Insight

Third-party funding: EU parliament’s proposals for regulation and their implications for arbitration

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The EU Parliament has proposed far-reaching regulations affecting third-party funding of EU-seated claims. The regulations, if implemented, could make third-party funding in the EU more expensive or even inaccessible in some circumstances, and could go as far as to impact intra-group company loans granted for the purpose of pursuing litigation or arbitration. To avoid the impact of the proposed rules, parties may wish to consider jurisdictions outside the EU as their arbitral seat of choice

On 13 September 2022, the EU Parliament passed a resolution requesting the EU Commission to promulgate a new directive regulating third-party funding. The Parliament appended a draft directive to its resolution (the “**Directive**”), giving an indication of the type of regulations that can be anticipated in EU Member States in the medium term.

As drafted, the Directive would apply a one-size-fits-all approach, applicable to third-party funding of all litigation and arbitration proceedings in the EU. It is drafted broadly enough to cover not only traditional third-party funding arrangements but potentially other commercial arrangements for funding the costs of legal proceedings where any non-party receives a return in the event of success. This could potentially cover intra-group company funding arrangements, depending on their structure.

What are the key proposals the EU Parliament recommended? And how will they affect claims in commercial or investment treaty arbitration where third-party funders (“**TPFs**”) are involved?

Regulation of arbitration procedures where TPFs are involved

First, the proposed regulations would impact the procedure of EU-seated arbitrations where the claimant (or, presumably, a respondent bringing a counterclaim) is party to a third-party funding agreement.

At the outset of proceedings, claimants and their counsel would be required to disclose the funding agreement in full, unredacted form. This goes beyond most arbitration laws and institutional rules, which usually only require disclosure of the fact that a TPF is funding the claim, and the identity of the TPF. Such disclosure would be commercially unattractive for TPFs and potentially strategically disadvantageous for claimants, as it may invite applications by respondents for security for costs.

The Directive would make TPFs jointly or severally liable for adverse costs in the event an unsuccessful claimant is ordered to pay the defendant’s costs. It is unclear how this would be implemented in arbitration, where tribunals do not have jurisdiction over non-parties, such as TPFs. It could result in defendants bringing claims in EU courts to enforce costs awards against TPFs following conclusion of an unsuccessful claim in arbitration. Alternatively, the regulations could require parties funded by TPFs to post security for costs. In either case, TPFs might require ATE (after the event) insurance as a matter of course when funding EU-seated arbitrations, as a result.

Regulation of funding agreements

Second, the Directive would regulate the terms of third-party funding agreements. Some of these regulations codify protections already granted to claimants as a matter of course, and therefore already align with the structure of typical commercial funding arrangements. For example, the Directive would prohibit TPFs taking any formal or informal control over the pursuit of the claim: this is already standard in most funding arrangements.

However, other aspects of the Directive would impose notable commercial limitations on the terms TPFs are able to offer claimants. For example:

- The amount a TPF would be entitled to recover would be limited to 40% of the claimant's recovery.
- TPFs would not be permitted to withdraw funding mid-claim, absent exceptional circumstances. They would be prohibited from terminating funding agreements unilaterally without a court's permission.
- The funding agreement would be required to grant the claimant priority of recovery over the TPF in terms of order of payment. By contrast, currently funding arrangements typically provide for a payment "waterfall" entitling the TPF to recover its share before the claimant is paid.
- Finally, TPFs would be made subject to a fiduciary duty of care, requiring them to act in the best interests of a claimant, rather than in their own commercial interests.

These proposals are also aimed at protecting claimants. However, in practice, they may have the opposite effect, particularly for sophisticated commercial parties capable of negotiating with TPFs. The regulations may increase the commercial risk of a transaction from the TPF's perspective and would likely restrict the terms the TPF is able to offer. Some funding arrangements might have to be structured differently, or some claims may even become commercially "unfundable".

Regulation of TPFs

Finally, the Directive proposes various regulations on how TPFs operate.

TPFs wishing to fund any claim seated in the EU would be required to obtain a licence and conduct their business through a registered office located in the EU. These restrictions may have the effect of limiting parties with EU-seated arbitration claims to TPFs willing to operate in the EU market, thereby excluding TPFs in other established and competitive markets (such as the UK, North America and Australia).

The Directive would also impose strict capital adequacy requirements on TPFs. It would require them to maintain sufficient capital to fund not only the claim itself, but "any subsequent appeal". Such a rule could create compliance limitations on TPFs, which typically only commit to funding an arbitration claim and not subsequent challenges to the eventual arbitral award.

Although the regulations on TPFs themselves would not impact arbitration users directly, they could increase costs of TPFs funding EU-seated claims. These costs could be passed to users of third-party funding or make TPFs less willing to fund EU-seated claims.

Conclusions and action points

The EU Parliament's proposals, if implemented, would have a significant impact on third-party funding of EU-seated arbitration claims. The regulations would likely make funding such claims less attractive to TPFs and, therefore, make it more expensive or even commercially unavailable for some claimants.

There is time for parties to pre-empt the potential regulations. The EU Parliament requested the European Commission to propose a Directive after 25 June 2023, following which, if it were enacted, Member States would have time to implement the Directive in their domestic law.

Fortunately, arbitration offers parties the flexibility of choosing where and how they wish to conduct their proceeding. Commercial parties who might consider third-party funding for future disputes may consider choosing a jurisdiction outside the EU for their seat of arbitration, seeking to avoid the impact of the potential EU regulations. For example, England and Switzerland both have an excellent track record as arbitral seats in Europe. Parties commencing claims under an investment treaty where there is a choice of forum (for example, under the Energy Charter Treaty) may opt for ICSID arbitration over EU-seated alternatives.

With offices in London, Geneva and Zurich, LALIVE is optimally placed to deal with such claims and has extensive experience dealing with third-party funded claims, in both commercial and investment treaty arbitration.

For further questions or comments about this topic, please contact the authors.