

Recoverability of third-party funding costs recognised in arbitration proceedings

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Introduction

In arbitrations seated in England, the successful party can recover the reasonable costs of the arbitration from the unsuccessful party in accordance with the general principle that costs should follow the event. The power to make awards allocating costs as between the parties on this basis and to determine the recoverable costs is conferred on tribunals by Sections 61 and 63 of the Arbitration Act 1996, and is subject to a number of restrictions.

Section 59 of the act makes clear that for these purposes, the costs of the arbitration comprise the arbitrators' and the arbitral institution's fees and expenses, as well as legal and other costs. It is generally accepted that these include the reasonable fees and expenses levied by external legal counsel and by party-instructed experts, which are recoverable.

What was far from clear until the decision in *Essar Oilfields Services Limited v Norscot Rig Management Pvt Limited*⁽¹⁾ was the recoverability of the costs of obtaining litigation funding under this heading. In this recent decision, the recoverability of third-party funding was considered in the context of a challenge of an arbitral award on the ground of serious irregularity. The court confirmed for the first time that third-party funding costs fall within the category of 'other costs' for the purposes of Section 59 of the act and are recoverable in arbitration proceedings in certain circumstances.

Facts

The dispute between Norscot and Essar arose out of an operations management agreement and was referred to International Chamber of Commerce (ICC) arbitration in London. To pursue its claims against Essar, Norscot entered into an agreement with a third-party funder. The funder advanced around £647,000 to Norscot for the arbitration. In the event of Norscot's success, the funder would receive a fee of 300% of the funding or 35% of the recovery.

The sole arbitrator decided the dispute in Norscot's favour, awarding damages and other sums to it that remained unpaid under the agreement. Insofar as the costs of the arbitration were concerned, Norscot now owed the funder just over £1.94 million. Norscot sought to recover this sum from Essar in full.

The arbitrator ruled that Norscot was entitled to its costs on an indemnity basis, including the third-party funding costs. These costs, he held, were 'other costs' pursuant to Section 59 of the act and the relevant provisions of the ICC Rules of Arbitration.

The arbitrator was highly critical of Essar's conduct in the arbitration and concluded that an award of indemnity costs was appropriate. He held that Essar had set out to cripple Norscot financially. The

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arbitrator accepted Norscot's evidence that Essar's exploitative conduct had forced Norscot to enter into a litigation funding arrangement. There was no credible alternative source of funding and the litigation funding costs reflected standard market rates. In the circumstances, the arbitrator was therefore entitled to rule that the third-party funding costs were recoverable.

Essar applied to the court to challenge the arbitrator's award under Section 68 of the act. This provision, which cannot be waived by agreement, gives parties the right to challenge awards before a court on the ground of a serious procedural irregularity. Essar argued that there was such a serious irregularity because the arbitrator had exceeded his powers by ruling that third-party funding costs were 'other costs' under Section 59 of the act.

The court dismissed the application and upheld the arbitrator's award.

Decision

The court held that there were two key issues for determination:

- The characterisation issue – was there a serious irregularity within the meaning of Section 68 of the act on the basis that the arbitrator had exceeded his powers or, by holding that 'other costs' could encompass third-party funding costs, had the arbitrator merely made an error of law on the basis of which the award could not be challenged?
- The construction issue – was there in fact any error of law or was the arbitrator's construction of 'other costs' so as to include the cost of third-party funding correct?

The court considered these issues in turn.

Characterisation issue

The court confirmed that challenges of awards for serious irregularity under Section 68 are available only in very narrow circumstances. A challenge on the basis that the tribunal exceeded its powers can be made only where the tribunal exercised a power it did not have – not where it erroneously exercised a power it did have. A mere error of law or fact will not amount to an excess of power. (By adopting the ICC rules, the parties had excluded the right to appeal the award on a point of law under Section 69 of the act.) The focus of the inquiry under Section 68 is due process, not the correctness of the decision.

The question of costs is governed by Sections 59, 61 and 63 of the act and by provisions of the ICC rules which are substantially in the same terms as those of the act. The ICC rules give the tribunal the power to make awards allocating the costs between the parties and confirm that the costs of the arbitration include the reasonable legal and other costs incurred by the parties.

