBPRIME VIRUS (2010).

Prudent voices have expressed the view that until we have a richer empirical data set on the scale, role and effect of TPF in ISDS, it would be premature to ban or heavily regulate TPF. While this paper recognizes the importance of data-driven regulation, it must also be pointed out that the scale of current investment, even imperfectly estimated, and the increasing rate of TPF funding,[19] suggest a strong momentum and powerful financial interests behind increased TPF activity in ISDS. Simply put, by the time we understand more empirically the full nature of the risks and effects, it may be too late to stop TPF. Certainly, many citizens of developing and other target countries will have seen public resources intended for their welfare diverted into portfolio returns to speculative financiers, at rates as high as 700% ROI.

Under such conditions, it would seem that the precautionary principle, an established principle of international law designed for just such situations, would support quick action in the face of large-scale and potentially irreversible harms to human well-being.[20] Essentially, the precautionary principle reminds regulators

[19] It is difficult to determine with any precision the exact extent of TPF activity in investment arbitration, principally because TPF funders and funded litigants have been loath to disclose the presence of TPF and on what terms. However, there is general consensus even within the arbitral community that the TPF presence is significant and increasing. *See* William Park & Catherine A. Rogers, *Third-Party Funding in International Arbitration: The ICCA Queen-Mary Task Force*, AUSTRIAN YEARBOOK ON INTERNATIONAL ARBITRATION 113 (Christian Klausegger et al. eds., 2015) (according to an estimate from a major funder on the Queen Mary Task Force, "at least two-thirds of ICSID cases filed in 2013 implicated claimants which had sought resources from a major funder"); *see also* David Gaukrodger & Kathryn Gordon, *Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community* 37 (OECD Working Papers on Int'l Inv., Paper No. 2012/03, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2207366 ("Commercial third-party funders generally prefer not to disclose their role to the other parties or to the adjudicators, and funders and parties appear to consider that no clear disclosure requirements currently exist. Accordingly, it is not possible to determine the scope of third party funding in ISDS. However, available evidence suggests an already significant role).
[20] *See* Sonia E. Rolland, *The Precautionary Principle: Development of an International Standard*, 23 MICH. J. INT'L L. 429 (2002).

that there is a social responsibility to protect the public from exposure to harm when serious substantive investigation has found a plausible risk, and justifies them in exercising discretion to prevent such harms even in the face of scientific uncertainty.

The well-documented asymmetries in investment treaty law, coupled with the clearly "fit-to-purpose" funding model employed by TPF funders, amount in this case to the responsible identification of a plausible risk, and would justify regulation in the face of a relatively less-developed empirical record, which is in fact lacking due to the deliberate secrecy policies of TPF funders themselves. In fact, given that the funders have the information to reduce such uncertainty but have chosen for self-interested reasons not to disclose it, the presumption should be that the information, if disclosed, would raise, not remedy, concerns re TPF in ISDS. It would be a further injustice to allow their cloaking behavior to become the pretext for further delaying regulatory action.

B. How TPF Could be Banned

One doesn't regulate exploitation—one stops it. In the case of TPF, banning this finance mechanism would require concerted action in a number of venues and jurisdictions.

To begin with, states which currently do not allow TPF in their domestic legal systems should maintain this ban, at least as far banning the recognition and enforcement in their jurisdictions of TPF-funded investment arbitral awards.[21] Such states should also consider in their BIT practice making clear in any subsequent or

[21] Thus it would be possible for a state to allow TPF in domestic litigation and arbitration while banning it in ISDS-related actions.

amended BITs that TPF is prohibited from disputes arising under the BIT in question. States so banning investment TPF from their jurisdictions would also be in a position to object to the presence of such funding in any investment arbitrations for which they are the situs.

States should also seek collective action opportunities to ban TPF. Such collective action could include the negotiation of investment TPF bans in the investment chapters of any regional FTAs they are party to, as well as the exercise of their role in arbitral associations such as ICSID and UNCITRAL to support a TPF ban in the arbitral rules of these key associations.[22] By acting in concert states could minimize any real or perceived risks of alienating foreign investment or investment arbitration business through unilateral bans.[23]

V. Conclusion

It is critically important that states, their negotiators, academics and civil society take a careful, public and sustained look at the risks that TPF poses to the public and to the investment regime itself. Rather than be positioned as a *fait accompli*, TPF should be eliminated outright while the possibility still exists. Otherwise, we risk looking back at this period as we do the run-up to the Global Financial Crisis, as a story of opportunities missed at the cost of suffering unleashed.

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[22] The Mauritius Convention may also be one such avenue. U.N. Convention on Transparency in Treaty-based Investor-State Arbitration, Dec. 10, 2014, *available at* http://www.uncitral.org/pdf/english/texts/arbitration/transparency-convention/Transparency-Convention-e.pdf.

[23] Moreover, clarifying that the state law ban affects only investment TPF and not commercial arbitration should allay any fears of alienating commercial arbitration business, an important industry for many jurisdictions.