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Reforms In Third Party Funding in ISDS: Are the interests of States overshadowing Investors' interests?

Tom Steindler · Friday, October 22nd, 2021

In the present-day economic scenario, as more and more companies engage in cross border transactions and investments, there has been a natural and commensurate increase in the number of Investor-State disputes.

However, for many investors, pursuing a claim against a state by way of treaty-based Investor State Dispute Settlement ("ISDS") can prove to be financially challenging.

Third party funding ("TPF") is growing rapidly across both litigation and arbitration with increasing numbers of countries working the mechanisms on TPF into their legislation. In ISDS claims, however, TPF, though growing, seems to be at a nascent stage, still facing scrutiny from States, legal organisations and practitioners.

The primary challenge that attracts the concerns of States and Investors alike remains the non-regulation of TPF practices in respect of ISDS claims. In order to counter this challenge to a certain extent, preparation of 'multilateral regulations' is being undertaken by organisations such as UNCITRAL and ICSID.

In February 2021, UNCITRAL released the Draft Provisions on Third-Party Funding in Investor State Dispute Settlement¬¬¬ ("Draft Reforms") inviting comments from various stakeholders. The first draft was released following a series of publications by the UNCITRAL detailing its concerns regarding the growing practice of TPF in the ISDS arena.

An examination of the suggested "reforms" in the UNCITRAL draft with regard to arguments against the growing use of TPF in ISDS claims demonstrates the following irregularities:

Regulation Models

1. The UNCITRAL's primary objective behind regulating TPF is rooted in the concern that the existence of TPF "…aggravates the structural imbalance in the ISDS regime and increases the number of ISDS cases, frivolous claims as well as the amount of damages claimed…". Apart from this concern being shared by the Respondent Host States, the UNCITRAL has failed to put forth or rely on any concrete empirical data to support the said concern. Discussing the concern of rise in the number of frivolous and speculative claims, the QMUL-ICCA Task Force Report on Third-Party Funding in International Arbitration of April 2018 notes that, "…speculative cases, such as Philip Morris v. Uruguay and Philip Morris v. Australia, are examples of the investment arbitration regime working as intended because those tribunals ultimately rejected the claims. They note that funders carefully vet cases and conduct independent assessments to determine both likelihood of success and an accurate estimate of expected damages".

2. However, despite the lack of any substantial empirical data, UNCITRAL in its Draft Reforms has suggested three regulatory models aimed at addressing the growing concerns regarding TPF in ISDS Claims. The first model (Draft Provision 2) is the Prohibition Model that prohibits TPF in ISDS to address the "structural imbalance" in the ISDS regime as TPF funding options are only available for the Claimants and to minimize frivolous claims.

3. The primary objective of encouraging and promoting TPF is to facilitate access to justice for claimants who otherwise would not be able to pursue claims against states in treaty-based arbitrations. This Prohibition Model, if adapted, will wind the clock back on all the progress made in the ISDS field and will reflect an entirely state friendly dispute resolution mechanism and this in turn will undermine the attraction of cross border investments. This presumption that TPF encourages frivolous claims seems to overlook the fact that a majority of funding is on a non-

recourse basis and therefore the funders do their due diligence on the merits of the claim before providing any funding.

4. Draft Provisions 3 to 5 provide for Restrictive Models that allow for only limited forms of TPF in ISDS. The first one, ironically named “Access to Justice” model permits TPF only if the claimant can prove that it will not be in a position to pursue the claim without TPF. This model is suggestive of the intention of the UNCITRAL and States’ objective of restricting TPF only to impecunious claimants. This may prevent funding options for investors seeking to manage cash flow and minimise financial risks while pursuing meritorious claims. In fact, in practical terms, this model is also adding additional stages to the dispute resolution process where the claimants would be first required to prove to the tribunal that they deserve TPF. Needless to say, apart from the fact that it comes down to the discretion of the tribunal, it will also lead to added costs and will impact the time efficiency of the proceedings.

5. The “Sustainable Development Model” allows TPF only if the Claimant’s investment in the host state complies with the sustainable development policies of said state. Further, the “Restriction List Model” prohibits TPF that is provided “on a non-recourse basis in exchange for a success fee and other forms of monetary renumeration or reimbursement wholly or partially dependent on the outcome of a proceeding or portfolio of proceedings…” or where the expected return to be paid to a funder exceeds a “reasonable” amount or where the number of cases that the funder funds against the host state exceeds a “reasonable” number. Needless to say, these models reflect an arbitrary and subjective situation. There are no guidelines or rules to determine this “reasonable” amount or number of claims and it is entirely left upon the arbitrators to adjudge whether TPF should be allowed or not.