The court considered the arbitrator's award. The court observed that, in order to determine whether what the arbitrator had done was an excess of power giving rise to a challenge under Section 68 or whether it was a mere erroneous exercise of power, the court had to focus on the power concerned. The relevant power for these purposes was the arbitrator's undoubted power to award costs. The court concluded that if the arbitrator fell into error, it was an error as to the scope of such costs by reason of the arbitrator's alleged erroneous interpretation of Section 59 of the act and the equivalent provisions of the ICC rules. There was therefore no serious irregularity within the meaning of Section 68, even if the arbitrator was wrong in his construction of 'other costs'.

Construction issue

The court proceeded to address the issue of construction even though it was now academic. Essar contended that the expression 'other costs' under Section 59 of the act does not – as a matter of construction – include costs of litigation funding.

The court gave short shrift to Essar's argument that the relevant sections of the act should be construed in accordance with the equivalent costs provisions for litigation under the Civil Procedure Rules 1998, which apply to litigation in England and Wales. The court held that the act was designed as a complete code for the conduct of arbitration. Section 59 of the act defines costs of arbitration as including both legal costs and other costs. There is no parallel provision in the Civil Procedure Rules. As a result, the approach taken by the courts on the recoverability of costs under the Civil Procedure

Rules was of little direct relevance.

The court also rejected Essar's argument that the governing expression in Section 59 was 'costs of the arbitration', which should exclude the costs of third-party funding, since that was not the cost of the arbitration but the cost of funding it. Essar argued that the expression 'other costs' in Section 59 covers costs not available in a court-based costs order, such as internal expert fees or managerial time, but does not extend to litigation funding. The court held that this distinction was somewhat arbitrary. The better view was to look at the expression functionally. The real limiting factor was whether the costs related to the arbitration and were for the purposes of it. On that basis, both management time and the costs of obtaining funding for the dispute could be included.

The court observed that this functional view was also supported by observations in the ICC Commission Report of 2015 to the effect that the requirement that the costs be reasonable serves as an important check and balance, and that tribunals have from time to time included third-party funders' success fees in the allocation of costs when assessing their reasonableness.

The court concluded that, as a matter of language, context and logic, the arbitrator's interpretation of 'other costs' as extending to the costs of obtaining third-party funding was correct. Whether then to award them was a matter of discretion for the arbitrator.

Further issues

The court went on to consider a limited number of further issues, which – it held – had also been rendered academic. It observed that had there been a finding of serious irregularity, the requirement under Section 68 that it caused substantial injustice would have also been met. The court also observed that while Essar had filed the application to challenge the award within the 28-day time limit, its claim would in any event have been defeated. Essar had waived its right to object under Section 73 of the act because it had failed to make it clear that the treatment of third-party costs amounted to an irregularity or improper conduct in the proceedings.

Comment

This decision, which accepts the principle of recoverability of third-party funding costs (including the funder's return) in English-seated arbitrations, has caused significant controversy. The ruling is in stark contrast to the much more restrictive costs regime applicable to litigation in England and Wales. Following the 2013 reforms spearheaded by Lord Justice Jackson, this does not allow the recovery of lawyers' success fees by the winning party. Subject to any appeal, the decision should enhance the attractiveness of London as an arbitral seat for parties wishing to take out third-party funding.

The ruling leaves the question of recoverability entirely at the tribunal's discretion. An increasing number of arbitration claimants will doubtless attempt to seek to recover their funding costs. However, whether and to what extent arbitrators will order that third-party funding is recoverable when allocating costs as between the parties remains to be seen. Key factors in the arbitrator's decision were Essar's exploitative conduct and the fact that Norscot was left with no alternative but to obtain third-party funding to pursue its claims. Tribunals may be more reluctant to include third-party funding in their costs awards where those factors are not present – for example, where there is no exploitative conduct or where a party obtained litigation funding not out of sheer necessity, but simply to mitigate its exposure and hedge its bets.

Third-party funding raises other issues not addressed in the decision. For example, a party obtaining third-party funding will need to decide when and how best to disclose the identity of the third-party funder in the arbitration. On the one hand, early disclosure can help to ensure that any potential conflict of interest between the funder and the arbitral tribunal is flushed out at the outset – ideally before the tribunal is appointed. A respondent should also be entitled to early disclosure to help it assess the ultimate costs with which it may be faced. On the other hand, a party making a disclosure that its claim is funded may expose itself to the risk of an application for security for costs from the other party. The funded party will also need to take precautions to preserve privilege over sensitive information exchanged with the funder, such as any assessment of its prospects of success.

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Endnotes

(1) [2016] EWHC 2361 (Comm).

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