THIRD PARTY FUNDING IN INTERNATIONAL ARBITRATION[1]

Bernardo M. Cremades

I met Luiz Olavo Baptista when, together with Guillermo Aguilar-Alvarez, we were appointed arbitrators within the framework of the ICSID to decide on the claim of the North American company LANCO against the Argentine Republic. Thanks to the legal creativity of my co-arbitrators we were able to issue an award over our jurisdiction and the reasoning of this award immediately became consistent case law. From this time, there has been an arbitral agreement arising from the claimant's acceptance of the State's public offer to submit to arbitration at the time of the investment with the acceptance being the presentation of the request for arbitration. A sovereign state could be sued by a foreign company before an international forum without having participated in the public concession, in application of the principles of State responsibility in respect of public bodies, in particular, local authorities. The international claim prevails over the forum agreed in the concession contract such as the territorially competent Court for contentious administrative proceedings, while a shareholder of a local concessionaire was, in his capacity as investor, enabled to claim international protection for his investment. International arbitration, in all its forms, owes much to the tireless activity of Professor Olavo Baptista and naturally those of us who have worked alongside him of late wish now to offer this deserved tribute.

Since we issued this award much has been happening in the arena of international arbitration. Our generation has had the opportunity to experience highly creative times in international law, firstly participating with our mentors in the development of international commercial arbitration, and later, constructing the broad framework of arbitration in investment protection.

Over these years we have witnessed how in some parts of Latin America international arbitration, where once prohibited, has flourished and received widespread acceptance. The so called Calvo doctrine gave way to the widespread ratification of multilateral,

[1] Work written in tribute to Professor Luiz Olavo Baptista

regional and bilateral treaties whereby international arbitration has become firmly rooted in our countries. The continental legal culture has taken a firm hold in international economic law; the high number of arbitration proceedings with Latin American arbitrators, lawyers and parties applying, moreover, the law of our own countries, has removed the spotlight from the oftentimes suffocating exclusivity of Anglo-Saxon law. Contrary to the well-known phrase of an English judge whereby international law is that which is applied in the English courts and tribunals, arbitral jurisprudence today has developed a modern international economic law with great Hispanic influence.

Arbitration clauses today are virtually routine in international commercial contracts. The 1958 New York Convention is the most widely ratified international treaty. Bilateral and sometimes regional agreements abound. Not surprisingly, then, it may be said that arbitration has triumphed in international relations.

If such is the case, we must naturally ask ourselves if we have indeed set all the necessary instruments in place to guarantee legal security. No longer is international arbitration the prerogative of large multinationals; small and medium-sized companies exercising their rights through arbitration claims, in accordance to prior agreements, is becoming increasingly common. However, the international structure built around arbitration has become expensive. Arbitration has become a great international industry, enormously competitive and furthermore extremely expensive.

Can we simply look on with folded arms while there are individuals and companies who cannot afford to exercise their rights to arbitration? State justice has resolved this issue in some countries through public aid to defray the professional costs of the so-called free defense. Other countries have streamlined mechanisms to enable lawyers to participate directly or indirectly in financing their clients, compensating in this way for these deficiencies. One way or another, then, it is about giving those who do not have the economic means access to justice. Without this we would be back in the times of Jeremy Bentham when he said: «*wealth has indeed the monopoly of justice against*

poverty…».[2] A modern and democratic state ought to guarantee effective judicial and arbitral protection to its citizens.

Since arbitration is about private justice, situations of utmost defencelessness may arise. The citizen who has agreed to an arbitration clause but lacks the financial means cannot safeguard his interests via arbitration without the prior provision of funds. A medium-sized company that follows the large multinationals of its country runs into problems when it comes up against breaches of the investment protection treaty, as the extraordinarily sophisticated investment arbitration system is not financially viable for the medium-sized company. For several decades States that export capital and technology have been demanding, either directly or via international financial entities, that emerging countries sign investment protection treaties as an indispensable requirement for receiving the financing necessary to develop their infrastructures. Administrative law has been globalized ever since. For example, water protection and waste processing have ceased to be matters of a local concern for the affected municipalities to become international projects of great importance. These projects naturally require a large injection of capital which cannot be granted without prior ratification of the treaties to guarantee the legal security of the financiers or foreign investors. Is it reasonable to require truly poor States to participate in international investment protection arbitrations with the enormous costs that these can imply? In recent years we have been witness to some truly abusive cases of arbitration claims which have little foundation and whose only objective would appear to be to put pressure on the state receiving the investment in order to reach a settlement. In all of these cases where there was need for the participation of third parties to finance arbitral claims the costs of which would be otherwise prohibitive.

