ARBITRATION & ADR - UNITED KINGDOM

Three's a crowd? Third-party arbitration funding

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Third-party arbitration funding can benefit both under-resourced growing businesses as well as established and profitable companies, allowing them to cover the legal costs of potentially complex proceedings. However, companies should be aware of its potential risks and downsides, such as concerns over confidentiality and privilege of sensitive information, the funder's self-interest in returning a profit on its investment and potential conflicts of interest between funders and arbitrators. A number of jurisdictions and arbitration institutions are considering introducing external regulation of third-party arbitration funding.

Is third-party arbitration funding common in your jurisdiction?

Third-party funding in return for a share of the proceeds of the arbitration will not, in and of itself, breach the rules against maintenance and champerty in England and Wales. However, the funding agreement must be structured carefully – such that the third-party funder has no control over the arbitration and cannot make an improper profit or risk inflaming damages – as otherwise the agreement risks being unenforceable as a matter of public policy.

Arbitration and litigation funding is becoming increasingly more prevalent in England and Wales, although the market is not yet as developed as in the United States or Australia. A 2017 report by Thomson Reuters suggested that the assets of the top 20 UK litigation funders totalled £723 million. (1)

Funders in England and Wales are legally sophisticated and understand a wide breadth of claim types, with each funder having a varying risk profile and appetite.

Recent product developments include funders seeking to identify and fund bundles or portfolios of claims, which could be structured around a corporate's book of disputes or be made available to a particular law firm. While funders have historically sought larger value claims (more than £1 million), certain funders are now targeting lower value claims (£100,000 or less if costs are proportionate to damages). Other innovations include pre-funding to allow claimants to determine the merits of an action and providing funding for general working capital (potentially useful in 'bet the company' arbitrations), including by way of an equity investment. While most funders purport to be able to fund claimants and respondents, the economics of the respondent model are much less clear, given that, in many cases, the respondent to the arbitration will not recover a monetary sum unless it has a counterclaim.

In England and Wales, arbitration can be funded at any stage. For example, a claimant might involve a funder before serving its request for arbitration, during the arbitration or after an award has been obtained, but before enforcement.

Parties exploring funding can approach funders directly, or specialist litigation funding brokers can:

- help provide advice to parties;
- seek quotes from funders; and
- explore funding terms with different funders concurrently.

The International Council for Commercial Arbitration (ICCA), working with Queen Mary University

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of London, has created a taskforce that has examined third-party funding in international arbitration. Public consultation on the draft report ran from September 1 2017 to October 31 2017, with a view to the final report being adopted in April 2018 at the ICCA congress.

What terms and conditions are generally associated with third-party arbitration funding in your jurisdiction? Does this type of funding usually include punitive measures in the event of an adverse outcome for the claimant company?

Funders will perform detailed due diligence on claims on the merits (including jurisdictional obstacles) and the economics of a claim (including its value, the nature and length of the proceedings and the creditworthiness of the opponent). In terms of the financial metrics, funders are typically seeking a return (via a success fee) of around two to five times their investment or 40% of the claim value, whichever is the highest. In some cases, a funder may require a funded party to contribute towards the legal costs to encourage risk sharing.

Parties considering funding should check whether any success fee is payable from the net revenue from the arbitral award (ie, after the funded party (if it contributed to legal costs) and its solicitors and counsel have been repaid). Finally, some funders offer a sliding scale, under which the proportion returned to the funded party decreases the longer the case takes to be resolved (in which case, higher costs will have been incurred).

Most funding is on a 'non-recourse basis', meaning that if the case is lost, the funded party does not have to repay the investment to the funder. The funder remains liable for any fees due to the funded party's lawyer. In relation to costs, the default position under the Arbitration Act 1996 is that the tribunal should award costs on the general principle that costs follow the event (ie, the loser pays costs position), subject to any agreement of the parties or whether the tribunal considers it to be inappropriate. The London Court of International Arbitration rules mirror this position, but also provide that a party's conduct can be considered.

