IF THEY FINANCE YOUR CLAIM, WILL THEY PAY ME IF I WIN: IMPLICATIONS OF THIRD PARTY FUNDING ON ADVERSE COSTS AWARDS IN INTERNATIONAL ARBITRATION

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Abstract

Third party funding is a *new* industry which provides financial support to parties in litigation and arbitration proceedings. The full variety of its implications on international commercial arbitration is yet to be seen. For that reason national courts, arbitral tribunals and doctrine are widely dealing with its repercussions on arbitration proceedings. In order to contribute to this wide discussion, this paper focuses on one particular aspect within the arbitration proceedings influenced by a third party funding: responsibility for payment of adverse costs in cases involving impecunious claimants. The problem presented in this paper is whether, in case where the claimant cannot cover the costs, the third party funder should be responsible for the successful adverse party's costs, and on which legal basis? The two parts of the paper analyze the possibilities for such funder's responsibility at two stages of the proceedings: (1) at the stage of a final award and (2) during the proceedings when the security for costs may be sought. The analysis encompasses the court practice and national arbitration laws from several jurisdictions (the United States, the United Kingdom and Germany), the arbitration rules of two leading arbitration institutions (ICC Rules, LCIA Rules), as well as arbitral practice, in order to predict possible issues and illustrate available solutions.

Keywords: International arbitration, third party funding, costs

Introduction

This article analyzes whether a third party funder may be liable for the successful adverse party's costs. As, at present, there is no universally accepted definition of third party funding, in this article we rely on the definition formulated by Lord Justice Jackson: third party funding means the funding of arbitration or litigation proceedings by a party who (i) has no pre-existing interest in the proceedings, (ii) will be paid out of any amounts recovered as a consequence of the proceedings, often as a percentage of the sum recovered, and (iii) the funder is not entitled to any payment if the funded party's claim fails (Jackson, 2009, p. xv).

The tendency in international commercial arbitration is to apply the "costs follow the event" principle unless the parties have agreed otherwise, or there are other circumstances that warrant different allocation of costs among the parties (Born, 2014, p. 3096; Williams & Walton, 2014, p. 437). In other words, if a claimant files a suit that proves to be meritless, such a claimant will usually be liable to cover the successful respondent's reasonable costs and expenses.

In general, presence of a third party funder serves as a red flag signaling to the respondent that the claimant is in a shaky financial situation and may not be able to meet an adverse costs award (Kirtley & Wietrzykowski, 2013, pp. 18, 21; Kuhner, 2014, p. 813). Some legal commentators described a specific instance of third party funding abuse as "the arbitral hit and run", where the claimant's legal fees and expenses are covered by a third party who gains the proceeds if the claimant wins, but is not liable for any costs award if the claimant loses, and the claimant itself is already impecunious or starts to dispose of its assets with an aim to avoid meting an adverse costs award (Rubins, 2000, p. 361; Kalicki, 2006; Kirtley & Wietrzykowski, 2013, pp. 20, 26; Kuhner, 2014, p. 814). Such conduct may alarm the respondent to seek protection against the aforementioned claimant's state and behavior. In the authors' opinion, in order to provide such protection to respondents, awareness of these issues should be raised in the doctrine as well.

This paper focuses on international commercial arbitration and takes into account relevant litigation practice. The situations which will be analyzed presuppose that the claimant, *i.e.* the funded party, is impecunious or bankrupt – that it is not in a financial position to cover the costs. With regard to such factual pattern this paper will cover, first, the issue of the funder's responsibility for the adverse costs as set in the *final award* and, second, the possibility to seek an order for security for costs, against the claimant or the funder, *during* the arbitration proceedings.

Liability of a third party funder for the adverse costs awards

As a practical matter, whether and to what extent the third party funder may be liable for the successful adverse party's costs is usually stipulated in the funding agreement between the funder and the claimant (Nieuwveld & Shannon, 2012, pp. 4, 12-13). Indeed, the Code of Conduct for Litigation Funders (2014, para. 10.1) requires the funding agreement to "state whether (and if so to what extent)" the funder is liable to the funded party "to meet any liability for adverse costs."