6. The reformatory models are a direct representation of the interests of hosts states and risk creating chaos rather than ‘regulating’ the ISDS process. Organizations such as the UNCITRAL need to understand that the objective of any type of reform / regulation should not be regressive and should promote balance of interests of the investors and states alike.

Disclosure of TPF Agreement

7. The UNCITRAL Draft Reforms (Draft Provision 7) also suggests disclosure of TPF as a mandatory and standalone regulation. It provides for disclosure by the funded party of:
“(a) the name and address of the third-party funder;
(b) the name and address of the beneficial owner of the third-party funder and any natural or legal person with decision-making authority for or on behalf of the third-party funder; and
(c) the funding agreement or the terms thereof”
In addition to the above, the draft also lists information that the Tribunal may require the funded party to disclose, such as, the expected return amount of the third-party funder, the rights of the third-party funder, agreements between the third-party funder and the legal counsel and “any other

information deemed necessary by the Tribunal”.

8. The draft provision is therefore aimed at expanding the scope of the information to be disclosed by the funded party and the scope of the powers of the arbitral tribunal in this regard. The objective behind such a provision, without expressly mentioning the concerns of host states regarding disclosure obligations, is laid out to be lack of transparency and risk of conflicts. While it is agreed that the disclosure of the TPF arrangements will address the issue of risk of conflict of interests, the extent of disclosure needs to be minimized to safeguard the interest of the funded party. Such broad and mandatory disclosures can have an adverse effect on the claims of the funded party as it lays bare for examination by the opposite party, the confidential and commercial considerations agreed between the funded party and the third-party funder. Any kind of reform to the underpinnings of ISDS mechanisms should balance out the interest of all the parties involved. An example of a workable model in this regard are the ICC Rules of Arbitration 2021 which aim to balance out the principles of transparency and confidentiality by minimizing the extent of disclosure only to the existence and identity of the third-party funder.

Code of Conduct

9. The UNCITRAL Draft Reforms argue for a Code of Conduct specifically for Third Party Funders to address issues of disclosure, transparency requirements, limitation on the returns to be paid to the funder, limitation on the control that the funder could have over the proceedings, limitation on the number of claims that a funder could provide to support claims against a single state and due diligence on claims to prevent frivolous claims.

10. Yet again, the approach of this draft provision seems to be based on no existing data to support the need for a Code of Conduct for the Third-Party funders. Instead, this seems to be a narrow and procedural rather than substantive approach which diminishes the larger objective of access to justice and growth of international investment. Simply put, limiting the interests of the Third-party funders would in turn decrease their interest in funding ISDS claims thus taking away the possible option for claimant investors to pursue claims against Host States which in turn would lead to less cross border investments in the Host states.

Security for Costs

11. As a principle, existence of TPF should be irrelevant while determining the need for security for costs. Of course, states have understandable concerns that they may be unable to recover their costs against the claimants, especially when they are judged impecunious. In light of this, the UNCITRAL Draft Reforms (Draft Regulation 9) aims to address the concerns of the investors and host states by providing 2 potential approaches for determining the ordering of security for costs by

a claimant who has received TPF.

12. “Option A” under the Draft Regulation provides for a “mandatory” regime where the Tribunal “shall” order security for costs should there be a claim funded by TPF unless the Claimant can prove that it falls under a list of exceptions. “Option A” appears to be formulated to address the concerns of the host states regarding recovery of costs in ISDS claims.

13. Alternatively, “Option B” provides that an order for security for costs from the funded party can made at the discretion of the Tribunal. “Option B” therefore seems a much more flexible approach, consistent with the realities of TPF and the fact that the existence of a funding agreement should not, in and of itself, warrant an order for security for costs. Litigation funding is not just for impecunious claimants and is instead regularly used by solvent businesses and investors, who would otherwise be in a position to finance the dispute and meet any order for adverse costs, to manage cash flow and financial risk.

Conclusion:

There is no denying that TPF is here to stay and the constant scrutiny / reforms will not prohibit the existence and growth of TPF in ISDS arena.

Investors, states and UNCITRAL therefore need to consider how to strike a balance between the interests of the parties involved. It is undeniable that TPF is an important tool facilitating access to justice in investment arbitration, therefore, reforms arguing for the adaptation of Prohibition or Restriction Models (in addition to penalizing sanctions) provide a limited and narrow ground for TPF to exist and grow. It also obstructs the growth of investment arbitration as a favourable dispute resolution mechanism.

The states’ growing concerns that TPF potentially opens up a path for increase of frivolous and speculative claims for political purposes is not based on any definitive data and should not be used as an obstructive tool by the states to limit the rights and interests of the claimants and investors. The underlying principle of access to justice needs to be upheld and considered while attempting to regulate TPF in ISDS.

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