In relation to any adverse costs award, the funding agreement will provide whether the funder will cover such costs. The funder may require the funded party to agree to pay for an after the event insurance policy. This policy will insure the funded party against the risk of having to pay their opponent's legal costs in the event that their claim fails. Unlike in the English courts, the funder itself is not at risk of an adverse costs award being made against it, because the tribunal lacks jurisdiction to issue such a cost order against the funder. However, in contrast to the position in the English courts, for arbitration conducted in England under the English Arbitration Act, *Essar Oilfields Services Ltd v Norscot Management Pvt Ltd*(2) has suggested that it is within a tribunal's discretion to award a funded party the costs of third-party funding, including any success fee, as parts of its costs award.

Funders have no control over arbitration,(3) but the funding agreement will contain detailed provisions setting out the funded party's reporting requirements and the funder's access to information and documentation, as well as provisions dealing with the termination of the agreement and settlement (as discussed below).

Funders may also require that their involvement in the arbitration and the terms of the arbitration funding be kept confidential by the funded party. At present, there is no obligation on a funded party to disclose the fact of its funding agreement to the tribunal or its opponent, but the tribunal may order disclosure.

The Code of Conduct for Litigation Funders was first published in 2011 by the Civil Justice Council (a Ministry of Justice agency), following consultation with senior lawyers, academics and funders, and was last updated in 2016.(4) The UK Association of Litigation Funders has been charged with administering self-regulation of the funding industry in line with the code. Full funder members of the association (which includes eight of the largest funders), must abide by the code, which sets out a number of requirements with respect to:

- the control of arbitration;
- funding agreements; and
- a funder's capital adequacy.

For other funders, compliance with the code is voluntary.

Third-party arbitration funding can involve potential risks for claimant companies. What measures can be taken to avoid or minimise such risks?

Parties seeking funding must be open with any potential funder (a funding agreement may contain representations, warranties and ongoing obligations concerning the disclosure of information). While both the funder and the funded party have a financial interest in the arbitration, their interests may not be identically aligned. For example, a funded party may wish to maintain a commercial relationship with its opponent and be more willing to settle. There may be issues of wider significance to the party's business, such as the reputational impact. It is prudent for a party to discuss with the funder its commercial (and particularly non-financial) objectives when negotiating the funding agreement and when the funder conducts its due diligence on the claim.

As noted above, funders have no control over arbitration, but will typically monitor the matter through their in-house team and require the funded party to keep them up to date with developments. The involvement of a funder and the necessary provision of information and documents will add costs, the size of which will vary depending on the nature of the arbitration and the funding terms. Conversely, the involvement of a funder's in-house lawyers may bring a helpful objective and commercial perspective to the management of the dispute.

The involvement of a funder in an arbitration (if known to the funded party's opponent) may cause (or be relevant to) interim applications pursued against the funded party, such as security for costs. The ICCA-Queen Mary taskforce considered third-party funding in connection with security for costs.(5) It concluded that such applications should be determined irrespective of any funding arrangement and on the basis of the test under the relevant applicable law, starting with impecuniousness. A funder's agreement to pay a costs award or an after the event insurance policy, for example, may be relevant evidence that no security need be posted.

Any funding agreement should address potential conflicts of interest which may occur during the arbitration. One potential area of tension between the funder and funded party concerns settlement. Under the code, the funding agreement should state "whether (and if so how), [the funder]... may... provide input to the [funded party's] decisions in relation to settlement".

While funders cannot direct a party to accept or decline a settlement offer, funding agreements typically require claimants to act reasonably when considering such an offer and may require referral to independent counsel or set the parameters for resolving any such disagreement. In contrast, under after the event arrangements, the insurer may have to formally consent to a settlement, which will restrict the funded party's decision making.

A funded party needs to understand exactly when a funder can terminate a funding arrangement. For example, under the code, termination may be allowed if:

- the funder ceases to be satisfied regarding the merits of the dispute;
- the funder believes that the dispute is no longer commercially viable; or
- a material breach of the funding agreement occurs (eg, suppression of relevant information or misleading of the funder).

