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THIRD-PARTY FUNDING: A TOOL TO DETER INVESTOR MISCONDUCT?

by Dr. Üzeyir Karabiyik and Charles B. Rosenberg

I. INTRODUCTION

In investor state dispute settlement (ISDS), host states have progressively defended themselves by alleging investor misconduct, such as bribery, fraud, abuse of process, and bringing frivolous cases. Tribunals have adopted a range of approaches to address such allegations, including the unclean hands doctrine, transnational public policy, outright dismissal of claims, and costs awards. This article explores the potential of third-party funding, a generally unregulated and burgeoning industry, to deter and reduce investor misconduct in ISDS.

II. THIRD-PARTY FUNDING AND FRIVOLOUS CLAIMS

As a preliminary matter, whether a claim is "frivolous" entails a variety of considerations that present a challenge to assess the extent to which third-party funding contributes to the proliferation of such claims. For example, skeptics of the ISDS system may cynically argue that the remuneration system of arbitrators—which is often based on an hourly or daily rate—may incentive arbitrators to adopt a more lenient interpretation of the law or assessment of the facts to allow "frivolous" claims to proceed that would otherwise be rejected early in the proceeding as "manifestly without legal merit"[1] or "not within the competence of the Tribunal."[2]

The impact of third-party funding on frivolous claims has generated considerable debate. Critics of third-party funding contend that it amplifies the occurrence of abusive litigation and fosters the proliferation of frivolous claims. Their argument boils down to: (i) litigants may be more likely to pursue a frivolous claim if they are not paying for it; and (ii) the potential for a substantial financial recovery may motivate a third-party funder to assume the risk of pursuing a claim that has a low likelihood of success. Empirical research suggests that third-party funders may

[1] ICSID Arbitration Rule 41(5).

[2] Convention on the Settlement of Investment Disputes between States and Nationals of Other States Art. 41(3), Mar. 18, 1965, 575 U.N.T.S. 159; ICSID Arbitration Rule 41(1).

exhibit a preference for investing in riskier claims with relatively lower prospects of success if they have the potential for a substantial financial recovery.[3]

Critics draw parallels with contingency fee arrangements to support their argument that third-party funding incentivizes frivolous claims. They contend that whereas contingency fee attorneys bear the ethical responsibility of advising their clients against pursuing meritless claims, no such duty exists for third-party funders. As a result, claims with questionable merit may be more likely to proceed because they are funded by third-party funders motivated by the prospect of extremely large profits.

In contrast, some commentators argue that the involvement of third-party funders weeds out many frivolous claims. Prior to making a commitment to fund a claim, third-party funders normally undertake a thorough examination of the strengths and weaknesses of the claim to evaluate the potential risks and ensure an adequate return on their investment. A funder's evaluation is largely motivated by considerations of business and risk management. Funders frequently rely on the expertise of external law firms and consultants to conduct this due diligence, which often takes several weeks or months and can cost tens of thousands of dollars. Funders recognize that investing in unmeritorious cases not only undermines their financial interests but also poses the potential threat of tarnishing their standing within the industry.

The nature of third-party funders themselves may also influence the effect of third-party funding on abusive litigation and meritless claims. Currently, the market for litigation financing is dominated by large investment firms that are well-known repeat players in the industry. Safeguarding their reputation within the expanding market is vital for their long-term financial objectives. Such funders likely would be reluctant to jeopardize their professional reputations by financing and facilitating frivolous claims. Nonetheless, as compared to smaller funders, larger funders are better suited to undertake "portfolio funding," which involves obtaining a financial

[3] *See* Brooke Guven & Lisa Johnson, *The Policy Implications of Third-Party Funding in Investor-State Dispute Settlement*, at 24 (Columbia Center on Sustainable Investment Working Paper 2019).

stake in a group of claims that may or may not involve the same claimant or counsel.[4] As a result, the funder's returns are determined by the overall performance of the portfolio, minimizing the risk and influence of each particular claim. By grouping higher-risk cases into a larger bundle of claims, portfolio funding may lead to an increase in the funding of frivolous claims.

