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# ***The Case Against Third-Party Funding in ISDS***

*Executive Summary*

**Boston College Law School – PUC University of Chile  
Working Group on Trade & Investment Law Reform  
Third-Party Funding Task Force**

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## What is TPF?

Third-party litigation funding (TPF) has been described as “a new industry composed of institutional investors who invest in litigation by providing finance in return for a stake in a legal claim and a contingency in the recovery”.<sup>1</sup> Commercial TPF has expanded rapidly in recent years.<sup>2</sup>

Proponents of third party funding argue that TPF provides a number of benefits across a range of dispute settlement platforms. It is said to promote access to justice (A2J) by providing an additional means to fund litigation and, for some parties, the only means of funding litigation. TPF is also expected to filter out some unmeritorious cases because it is said funders will not take on the risk of such cases, requiring claimants to take a second look at their case if potential funders are not impressed.<sup>3</sup> However, many countries continue to see the practice as illegitimate, and TPF has in fact until recently been illegal under the common law.<sup>4</sup>

In the wake of the Global Financial Crisis and the demand by speculative finance for new investment vehicles, TPF has discovered the BIT/ISDS system. The high costs and potentially high damages characteristic of ISDS cases have made it a new and highly attractive market for TPF. It is difficult to estimate the scale of TPF in ISDS today, since TPF funders generally prefer not to disclose their role to the other parties or to the adjudicators and argue strenuously that no clear disclosure requirements exist. However, available evidence suggests an already significant role, with TPF (actual or alleged) at issue in several recent ISDS cases.<sup>5</sup>

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<sup>1</sup> Maya Steinitz, *Whose claim is this anyway? Third Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011). Commercial third party funding has been defined as “[t]he funding of litigation by a party who has no pre-existing interest in the litigation, usually on the basis that (i) the funder will be paid out of the proceeds of any amounts recovered as a consequence of the litigation, often as a percentage of the recovery sum; and (ii) the funder is not entitled to payment should the claim fail”. RUPERT JACKSON, REVIEW OF CIVIL LITIGATION COSTS: PRELIMINARY REPORT at viii (2009), available at <https://www.judiciary.gov.uk/wp-content/uploads/JCO/Documents/Guidance/jackson-vol1-low.pdf>.

<sup>2</sup> One commentator has identified a “second wave” of litigation funding by major banks and insurance companies who have joined the smaller boutique firms. Gaukrodger, D. and K. Gordon, *Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community* (OECD Working Papers on Int’l Inv., Paper No. 2012/03, 2012), <http://dx.doi.org/10.1787/5k46b1r85j6f-en>.

<sup>3</sup> *Campbells Cash and Carry Pty Ltd. v Fostif Pty Ltd.* [2006] 229 CLR 386 (Austl.) (permitting third-party funding with the funder having broad powers to control the litigation; the court stressed the value provided by the access to funding, and the funder’s need to have some measure of control over the litigation while stating that court supervision, ethics rules, and rules governing representative proceedings mitigated the traditional dangers posed by third-party funding).

<sup>4</sup> Australia was one of the first jurisdictions to loosen centuries-old prohibitions against maintenance and champerty, citing the access to justice rationale. See, e.g., *Campbells Cash and Carry*, *supra* note 3.

<sup>5</sup> See *Abaclat v. Republic of Arg.*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, (Aug. 4, 2011); *Abaclat v. Republic of Arg.*, ICSID Case No. ARB/07/5, Dissenting Opinion, Georges Abi-Saad, (Oct. 28, 2011); *RSM Production Corp. v Grenada*, ICSID Case No. Arb/05/14, Annulment Proceeding, (Apr. 28, 2011); *Ioannis Kardassopoulos and Ron Fuchs v. Republic of Georgia.*, ICSID Case No. ARB/07/15, Award (March 3, 2010); *ATA Constr., Indust. & Trading Co. v. The Hashemite Kingdom of Jordan*, ICSID Case No. 08/2, Annulment Proceeding, (Aug. 2011) (unpublished) (as

Whatever the merits of TPF in civil and commercial litigation (and this paper takes no position on this), in the investment arbitration context the traditional justifications for TPF are upended and the risks of TPF magnified. The legal context (asymmetric treaties) and political economy of ISDS (awards are paid by states out of public funds, and cases are settled or lost by states in two-thirds of the disputes) raise important concerns about TPF unique to the investment arbitration context.