In the case of the first or second bullets, the code provides that the funder will remain liable for all funding obligations accrued to the date of termination. However, the withdrawal of funding may significantly impact the funded party's ability to continue with the arbitration (potentially at the most inopportune moment). Thus, a funded party must ensure that:

- it receives detailed legal advice when negotiating the terms of the funding agreement; and
- it and its lawyers comply with all such funding terms throughout the arbitration.

Funding agents often provide that any dispute should be referred to expert determination.

How does third-party funding affect the confidentiality and privilege of sensitive

material in arbitration proceedings?

As noted above, funders will require information about the arbitration claim, both before funding and during the arbitration itself. The merits of the arbitration claim are the key criteria, with funders seeking claims with strong prospects of success and good prospects for enforcement of an award. As a result, funders will conduct extensive due diligence. Funders will typically take their own legal advice on potential claims, using their in-house or independent counsel, but may also want to see the funded party's legal advice.

Therefore, proper arrangements must be put in place between the funder and the funded party in order to ensure that:

- confidentiality is maintained in any documents and other information supplied to the funder; and
- privilege is not waived.

Ideally, this will involve the funder signing a confidentiality or non-waiver letter before it receives any information.

Given the significant legal and ethical issues associated with third-party arbitration funding, such as potential conflicts of interest and questions regarding impartiality, is external regulation needed in your jurisdiction?

Arbitration funding is an activity that would once have been condemned as champertous, but is now accepted as means of trying to ensure access to justice (or at least commercially and legally acceptable and not contrary to public policy). At present, funders in the United Kingdom are self-regulated via the code, which (as noted above) is administered by the Association of Litigation Funders and provides for a complaints procedure.(6) Further, lawyers acting for a funded party and the funder are regulated by their own professional bodies (The Bar Council and the Solicitors Regulation Authority) and specialist litigation funding brokers are regulated via the Financial Conduct Authority.

Organisations such as Justice Not Profit (backed by the US Chamber Institute for Legal Reform) continue to assert that "[t]hird party litigation funders must be regulated, with all providers subject to registration and compulsory rules".(7) Lord Faulks, a Conservative peer, expressed the following view in a debate in the House of Lords in March 2017:

> *"where the litigation is an investment, and those running the case are not regulated, as are solicitors and barristers, the risk of a wholly commercial approach to issues of justice is worrying... Once a party knows that the other side has third-party funding, this can bring about a form of bullying in relation to the non-funded party. The temptation not to be straight with opponents is considerable. Accepting offers early because of external financial pressures nothing to do with the litigation can distort the process."*(8)

In response, the earl of Courtown indicated that: "[t]he Government are not persuaded that any changes to the regulation of third-party litigation funding are warranted at this time. However, the Government will keep this matter under review as the market for third-party funding develops, and are ready to investigate further should the need arise".(9)

Thus, the position in relation to regulation looks unlikely to change in England and Wales in the near future (in contrast to Hong Kong or Singapore). Separately, in the specific context of international arbitration, the ICCA-Queen Mary taskforce is looking at the viability of introducing international best practice guidelines for the use of third-party funding.

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Endnotes

(1) Thomson Reuters Release: UK's Biggest Companies Face a Rising Tide of Litigation – Number of High Court Cases for FTSE100 More Than Doubles.

(2) *Essar Oilfields Services Ltd v Norscot Management Pvt Ltd* [2016] EWHC 2361 (Comm).

(3) Under the Code of Conduct for Litigation, funders agree "not to seek to influence the Funded Party's solicitor or barrister to cede control or conduct of the dispute to the Funder".

(4) Further information is available here and here.

(5) See Chapter 6 of the ICCA-QM draft report.

(6) Further information is available here.

(7) Further information is available here.

(8) Further information is available here.

(9) *Ibid.*
