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COMMENTS
TO THE LAW REFORM COMMISSION of HONG KONG
THIRD PARTY FUNDING FOR ARBITRATION SUB-COMMITTEE

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The U.S. Chamber Institute for Legal Reform is a not-for-profit public advocacy organisation affiliated with the U.S. Chamber of Commerce, the world's largest business federation, which represents the interests of more than three million businesses of all sizes, sectors and regions, in addition to state and local chambers and industry associations. Many of the U.S. Chamber's members are companies that conduct substantial business in Asia-Pacific countries, and in particular, Hong Kong. ILR is therefore deeply interested in the orderly administration of justice in Hong Kong.

ILR's mission is to restore balance, ensure justice for both claimants and defendants, and maintain integrity within the civil legal system. We do this by creating broad awareness of the impact of litigation on society and by championing common sense legal reforms at the state, federal and global levels. Since its founding in 1998, ILR has worked diligently to limit the incidence of litigation abuse and has participated actively in legal reform efforts in the United States, the European Union, Asia-Pacific, Hong Kong and elsewhere.

I. Introduction

The U.S. Chamber Institute for Legal Reform ("ILR") is pleased to submit the following comments in response to the Consultation Paper on Third Party Funding for Arbitration issued by the Third Party Funding for Arbitration Sub-Committee of the Law Reform Commission of Hong Kong ("the Commission"). ILR has consistently expressed concern about the unfettered use of third party financing ("TPF") in litigation and arbitration and has supported the establishment of safeguards to prevent abuses posed by the practice, thereby protecting consumers, defendants and the fair and efficient administration of civil justice in the United States and abroad.

ILR welcomes the apparent consensus in Hong Kong that TPF is not an appropriate element of litigation and appreciates that the Commission is proposing to permit TPF only in arbitration matters, not general litigation. "As a British colony until 1997, Hong Kong derived its laws on maintenance and champerty directly from the English legal tradition," and Hong Kong courts have recently reaffirmed the applicability of those doctrines to litigation matters.[1] However, ILR also recognizes that Hong Kong courts have begun to exempt international and domestic arbitration matters from the broad prohibitions on TPF usage.[2] Further, some legal commentators have remarked that "the use of third-party funding in major arbitration cases is a development that is here to stay."[3] As the Commission considers the prospect of TPF in arbitration matters, it should proceed judiciously, recognizing that some of the concerns and challenges inherent in TPF with respect to litigated cases apply with equal force to TPF in the arbitration arena. Most notably, TPF in arbitration diminishes client control over arbitrated claims; threatens the independence of the legal profession; and creates conflicts of interest.

Because these concerns are not just limited to TPF in litigated cases, ILR urges the adoption of common-sense regulation of TPF in the arbitration context as well. In particular, ILR, which has studied TPF and its effects in jurisdictions throughout the world, believes that reasonable disclosure requirements and provisions barring funders from exercising control over arbitration proceedings would go a long way towards mitigating the abuses posed by TPF.

II. Who We Are

ILR is a not-for-profit public-advocacy organization affiliated with the U.S. Chamber of Commerce, the world's largest business federation, representing the interests of more than three million businesses of all sizes and sectors, as well as state and local chambers and industry associations. ILR's mission is to ensure a simple, efficient and fair legal system. Since ILR's founding in 1998, it has worked diligently to limit litigation abuse in courts around the world and actively participated in legal reform efforts in the United States and abroad.

As part of its core mission, ILR has studied the effects of TPF for several years. It has sponsored a number of non-partisan symposia and conferences attended by members of the plaintiffs' and defense bars, the TPF industry and academia. ILR has supported the publication of articles on the effects of TPF in the United States, Europe, the United Kingdom, Australia, and Canada, and its

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[1] Lisa Bench Nieuwveld & Victoria Shannon, Third-Party Funding in International Arbitration, at 226 (2012), *available at* http://www.kluwerarbitration.com/CommonUI/book-toc.aspx?book=TOC+Nieuwveld_2012.