Traditionally, the participation and investment of third parties in procedural or arbitral claims has been frowned upon. On the continent the *quota litis* pact is considered unethical. The idea of the lawyer taking a share with his client in the outcome of the dispute was considered both reprehensible and punishable by the respective professional

[2] Letter of March 1787, The Works of Jeremy Bentham, vol.3, chapter XII.

associations. This ethical disapproval was paralleled in the Anglo Saxon world through the legal doctrines of champerty, barratry and maintenance. Champerty arises from the agreement between the lawyer and the client by virtue of which the lawyer initiates litigation and pays client's costs, agreeing a contingency fee on any damages awarded. Barratry is defined by Black's Law Dictionary as the "*vexatious incitement to litigation, especially by someone soliciting potential legal clients*"[3]. The same dictionary defines the concept of maintenance as the "*assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the cause; meddling in someone else's litigation*"[4] It is notable that in both continental and Anglo-Saxon countries we continue to characterize the intervention of a third party as dishonest. However, in practice and although the rules dictate the contrary there has been a relaxation of these rigid ethical regulations. In the times of the Spanish empire it was said that the rules dictated by the King of Spain were respected but not obeyed, since the distance from central power demanded an adaptation to the circumstances of each place. Today international commerce has radically changed the role of the professional. The individual lawyer has been replaced by large corporations, causing their professional services now to be exceedingly commercialised. In practice the success fee figure no longer poses ethical problems in any of our countries even though there are laws in place forbidding it.

Third party funding is necessarily connected to the concept of the contingency fee arrangement. A third party participates in the financing of arbitration in the confidence that the claim has legal grounds and a strong likelihood of success before the tribunal. The third party funder rests assured that the claimant is being assisted by a solid legal professional and, furthermore, usually demands a personal commitment by the lawyer to the representation of his client, basing his fees wholly or very significantly on the outcome of the proceedings. Recently, there has been strong interest on the part of financial entities in litigation against states and above all in international arbitration. The latest trend is the presence of hedge funds in international arbitration. Recently they

[3] Black's Law Dictionary 144 (7th ed. B. Garner 1999 edition).

[4] Black's Law Dictionary 144 quote 965

have been found at the arbitral hearings on one of the teams of the parties. Today it is quite common to find included on the list of attendees that is often requested by the tribunal the name of a representative of one of these financial funds. Their presence is also very common at international arbitration conferences which afford them the opportunity to hear and thus familiarize themselves with the points of view of the arbitrators and lawyers.

The financing of one of the parties to initiate or defend an arbitral proceeding is nothing new. A party lacking liquidity used to request financing with the intention of later repaying the loan. Today, financing has become rather more sophisticated. Now arbitration might be financed through insurance, on the sale and purchase of a claim or, for greater anonymity, acquiring the claimant company to start up a specific claim without this having any repercussions on third parties. Venture capital also has its place in third party funding, with occasional recourse to credit default swaps.

Logically, with the increased sophistication of financing, distrust begins to take seed in the world of international arbitration. In the US the Institute for Legal Reform of the US Chamber of Commerce has been highly critical. Firstly, they say that third party financing implies the breakdown of client-attorney relationship, both in trust and in respect of the privileges constitutionally vested in the professional activity of the attorney. They point out that this fosters frivolous litigation. It also implies a serious distortion of parties' incentives in reaching an agreement since it is not only their interests at stake but also those of the financier. For this reason the aforementioned Institute recommends the vigorous renewal of the former prohibition of the Anglo-Saxon champerty law. On the other hand, there are those in favour of removing barriers and promoting the possibility of third party financing, especially in international arbitration. Any professional financier must analyse the particular case submitted to him. Before committing any funds, he should request an independent legal opinion to enable him to undertake a risk assessment. The financier will have the greatest interest in assessing whether the claim or defense are frivolous or, on the contrary, serious enough to merit funding. The would-be financier has to analyse the solvency of the respondent and the prospects of recovery. He must consider the legal and factual issues

in question, if the documentary evidence is sufficient and what witnesses may be required, the duration and merits of the proceedings, issues of quantification and whether the calculation of damages is cautious or reasonable. As we have said before, the role of the legal professional who is to handle the matter is important and for this reason it will be necessary to assess the legal budget and that the lawyers are prepared to share risks through the success fee. In short, the proponents of third party financing in international arbitration see the presence of the professional financier as a guarantee that there is solid basis for the claim. The respondent should reconsider his defense with regard to a claim that has passed the study of a financing entity and its advisors.