However, both in the U.S. and in the UK courts have ordered third party funders to pay a successful adverse party's costs (Cremades, 2012, p. 181). Some factors, which played a role in the courts' determination of these costs orders, included the extent of the funder's involvement in the proceedings, whether the funder maintained litigation solely for its financial benefit, and the amount of funding advanced.

In the U.S., Florida's Third District Court of Appeal ruled that litigation funders had "such control thereof as to be entitled to direct the course of the proceedings" and thus were a "party" to the litigation: the funders had a right to approve counsel for the plaintiffs, veto power over whether the suit was filed and how it would be pursued, and the final say over any settlement agreements; the funders paid the litigation costs, medical expenses for one of the plaintiff's main witnesses, and were entitled to receive a percentage of sum awarded to the plaintiffs (Abu-Ghazaleh v. Chaul, 2009, p. 694).

In the UK, the Privy Council held that where a third party promotes and finances litigation proceedings by an insolvent company "solely or substantially for his own financial benefit" and without the funder's involvement such proceedings would not have been pursued, the court has discretion to order the funder to pay the successful adverse party's costs (Dymocks Franchise Systems v Todd, 2004, p. 2818).

Also, in McFarlane v E.E. Caledonia Ltd (1995, p. 373) Longmore J reasoned that in some cases the maintenance may be lawful even if the maintainer (for instance, a family member or a religious fraternity) does not accept liability for the possible adverse costs award, but in the business context "*the acceptance of such liability will always […] be a highly relevant consideration*." Therefore, the Scottish company's policy of not accepting liability rendered the funding agreement illegal as a matter of English law, and the funder was ordered to pay the defendants' costs.

Finally, in Arkin v Borchard Lines Ltd (2005, pp. 3064, 3069) the UK Court of Appeal noted that, on the one hand, it would be just to demand that “the non-party [who] is wholly or partly responsible for the fact that litigation has taken place” reimburses the successful party’s costs, but, on the other hand, no funder would be willing to advance necessary funds if the funder who contemplates “funding a discrete part of an impecunious claimant's expenses” is exposed to potential liability for the entirety of the defendant’s costs. Therefore, a professional third party funder should be liable for the successful adverse party’s costs only “to the extent of the funding provided” (Arkin v Borchard Lines Ltd, 2005, p. 3069).

Lord Justice Jackson criticized the Arkin approach: the principle that a litigation funder may escape liability for costs is unjust both to the opposing party, which may be unable to recover a portion of its costs, and to the funded party, which may end up liable for costs it cannot meet (Jackson, 2009, pp. 122-123). Lord Justice Jackson recommended that (i) funders should be exposed to liability for adverse costs, (ii) the extent of the funder’s liability should be a matter for the judge’s discretion in each individual case, and (iii) the funder’s potential liability should not be limited by the amount of its contribution (Jackson, 2009, pp. 123-124).

However, in arbitration the situation is different. As Lee pointed out at the roundtable on third party funding organized by Global Arbitration Review and Fulbrook Management in 2012, one of the differences between arbitration and litigation “is that judges can make direct adverse costs orders against third party funders (if they know of their existence), but arbitral tribunals have no power to do that given the consensual nature of arbitration” (Ross, 2012, p. 19). Similarly, Howell noted that because in the UK the arbitral tribunals have no power to make costs orders that directly bind a third party, “it is a concern that funders may look to take the benefit of arbitration without being subject to the risk of the costs” (Ross, 2012, p. 19).

Indeed, textual analysis of several arbitration rules leads to the conclusion that arbitral tribunal does not have the authority to oblige the third party funder to pay the successful adverse party’s costs. In particular, the 2010 UNCITRAL Arbitration Rules provide that the tribunal shall, in the final award or in any other award (if appropriate), determine an amount that “a party may have to pay to another party” as a result of cost allocation (Art. 42(2)). Also, pursuant to the 2012 ICC Arbitration Rules the final award shall decide “which of the parties” shall bear the costs of arbitration (Art. 37(4)).