[2] *Id.*

[3] Jean E. Kalicki, *Third-Party Funding in Arbitration, Innovations and Limits in Self-Regulation (Part 2 of 2)*, KLUWER ARB.BLOG (Mar. 14, 2012), http://kluwerarbitrationblog.com/2012/03/14/third-party-funding-in-arbitration-innovations-and-limits-in-self-regulation-part-2-of-2/; *see also* Jennifer A. Trusz, *Full Disclosure? Conflicts of Interest Arising from Third-Party Funding in International Commercial Arbitration*, 101 Geo. L.J. 1649, 1658 (2013) (noting that the "prevalence" of third-party funding in commercial arbitration "can only be growing").

representatives are invited frequently to speak about TPF before law schools, trade associations, and bar associations. ILR has also engaged in public advocacy before the legislatures of several states in the United States, the United States Congress, the national governments of a number of European and Asian-Pacific countries, and the European Commission related to protecting the administration of civil justice from the harms caused by TPF.

Because many of ILR's members have substantial business activities in Hong Kong, ILR is deeply interested in the orderly administration of justice in the Hong Kong market and in the evolution of its legal regimes. In addition, because Hong Kong is regarded as one of the five most preferred and widely used arbitral seats for international arbitration,[4] the development of TPF in Hong Kong arbitration proceedings will undoubtedly have a global impact. ILR joins the debate over the future of TPF in Hong Kong to ensure that the interests of its constituents – from the largest multinationals to the smallest mom-and-pop stores, to the countless employees, shareholders, and consumers who rely upon them – will be adequately heard.

III. <u>Concerns Raised By TPF In Arbitration</u>

a. TPF Weakens Claimant Control Over Arbitrated Claims

TPF arrangements threaten to undercut a claimant's control over his or her own claim in arbitration because TPF companies inherently desire to protect their investment and will therefore seek to exert control over strategic decisions throughout the arbitration proceedings. This is troubling because it reduces an arbitral system designed to resolve claims on their merits to a system effectively controlled by third parties interested solely in profit. Moreover, this process robs claimants of their autonomy. A TPF company will prosecute a case in pursuit of its own interest in profits, even if the interests of the claimant in vindicating his or her claims diverge. One observer has suggested that in a TPF-funded case, "clients may have to relinquish some decision-making authority to the funder" and that "the client's interests may diverge from the funder."[5] TPF funders make no secret of their interest in protecting their investments by influencing cases. A principal of the now-defunct BlackRobe Capital Partners, LLC, was quoted as saying his firm would take a "'pro-active' role in lawsuits."[6] Bentham IMF's "best practices" guide to TPF underscores this dynamic as well. Specifically, it notes the importance of setting forth specific terms in funding agreements that address the extent to which

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[4] *2015 International Arbitration Survey: Improvements and Innovations in International Arbitration*, White & Case, at 2.

[5] Timothy Hart, Vice President, Accounting & Financial Consulting for Huron Consulting Group, *quoted in* Anne Urda, *Legal Funding Gains Steam But Doubts Linger*, Law360 (Aug. 27, 2008).

[6] Nate Raymond, *Sean Coffey Launches New Litigation Finance Firm with Juridica Co-Founder, Vows to Move Beyond 'Litigation Funding 1.0,'* The American Lawyer (June 17, 2011).

the TPF investor is permitted to "manage the Claimant's litigation expenses"; "receive notice of and provide input on any settlement and/or offer, and any response"; and participate in settlement decisions.[7] And realistically, if a party's lawyer is being paid by the investor, it will be difficult to resist that pressure, whether in the context of litigation or arbitration. The same would be true in cases where a TPF funder retains an ownership or membership interest in the law firm that is representing the party to the litigation or arbitration proceeding. Even when the TPF provider's efforts to control a party's case are not overt, the existence of TPF naturally subordinates the party's own interests in the resolution of the matter to the interests of the TPF investor.