On the other hand, small or medium-sized new entrants may be more willing to fund riskier claims, given that the possibility of exceptionally high returns could help them establish a reputation and gain a foothold in the market. Further, as the market for third-party funding continues to expand, one can anticipate an increase in the number of new entrants. The influx of additional participants could result in heightened competition among funders, potentially fostering a climate in which even high-risk claims are in demand.

III. THIRD-PARTY FUNDING AND OTHER TYPES OF MISCONDUCT

Investor misconduct may have a variety of adverse consequences. For example, an investor's misconduct may lead to a tribunal dismissing the claim for lack of jurisdiction or as inadmissible.[5] A tribunal also may reduce the damages awarded to the investor or factor in the investor's misconduct when apportioning the costs of the proceeding.[6] In light of these risks, a third-party funder can impose certain responsibilities and constraints on a litigant through representations and warranties in a litigation financing agreement to protect the funder's interest in the case.

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[4] *See* Annual Report 2018, IMF Bentham, at 14, https://www.annualreports.com/HostedData/AnnualReportArchive/o/ASX_OBL_2018.pdf ("Portfolio investing allows costs and risks to be collateralised across the cases within the portfolio, with a commensurate reduction in return. Investing in single-party cases generally involves greater risk, given the binary nature of the outcome, but concurrently delivers greater returns.").

[5] *See*, *e.g.*, Phoenix Action, Ltd. v. The Czech Republic, ICSID Case No. ARB/06/5, Award, ¶¶ 143-147 (Apr. 15, 2009) (dismissing for lack of jurisdiction because "the Claimant's initiation and pursuit of this arbitration is an abuse of the system of international ICSID investment arbitration"); Metal-Tech Ltd. v. Republic of Uzbekistan, ICSID Case No. ARB/10/3, Award, ¶ 389 (Oct. 4, 2013) (dismissing for lack of jurisdiction due to corruption).

[6] *See*, *e.g.*, Occidental Petroleum Corp. & Occidental Exploration & Production Co. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶¶ 687, 825 (Oct. 5, 2012) (reducing damages by 25% as a result of the claimants' material and significant wrongful act); Cementownia "Nowa Huta" S.A. v. Republic of Turkey, ICSID Case No. ARB(AF)/06/2, Award, ¶¶ 176-78 (Sept. 17, 2009) (ordering the claimant to pay the respondents costs because the claimant "filed a fraudulent claim").

Representations: The litigant would represent to the funder that it did not engage in any misconduct regarding the claim and provide guarantees about its past actions. For example, the litigation financing agreement could provide: "[t]he Plaintiff represents that, as of the date of this Agreement, the Plaintiff has provided the Funder all material information relating to the Claim, excluding information protected solely by the attorney-client privilege" or "[o]ther than as already disclosed to the Funder, the Plaintiff has not taken any action (including executing documents) or failed to take any action, which would materially and adversely affect the Claim."[7]

Warranties: The litigant would promise to the funder that it will not engage in misconduct throughout the arbitration. For example, the litigation financing agreement could provide: "The Plaintiff agrees and undertakes that . . . it will not take any step reasonably likely to have a materially adverse impact on the Claim or the Funder's share of any Proceeds … ."[8]

Third-party funders are likely to abstain from funding claims that involve prior investor misconduct directly linked to the claim, such as corruption, fraud, or abuse of process. Similarly, an investor who has concluded a litigation financing agreement that includes robust representations and warranties likely would be hesitant to participate in any type of wrongful conduct in the future due to the risk of losing the funding and subjecting itself to liability from the third-party funder. Accordingly, due to the contractual obligations between the third-party funder and the investor, third-party funding has the real potential to deter and reduce the occurrence of ISDS claims that involve investor misconduct.

IV. CONCLUSION

Although there are strong arguments that third-party funding deters and reduces investor misconduct in ISDS, there currently is a lack of empirical evidence. The need for regulating third-party funding in investment arbitration has been one of the most popular topics of the recent ISDS reform process. The continuous expansion of third-

[7] *See* Maya Steinitz & Abigail C. Field, A *Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 757-58 (2014).

[8] *Id.*

party funding combined with further regulation of the third-party funding industry (perhaps under the ambit of United Nations Commission on International Trade Law (UNCITRAL)) would help shed further light on the effects of third-party funding on investor misconduct.

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