Investment arbitration 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 jurisdiction under this system 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. However, the political economy of investment disputes has fundamentally changed, as doctrines such as Fair and Equitable Treatment have been interpreted expansively to render a range of public regulation vulnerable to ISDS challenge, in a system with no appellate mechanism and significant rule-of-law deficits.<sup>6</sup>

This puts respondent states and their citizens in a uniquely vulnerable 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. Developing states are particularly vulnerable, as research suggests the vast majority (88%) of all claimant investors are from high income countries, and developing countries win only half as often as developed countries,<sup>7</sup> factors which TPF funders have admitted enter into their preliminary evaluation of a potential claim/investment.<sup>8</sup>

As many jurisdictions have begun to recognize the reality of TPF, as well as its unique role in international investment arbitration, it is important to consider whether TPF is consistent with the goals of the investment law system and with the values and interests states must advance and protect as they mediate and manage the foreign investor - domestic public welfare relationship.

### **Does TPF Promote Access to Justice as Claimed?**

TPF proponents in ISDS have drawn on traditional TPF rationales, arguing that the funding they provide is primarily utilized by impecunious or financially

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reported by Jarrod Hepburn, *Investment Arbitration Reporter* (Aug. 19, 2011)) (ICSID annulment proceeding is discontinued in Jordan construction case, as third-party funding is again flagged).

<sup>6</sup> See Garcia et al., *Reforming the International Investment Regime: Lessons from International Trade Law*, 18 J. Int’l Econ. L. 861 (2015).

<sup>7</sup> Thomas Schultz & Cédric Dupont, *Investment Arbitration: Promoting the Rule of Law or Over-Empowering Investors? A Quantitative Study*, 25 EUR. J. INT’L L. 1147 (2015).

<sup>8</sup> 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).

distressed investors, who would otherwise be unable to bring a claim against bad actor states<sup>9</sup>. It follows, they argue, that funding of investment claims provides access to justice for investors who wish to seek redress, but are financially unable, perhaps due to a foreign governments expropriation of their investment. This is a view favored by funders, as it frames their role as a vital one, which facilitates and contributes to global economic justice.

However, in the ISDS context this rationale is fundamentally flawed because the role of TPF in the ISDS system cannot be equated with providing financing for parties who lack the resources to litigate. This fact, coupled with the general disagreement over the efficacy and fairness of the ISDS system as a whole, should render suspect the use of A2J rhetoric to justify the presence of TPF in ISDS.

Traditionally A2J has meant capacity-building for social justice, i.e., the provision of financing or other support for parties who lack the human and financial resources to litigate. Such rhetoric has been the hallmark of rationales underlying organizations representing and fighting for civil rights in the United States. The American Civil Liberties Union and the Legal Service Corporation, for example, are dedicated to promoting equal access to justice by fighting for and representing the poor and disadvantaged in communities across the United States. A2J has also been recognized internationally as playing a central role in ensuring sustainable development, security, human rights, and peace at both the national and international levels.<sup>10</sup>

In contrast, TPF in ISDS is primarily about balance-sheet management, offering well-resourced claimants the ability to minimize the risk associated with bringing a claim, and does not focus on providing funding to impecunious or disadvantaged claimants. In fact, “much of the focus of the litigation finance market today is on the growing corporate utilization of funding by large, well-resourced entities, who are looking for ways to manage risk, reduce legal budgets or take the cost of pursuing arbitration off-balance sheet, or other business reasons for not wanting to allocate resources to financing an arbitration matter.<sup>11</sup>” In the words of a leading TPF funder, “the use of funding offers the client the ability to minimize risk, does not have any negative effect on their cash flow, and ensures payment of lawyers.<sup>12</sup>” This has resulted in portfolio-style funding, where packages of lawsuits

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<sup>9</sup> CHRISTOPHER P. BOGART, *Third-party financing of international Arbitration*, in *THE ARBITRATION REVIEW OF THE AMERICAS* 51 (2017).

<sup>10</sup> See G.A. Res. 67/1, at 1, Declaration of the High-Level Meeting of the General Assembly on the Rule of Law at the National and International Levels (Nov. 30, 2012) (United Nations General Assembly recognizes, “the importance of fair, stable and predictable legal frameworks for generating inclusive, sustainable and equitable development, economic growth and employment, generating investment and facilitating entrepreneurship.”).

<sup>11</sup> See INT’L COUNCIL FOR COMMERCIAL ARBITRATION, REPORT OF THE ICCA-QUEEN MARY TASK FORCE ON THIRD-PARTY FUNDING IN INTERNATIONAL ARBITRATION (2018), *available at* [http://www.arbitration-icca.org/media/10/40280243154551/icca\\_reports\\_4\\_tpf\\_final\\_for\\_print\\_5\\_april.pdf](http://www.arbitration-icca.org/media/10/40280243154551/icca_reports_4_tpf_final_for_print_5_april.pdf).