Similarly, because the TPF provider is the one funding the claims in arbitration and paying the lawyer's fees, there is a serious risk that the lawyer will feel more beholden to the funder than the client, leading to conflicting loyalties and diminished professional independence. TPF arrangements thus risk placing the power to make strategic decisions about an arbitrated matter in the hands of the TPF company, whose duties are to its investors – instead of the lawyer, whose duties are to the client. In addition, since both TPF companies and lawyers are repeat players in the arbitration market, it can be expected that relationships among them will develop over time, under which lawyers will steer clients to favored TPF companies, even if the client's particular circumstances suggest a different firm may be more appropriate, and vice versa.[8]

These are not idle concerns. For example, in 2006, the Australian High Court issued two companion cases in which it approved of TPF "with the funder having ***broad*** powers to control the litigation."[9] In one of the cases, the third-party funder "actively searched for and propositioned potential plaintiffs in the case."[10] The funding agreement authorized the TPF provider to "conduct representative proceedings, choose the attorney (who regarded the funder as its client), and settle with the defendant for seventy-five percent of the amount claimed."[11] The Australian High Court endorsed the agreement, emphasizing the "need to have some measure of control over the litigation."[12] Decisions like the one described above will only perpetuate a cycle of TPF whereby funders seek to dominate the progression of litigation and arbitration.

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[7] Bentham IMF, Code of Best Practices (Jan. 2014).

[8] *See* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 Minn. L. Rev. 1268, 1309 (2011) ("Given the highly centralized and exclusive nature of the International Arbitration Bar, agency problems between the client, on the one hand, and the funders and attorney, on the other, may pose particular challenges as the funder-attorney relationships are likely to often become a repeat-play relationship.").

[9] *Id.* at 1279 (emphasis added) (citing *Campbells Cash and Carry Pty. Ltd. v. Fostif Pty. Ltd.* and *Mobil Oil Australia Pty. Ltd. v. Trendlen Pty. Ltd.*).

[10] *Id.*

[11] *Id.* at 1279-80.

[12] *Id.* at 1280 (citing *Fostif*, 229 CLR at 435-36).

Defendants are harmed by the shift in control as well, because funders typically shroud their investments in a "veil of secrecy."[13] This lack of transparency was on full display in class action litigation being mounted by the Australia-based law firm of Maurice Blackburn on behalf of more than 500 horse owners, businesses and clubs against Australia over a 2007 outbreak of equine influenza that harmed the horse-racing industry.[14] All of the money initially funding the case came "directly or indirectly" from entities controlled by Hong Kong-based businessman Brendan Terrill, including Mr. Terrill's Cayman Islands-registered Centaur Litigation, which was being run from the Hong Kong office of another of his companies, Buttonwood Legal Capital.[15] The actual source of these funds has remained a mystery because the "[d]etails of Cayman Island companies are normally kept secret."[16] Allegations by OffshoreAlert that Centaur is a Ponzi scheme ultimately prompted Blackburn to obtain alternative financing for the equine influenza litigation.[17]

The "veil of secrecy" illustrated above is just as much a problem in the arbitration context as it is in the litigation context. After all, TPF funders in the arbitration context frequently rely on confidentiality agreements to avoid disclosing their existence and other related information.[18] As a result, a company defending against an arbitrated claim may not even realize who is guiding arbitration strategy and decisions on the other side, making it difficult to defend itself fairly.

b. TPF Diminishes The Independence Of The Legal Profession And Creates Conflicts Of Interest

From the beginning, the legal profession has been unlike other businesses. It is a tightly regulated profession whose practitioners are highly trained, must take an oath before practicing, and are bound by rules of ethics. Obviously, lawyers earn money practicing law, but their chief goal is (and should be) the zealous representation of their clients and the advancement of their clients' interests. TPF providers have no such regulatory or ethical constraints.