Similarly, provisions of national arbitration laws generally provide that the tribunal may order the costs only against the parties to the proceedings. For instance, under the German Arbitration Act (“GAA”) the tribunal shall “decide on the amount to be borne by each party” (s. 1057(2)). Pursuant to the English Arbitration Act (“EAA”) the tribunal “may make an award allocating the costs of the arbitration as between the parties” (s. 61(1)).

In sum, arbitration rules and national arbitration laws generally provide that the tribunal may allocate the costs only between the “parties”, *i.e.* claimant, respondent, and additional parties joined to the proceedings, but does not have the authority to order a non-“party” funder to cover the successful adverse party’s costs.

The impossibility of arbitral tribunal to make an adverse costs award against the third party funder (Kirtley & Wietrzykowski, 2013, pp. 29-30; Rubins, 2000, p. 361) exposes the successful respondent to the risk that it would not be able to recover the costs neither from the unsuccessful impecunious claimant nor from the funder. There may be (at least in theory) several ways to overcome this problem.

To begin with, the tribunal would be able to render an award against the third party funder if it first “extends” the arbitration clause to the funder, so that the funder becomes a party to the proceedings. In particular, in the U.S. courts recognized a number of theories, which "arise out of common law principles of contract and agency law", that justify extension of arbitration agreement to non-signatories, namely (1) incorporation by reference; (2) assumption; (3) agency; (4) veil-piercing/alter ego; and (5) estoppel (Thomson-CSF v. AAA, 1995, p. 777). Taking into account that there is no contractual relationship between the funder and the respondent, usually the plaintiff does not assign contractual rights and obligations to the funders, but only a share of possible proceeds from the award, and the funder is a company independent from the plaintiff, the arbitration clause in the contract between the plaintiff and the defendant can hardly be extended to the funder (Levy & Bonnan, 2012, pp. 82-84). As Pinsolle pointed out, "*[e]ven in France, where we are very generous and flexible about the involvement of third parties in arbitrations, the party must have some involvement in the contract itself – not the dispute that arises, but the performance of the contract – to become a party to the case*" (Ross, 2012, p. 22).

Secondly, as Parker suggested, third party funders may develop a practice of "voluntarily submitting" to the tribunal's jurisdiction for the purpose of adverse costs awards (Ross, 2012, p. 22). However, taking into account that a funder gets no monetary advantages by accepting the tribunal's jurisdiction, whereas it potentially becomes exposed to significant liability for the defendant's costs and expenses, it is hard to explain why third party funders would be willing to engage in "voluntary submission".

Finally, the tribunals would be able to order the funder to cover the successful adverse party's costs, if the arbitral awards had effect on the third parties. Arbitration rules and laws presently in force are far from providing a clear and comprehensive framework for the effect of arbitral award *in personam* (Brekoulakis, 2010, para. 9.06). The UNCITRAL Model Law on International Commercial Arbitration ("Model Law") merely states that an arbitral award "shall be recognized as binding" (Art. 35(1)). In turn, the GAA provides that an arbitral award "has the same effect between the parties as a final and binding court judgment" (s. 1055). The EAA goes a step further: an award "is final and binding both on the parties and on any persons claiming through or under them" (s. 58(1)), since under the EAA a "party" includes also "any person claiming under or through a party" (s. 82(2)). However, English courts have interpreted section 82(2) narrowly, only allowing third party claims that could be made under "traditional" contract law theories such as assignment or subrogation (Brekoulakis, 2010, paras. 3.45, 3.46). Therefore, the international dominant view is that an arbitral award only binds and affects the parties to the arbitration proceedings ("same parties" requirement), the same way that a court decision only binds and affects the parties to the litigation (Brekoulakis, 2010, paras. 9.10, 9.12). This is not to mention that consent is the cornerstone of arbitration, and arbitration thus may not extend its effect to the parties that never agreed to arbitrate (Born, 2014, p. 1406).