<sup>12</sup> *Id.* at 14.

are bundled together by third party funders in a scheme to attract speculative investment by diversifying risk across a myriad of claims. Part of diversification in finance necessarily means the inclusion of at least some higher-risk claims if the potential return is high enough, and in ISDS it will be.<sup>13</sup>

In a rhetorical maneuver which stretches the A2J rationale beyond any recognizable application, TPF proponents argue that they nevertheless provide A2J because true A2J in the Western economy means a business being able to retain its competitive position while simultaneously litigating for justice.<sup>14</sup> Furthermore, it is argued, funders have no incentive to finance non-meritorious claims, as their return on investment is necessarily tied to claimant success.<sup>15</sup> However, the settlement value of even a weak claim is still considerable in a diversified portfolio, given that it costs states an average of \$8-10 million to defend a claim. This does not even factor in the net present value of establishing a TPF-favorable precedent should the claim prevail, even in a legal system such as ISDS with no formal doctrine of precedent. Within a diversified portfolio, it is simply rational for speculative investors to roll the dice under such circumstances with, as we learned through such speculative instruments in the banking sphere, predictably negative results for taxpayers.

Fundamentally the TPF position on A2J disregards and in fact subverts important goals and values underlying the ISDS system. First, any analysis of the likelihood of a claim's success will involve looking at the ability of a respondent state to successfully defend the claim. Empirical data points to correlations between claimant success and lower GDP per capita and weaker than normal rule of law in the respondent state.<sup>16</sup> To the extent such factors are included in a funders investment analysis, and it appears they are,<sup>17</sup> this results in disproportionately negative impacts on lesser developed and developing economies, paradoxically the very economies seeking sustainable development through the foreign direct investment allegedly promoted by the inclusion of ISDS mechanisms in investment

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<sup>13</sup> Funders have touted returns in excess of 700% ROI. 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.* See PIA EBERHARDT ET AL., PROFITING FROM INJUSTICE: HOW LAW FIRMS, ARBITRATORS AND FINANCIERS ARE FUELING AN INVESTMENT ARBITRATION BOOM 9 (2012), available at <https://www.tni.org/files/download/profitfrominjustice.pdf>.

<sup>14</sup> See Ylli Dautaj & Bruno Gustafsson, *Access to Justice: Rebalancing the Third-Party Funding Equilibrium in Investment Treaty Arbitration*, KLUWER ARBITRATION BLOG (Nov. 18, 2017), <http://arbitrationblog.kluwerarbitration.com/2017/11/18/access-justice-rebalancing-third-party-funding-equilibrium-investment-treaty-arbitration-2/>.

<sup>15</sup> INT'L COUNCIL FOR COMMERCIAL ARBITRATION, *supra* note 11, at 160.

<sup>16</sup> See Julian Donaubauer & Peter Nunnenkamp, *International Arbitration of Investment Disputes: Are Poor and Badly Governed Respondent States More Likely to Lose?* 25 APPLIED ECON. LETTERS 321, 325 (2018). A study of the effects of respondent state's per-capita income and the strength of domestic rule of law on ISDS found that higher income and stronger rule of law reduce the probability of investor wins in investor-state arbitration.

<sup>17</sup> See *supra* note 8.

treaties. When it is considered that these costs to such states are imposed for the benefit of profit-driven speculative financiers, it is easy to see why TPF opponents consider TPF a threat to the integrity of the investment system.

Second, while some leading funders have recently expressed their willingness to fund respondent states in ISDS,<sup>18</sup> there is no real incentive to do so given that respondent states that prevail gain no financial award under current BIT rules. In fact, when one considers A2J in its broadest social context, TPF actually impairs A2J for developing respondent states and their citizens. TPF funding for well-resourced claimants exacerbates the inherent imbalance in the BIT system, disproportionately affecting already disadvantaged states' ability to control regulatory change within their borders and deliver improved social welfare benefits.<sup>19</sup> Instead, TPF further shifts power and resources towards private investors, who can in turn negatively impact the political affairs and social welfare of developing nations.

### **TPF is a Threat to the Integrity of the BIT/ISDS System**

Given the many risks TPF poses to the integrity of the investment treaty system and the public finances of target countries, it is the conclusion of this Task Force that TPF, at least as currently practiced, has no place in the ISDS system. Under these 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 respondent states, their taxpayers and citizens.<sup>20</sup>

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. The funding model assumes a system in which states have no substantive rights under the treaty, claimants have a direct 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.