The relationship between the party requesting financing and the financier is chrystallised in a funding agreement. Here the rights and obligations of both parties are established and the financing and method of payment agreed. Equally, the financier should set forth payment criteria establishing a maximum and minimum according to the result of the arbitral award. The funding agreement should also set forth the financier's final share in the event of settlement. Similarly, the nature of the financier's participation in the arbitral proceedings should be addressed. In some cases the financier simply wishes to be kept informed, whilst in others he wishes to take a more active role. The funding agreement should equally establish the causes whereby the relationship can be terminated.

Third party financing in arbitration raises difficult questions regarding the arbitral tribunal. Until recently, the tribunal was simply a silent onlooker with regard to third party financing in international arbitration. It seemingly took little interest in knowing who was officially behind the claimant and who was funding the operation. It is my belief that circumstances are changing and that arbitration is becoming increasingly transparent with a greater interaction between the parties and the arbitral tribunal. Undoubtedly, investment protection arbitration has altered the traditional relationship between the tribunal and the parties. The public nature of these proceedings is not only inevitable but also desirable since one of the parties is a sovereign state and is thus compelled to inform its Parliament and citizens of the liabilities that it may acquire through arbitration. For this reason, exactly who is behind the official claimant is highly

relevant. Investment protection treaties characterise very precisely the investor and the investment in such a way that the entity with the real interest in a claim can be of any nationality, thus changing the scope of a bilateral treaty. Furthermore, the investing party acquires certain rights and commitments with regard to the host state and cannot appear and disappear frivolously in the same way as with a purely financial transaction. The state has an interest in knowing the identity and origin of the investment.

On occasion, the participation of third party financiers in arbitration without the corresponding disclosure to the other party and arbitral tribunal could imply a breach of the procedural good faith with which the parties should conduct themselves. Specifically, many objections and delays in proceedings could be due to a clear lack of procedural strategy deriving from the participation of third party financiers.

One potential problem is the privileged relationship between the attorney and his client. At the discovery stage the other party might request disclosure of the correspondence with the funder both from the time when the financing was agreed as well as the subsequent correspondence. Could an exception not be made for the attorney-client privilege of correspondence in this regard? Is it right to be able to request the correspondence with a third party funder who had previously refused requested financing in order to find out the reasons for this refusal? These are the procedural issues that the arbitral tribunal must decide on a case by case basis.

Given the magnitude of many investment arbitral proceedings, it is logical that third party financing has increased in recent times. The claimant-financier relationship seems clear insofar as the latter’s financing in return for an increased share in the outcome of the proceedings. The area is somewhat greyer when it comes to the financing of recipient states. It is difficult to articulate criteria for repayment of the financier of the respondent state. Success criteria cannot be the same as that used in the assistance to a claimant. More so when, except on rare occasions, the respondent states do not usually make a counterclaim.

Third party financing in international investment arbitration proceedings can take many legal guises. Reactions for or against such third party financing depends very directly on the ways in which this financing crystallizes. The straightforward, simple bank financing from a party who commits to return the loan at the agreed time poses few problems, but other more active and even aggressive forms of a third party funding raise difficult questions.

It is precisely this active participation, to a greater or lesser degree, in the arbitral proceedings that in practice poses specific problems that the arbitral tribunal has to solve, attempting to strike the balance between the right to defense of the parties in arbitration and the necessary transparency that procedural good faith obliges of the parties. It cannot be denied, however, that the phenomenon of third party funding in international arbitration is becoming increasingly important, particularly in investment protection arbitration. It is without doubt the market response to the needs of small and medium-sized companies to enable their access to arbitration, and indeed maybe the only the way.

Third party funding in international arbitration has already contributed to important changes in professional ethics, compared with what might be the ethical position in domestic litigation or arbitration. The role of the third party financier poses practical problems regarding the relationship between the parties as well as between the parties and the arbitral tribunal. As with many other issues, and as the poet Machado said “the road is made by walking”. The financier’s road poses new challenges and a new problem that we must all address in our daily professional practice.