However, majority of legal systems have exceptions for the "same parties" requirement: effect of judgments extends to the parties' successors, assignees, administrators, trustees, other third parties that are in privity, have identical interests with the party to the original proceedings (Brekoulakis, 2010, paras. 9.12-9.14). The category of "privies" is potentially broad, as it includes not only the parties to the arbitration, but also "*related entities and persons who would have had the opportunity to participate in previous arbitral proceedings*" (Born, 2014, p. 3752).

To conclude, if a third party funder exercises such control over the claimant's behavior in the arbitration proceedings that the funder directs the course of the proceedings and its interests align with those of the claimant (the funder is the real party in interest), the tribunal's adverse costs award may have effect on the funder. However, as at present there is no relevant court or arbitral practice to support this position, adverse costs orders against the third party funders in international arbitration remain the subject of theoretical discussions, not the legal reality.

Third party funding and an order for security for costs

As shown above, current arbitral and judicial practice does not recognize the possibility for an arbitral tribunal to make an adverse costs award against the third party funder. While this may be doctrinally justifiable, it still exposes the successful respondent to the risk that it would not be able to recover the costs. Namely, if a case involves impecunious, or even bankrupt, claimant who sought the funds from a third party, a respondent may be strongly interested in seeking a protection as to its adverse costs. Since rendering the final award against the third party funder is initially precluded due to the lack of funder's involvement in the negotiation and performance of the contract between the parties, the respondent may turn to reliefs of procedural nature, in particular, an order for security for costs.

Granting the security for costs requires many observations to be made, even if the third party is not involved. When focusing on the situations involving third party funder, there are two possible ways in which respondent may obtain protection. First, the respondent can ask the arbitral tribunal or the court to *take into account* third party funding when deciding on granting the security for costs. This is the least that the respondent can expect and claim in these circumstances. On the other hand, the most effective relief would be achieved if the respondent can successfully obtain and enforce an order for security for costs *against the funder*. Both situations can be summarized in the following question: which right shall prevail – right of access to arbitral justice or right on secured payment of potential adverse costs award?

Security for costs is an interim measure which is sought to be sure that the likely amounts which would be awarded to the party, if it prevails in the arbitration, will be covered (Born, 2014, p. 2495). Interim measures can usually be sought before two forums: the arbitral tribunal and the national courts (Wirth, 2000, pp. 32, 40; Yesilirmak, 2005, p. 48). In spite of the discussion that took place in the doctrine and in arbitral practice whether arbitral tribunals have a power to order the security for costs or not, the authors of the paper share the opinion of Born that this tribunal's power is recognized in the countries which adopted the Model Law (Born, 2014, p. 2495). Furthermore, UNCITRAL Arbitration Rules clearly encompass such tribunal's power by stating that interim measures can be issued to "provide a means of preserving assets out of which a subsequent award may be satisfied" (Petrochilos, 2010, p. 885). Besides the arbitral tribunals, *the national courts* also have a power to order such security under Article 17(J) of the Model Law (Emanuele & Molfa, 2014, p. 156). Without going in further discussion on the on the detailed jurisdictional specifics of some legal systems when it comes to granting this provisional relief, we turn to question which circumstances are usually taken into consideration when the forum decides on granting the security for costs. This analysis shall help to reach the conclusion whether third party funding shall be taken into account as well.

When granting the security for costs, the usual requirements for interim measures shall be satisfied (Berger, 2010, p. 9). These requirements are the following: (i) *prima facie* establishment of jurisdiction, (ii) *prima facie* establishment of case, (iii) urgency, (iv) threatening harm, and (v) proportionality (Yesilirmak, 2005, p. 175). Regarding the first two requirements, the former (*prima facie* establishment of jurisdiction) is considered to be automatically satisfied due to the "urgent" nature of the situation which interim measures serve, while the latter (*prima facie* establishment of case) is not specifically considered to be relevant for granting the security for costs (Born, 2014, p. 2496; Yesilirmak, 2005, pp. 175-176). Nevertheless, the second requirement, *i.e.* the *prima facie* establishment of case, can be proven by showing an existence of potential claim for reimbursement of costs (Berger, 2010, p. 9). These two requirements, however, seem not to be under influence of the fact that the party is funded by a third person.