Second, TPF takes advantage in a way that is unfair because it intensifies the resources available to this privileged class of claimants. TPF further concentrates

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<sup>18</sup> BURFORD CAPITAL, 2017 ANNUAL REPORT (2017), *available at* <http://www.burfordcapital.com/wp-content/uploads/2018/03/BUR-28711-Annual-Report-2017-web.pdf>.

<sup>19</sup> Public health, public safety and environmental protection measures have all been challenged under the BIT/ISDS system, and developing states can further ill afford the burden to public finances that even non-public welfare arbitration claims will create when paid out of the public fisc.

<sup>20</sup> See PIA EBERHARDT & CECILIA OLIVET, PROFITING FROM INJUSTICE: HOW LAW FIRMS, ARBITRATORS AND FINANCIERS ARE FUELING AN INVESTMENT ARBITRATION BOOM (2012).

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. TPF thus gives a small class of investors even more resources to prosecute unbalanced claims against a constrained State. This advantage 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.<sup>21</sup>

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 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.

For all of these reasons, TPF as currently constituted cannot play a constructive role in investment arbitration until TPF is regulated and the BIT/ISDS system significantly reformed. The integrity of the international investment regime is at stake when it is allowed to become a facilitation mechanism for such unfair extractions.

## **Regulatory Options for Eliminating or Mitigating TPF Risks**

### *Banning TPF from ISDS*

States should consider banning TPF entirely, at least until the international investment regime can be reformed towards more balanced agreements. Banning this finance mechanism from ISDS 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.<sup>22</sup> Such states should also consider how to address TPF in their BIT practice. For example, reformist states could make it clear in any subsequent or amended BITs that TPF is prohibited from disputes arising under the BIT in question. States banning investment TPF from their jurisdictions in this way would also be in a position to object to the presence of TPF in any arbitrations for which they are the *situs*.

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<sup>21</sup> Moreover, regulatory settlements (e.g. waivers of environmental law requirements) can impose negative externalities on the public as well.

<sup>22</sup> Thus, it would be possible for a state to allow TPF in domestic litigation and arbitration while banning it in ISDS-related actions.



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. States should also consider exercising leadership in arbitral associations such as ICSID and UNCITRAL to support a TPF ban in the arbitral rules of these key associations.<sup>23</sup> By acting in concert states could minimize any real or perceived risks of alienating foreign investment or investment arbitration business through unilateral bans.<sup>24</sup>

### *Significantly Regulating TPF*

If TPF is to be allowed in ISDS at all, we argue that in order to do so the system should require mandatory, expansive disclosure of third-party funding agreements. 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, while the Singapore Investment Arbitration Commission, 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, and agreements, however, TPF is left unregulated.

Admittedly, there are competing interests when it comes to disclosure vs. confidentiality.<sup>25</sup> However, the high likelihood of accidental or delayed disclosure, as well as the high cost to both parties of such late disclosure in the event that an award is set aside, mean that taken together both the systemic and party interests in disclosure substantially outweigh those in confidentiality. The growing consensus, therefore, is that the existence and identity of a TPF funder should be disclosed.

However, this is not enough. Funding agreements vary in their terms, but often contain the same main components. One the most important aspects is the control that the funder might exercise over litigation decisions. Funders expect a voice in whether and when a claimant would decide to settle as opposed to pushing for an arbitral win, rendering claimants (and respondents and the ISDS system as a whole) vulnerable to the underlying profit-based incentives motivating the funder.

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<sup>23</sup> 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>.

<sup>24</sup> 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.

<sup>25</sup> 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. 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.

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 or complete disclosure of TPF agreements could address some of the concerns, both on the side of the respondent and the claimant. First of all, 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. Second, increased transparency of the funding agreements aligns well with the general institutional trends toward transparency, and highlights funding agreement provisions that create perverse incentives.

Finally, expansive disclosure will provide the much-needed data for future research into the benefits and harms involved in TPF and enable more effective regulation going forward. However, such data comes at the cost of accepting in the meantime a rapidly-growing TPF presence in ISDS and foregoing the broad systemic benefits a TPF ban would stand to garner.

## **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 heavily regulated, if not 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.

## **Resources:**

Frank J. Garcia, *The Case Against Third-Party Funding in ISDS*, <http://lawdigitalcommons.bc.edu/lisfp/1125/>.

Tara Santosuosso & Randall Scarlett, *Third-Party Funding in Investment Arbitration: Misappropriation of Access to Justice Rhetoric by Global Speculative Finance*, <http://lawdigitalcommons.bc.edu/ljawps/8/>.

Rachel Denae Thrasher, *The Regulation of Third Party Funding: Gathering Data for Future Analysis and Reform*, <http://lawdigitalcommons.bc.edu/ljawps/9/>.