The analysis of the other three requirements will show whether third party funding shall contribute to the decision at all. Requirement of urgency is understood as a state in which "*a party's potential losses are likely to increase with the mere passing of time and that it would be unreasonable to expect that a party to wait for the final award suffices*" (Yesilirmak, 2005, p. 149). Since the party is incurring legal costs throughout the proceedings, this is seemingly a persuasive argument for the requirement of urgency to be satisfied. The party's potential losses are here presented as future legal costs that will inevitably be incurred. Third party funding, however, can undermine the reasonability for a respondent to wait till the final award, when there is a severe doubt whether it will be paid at all by the claimant who is funding its costs from an external source. This leads us to the last two requirements.

When the requirements of threatening harm and proportionality are being assessed, financial state of the claimant can have more severe repercussions on the tribunal's or the court's decision. The threatening harm for the respondent may be presented as a potential non-enforceability of an adverse costs award due to claimant's insolvency (Sandrock, 1997, p. 34; Wirth, 2000, p. 36). Insolvency, however, does not automatically suppose the threatening harm, and the order for security for costs can be rendered in exceptional circumstances only. An arbitral tribunal sitting in Switzerland acknowledged this exceptional nature of security for costs by stating that "*[a]rbitral precedents also show that security for costs should only be granted in extraordinary circumstances and with the greatest reluctance*" (ABC AG v Mr X., 2002, p. 112). The same tribunal decided that even though it was proven that claimant is insolvent, it was not sufficient to order the security for costs: "*Given the cash available to Claimant about a month ago […] there is some likelihood that any claims for costs of Respondent […] are not at risk*"(ABC AG v Mr X., 2002, p. 114). In other words, insolvency may be used as an indicator of financial incapability to cover the final costs. However, it will not automatically grant the protection to the other party, as to the exceptional nature of this remedy. This rule *argumentum a maiore ad minus* should be applied to the state of impecuniosity. It remains to see in which situations insolvency or impecuniosity of a claimant will be considered to be an extraordinary circumstance that justifies ordering the security for costs, and whether third party funding can contribute to such justification.

A sole arbitrator decided to grant security for costs because claimant was bankrupt, and the fact that bankruptcy proceedings were suspended due to lack of assets (Swiss entity v Dutch entity, 2001). The claimant had already obtained the funds from an external source at that point in proceedings, however, although this fact was mentioned, the arbitrators did not refer to it again in its reasoning for the security for costs (Swiss entity v Dutch entity, 2001; Kirtley & Wietrzykowski, 2013, p. 25). Quite the opposite was done by another arbitral tribunal which granted the security for costs: "*If a party has become manifestly insolvent and therefore is likely* ***relying on funds from third parties*** *in order to finance its own costs of the arbitration, the right to have access to arbitral justice can only be granted under the condition that those third parties are also ready and willing to secure the other party's reasonable costs to be incurred*" (Berger, 2010, p. 11). It follows that third party funding may be one of the circumstances which are taken into account by an arbitral tribunal when deciding on security for costs. It can be, for example, an indicator of potential harm, *i.e.* that the funded party will not be financially capable of paying the adverse costs at the end of arbitration proceedings. This is true so far as the agreement with the funder does not provide for such coverage. However, taking this circumstance into account should not contradict the exceptional nature of this relief: the fact that a claimant is using external funds should not lead to automatic granting of security for costs.

Moreover, the latter tribunal made an observation about the third party funding not regarding the requirement of threatening harm, but regarding the proportionality requirement when assessing the granting of security for costs. Under that requirement, "*the possible injury* *caused by the requested interim measure must not be out of proportion with the advantage which the claimant hopes to derive from it*" (Yesilirmak, 2005, p. 182). When this is applied to cases which involve an external funder, the following question can be raised: should the protection of the solvent party's rights prevail over the impecunious party's right of access to arbitral justice? Namely, if the impecunious party has to obtain funds from an external source it means that, otherwise, it would not be able to finance the arbitration proceedings. If the continuation of the arbitration is conditioned by payment of security for costs, the impecunious party who does not have such payment covered by its agreement with the funder might be denied access to arbitral justice. The cited decision was obviously in favor of imposing security for costs on the funded party and insisting on such payment by the external funders as it stated that "*arbitral justice can only be granted under the condition that those third parties are also ready and willing to secure the other party's reasonable costs to be incurred*" (Berger, 2010, p. 11). Some authors are of the opinion that the third party funders, even if the initial agreement does not cover such payment, will make it any way in order not to lose the investment already made (Kirtley & Wietrzykowski, 2013, p. 27).

At the same time, the doctrine warns about several strong reasons why the third party funding as a relevant circumstance should be approached with caution when deciding on these issues. The main three issues which may arise if the third party funding is taken into account anyways are: otherwise meritorious claim may be stifled, arbitration proceedings may be delayed and/or funded claimant may complain that it is threated worse than those parties who are suing other forms of financing, for example, bank loan (Kirtley & Wietrzykowski, 2013, pp. 23-25). Furthermore, the doctrine suggests that taking this as a relevant circumstance into account is not backed up in the theory of arbitration as well. It was said that respondent's right on security as a reaction to the claimant's external funding "*seems contrary to essence of an arbitration agreement where the possibility of a third party funder of either side's legal costs is not contemplated at the moment of consent to the arbitration, at which point each side accepts the risks around the other party being able to pay the costs or damages, or provide security for costs, associated with any future arbitration under the relevant contractual jurisdiction clause*" (Nieuwveld, 2012, p. 27 ft. 8).

Therefore, while third party funding may be used as an indicator that will contribute to ordering the security for costs to be paid, the arbitral tribunal will be faced with many equally relevant circumstances why this should not be taken into account. It would be advisable to look at the third party funding only as an additional, but not the crucial justification for making such order, and to give the force to all relevant circumstances of each case.

If respondent is successful in obtaining an order for security for costs, a following issue might arise: whether this order can be enforced against the funder? If the order is rendered by an arbitral tribunal, the tribunal will lack any power to give any directions to the third parties (Yesilirmak, 2005, p. 72). However, on the other hand, the national courts may be able to order more effective relief, directed to the third party funder itself. It is considered that under Article 9 of the Model Law, the national courts can grant interim measures vis-à-vis third parties (Srinivasan, 2010). To the authors' knowledge, no such decision was rendered specifically related to security for costs. Assuming that third party funders did not agree to such coverage in the first place, this solution might never come to life. However, as shown in the first part of this paper, the national courts did not refrain from ordering the adverse costs against the third party funders. Therefore, there is a theoretical possibility that they will not refrain from ordering an interim measure in the form of security for costs against them as well. It remains to see whether the judicial practice will ever adopt this solution.

Conclusion

Since the tendency in international commercial arbitration is to apply the "costs follow the event" principle unless the parties have agreed otherwise, the payment of successful respondent's adverse costs might be jeopardized by impecuniosity or bankruptcy of a claimant. This article analyzed whether a third party funder may be liable for the successful adverse party's costs.

The first part of the paper, therefore, addressed the possibility for an arbitral tribunal to render a final award against the third party funder. It was found that when there is no voluntary submission to the tribunal's jurisdiction on the funder's side, the effect of the award might be extended to the funder only if it is *the real party in interest*. Regarding the security for costs and its relation with the third party funding which was discussed in the second part of the paper, it can be concluded that third party funding *should be taken into account* when deciding on this type of interim measures. Arbitral tribunal, however, has no power to *order the funder* to cover such security. The national courts may have a reasonable legal ground to make such an order against the funder, but this remains to be confirmed in the practice.

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