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13 Roger Parloff, *Have You Got a Piece of this Lawsuit? The Bitter Environmental Suit against Chevron in Ecuador Opens a Window on a Troubling New Business: Speculating in Court Cases*, *Fortune*, June 13, 2011, http://fortune.com/2011/06/28/have-you-got-a-piece-of-this-lawsuit-2/.

14 *See* Ben Butler, *Ponzi Scheme Claims Against Litigation Funder of Equine Class Action*, The Sydney Morning Herald, Feb. 22, 2014, http://www.smh.com.au/business/ponzi-scheme-claims-against-litigation-funder-of-equine-class-action-20140221-337my.html.

15 *Id.*

16 *Id.*

17 Ben Butler, *Alleged Cayman Island Ponzi Scheme Centaur Litigation To Wind Up*, Cayman iNews, May 27, 2014, http://www.ieyenews.com/wordpress/alleged-cayman-island-ponzi-scheme-centaur-litigation-to-wind-up/.

18 Nieuwveld & Shannon, *supra* note 1, at 64-65.

In contrast, on a fundamental level, TPF is an ethical morass. Current ethical rules do not directly speak to TPF because it fundamentally changes the nature of traditional dispute resolution. Legal ethics contemplate a system that is designed to resolve disputes between parties. TPF drops a stranger into the lawsuit whose goal is to make money from the parties' disagreement. While conflicts of interest and other ethical dilemmas are particularly acute in the context of third-party funding of ***litigation***, these challenges are also palpable in the context of ***arbitration***. As one recent scholarly article explains in the context of TPF, "[l]itigation and arbitration are inextricably intertwined."[19] Indeed, third-party funding of either form of dispute resolution can lead to imbalances of power and incentives for collusion – i.e., funder-lawyer collusion against the client's interests, or funder-client collusion against the lawyer's obligations.[20] Such imbalances have the potential to "disadvantage other actors and threaten the integrity of our worldwide system of dispute resolution."[21]

International commercial arbitration between a U.S.-based company called S&T Oil Equipment & Machinery Ltd. and the Romanian government is illustrative. S&T had sought financing for its case from Juridica Investments Limited, one of the largest international funders of litigation and arbitrated matters. Under the investment agreement, Juridica paid some legal fees for S&T in exchange for a percentage of arbitration proceeds. The funding arrangement entered into between S&T and Juridica specifically provided that Juridica was to be provided access to "all confidential information, including attorney-client and work product documents[.]"[22] After Juridica withdrew funding, causing S&T's case to collapse, S&T filed a sealed lawsuit against Juridica in federal court in the United States, alleging that S&T's own lawyers had begun seeking legal advice from Juridica after Juridica began paying their fees, and that Juridica required the lawyers to share their legal strategy for the arbitration, along with factual and legal developments in the case.[23] S&T further alleged that the TPF agreement violated the attorney-client privilege and that Juridica intended to use S&T's attorney-client and other privileged information against the latter in subsequent proceedings.[24]

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[19] Victoria A. Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 Cardozo L. Rev. 861, 887 (2015).

[20] *Id.* at 866.

[21] *Id.*

[22] B.M. Cremades, Jr., *Third Party Litigation Funding: Investing in Arbitration, Transnational Dispute Management*, Vol. 8, Issue 4 (Oct. 2011), at 27.

[23] *Id.* at 25-33, 27 n.105 (citing *S&T Oil Equip. & Mach. Ltd. v. Juridica Invs. Ltd.*, No. H-11-0542 (S.D. Tex. Feb. 14, 2011), sealed complaint, ¶¶ 29, 30).

[24] *Id.*

The suit was ultimately dismissed, and S&T was unable to revive it in an appeal to the U.S. Court of Appeals for the Fifth Circuit.[25] "[D]espite Juridica's efforts to keep many of the documents in the case under seal because they purportedly reveal trade secrets, S&T . . . managed to expose key details of its relationship with Juridica and King & Spalding," the law firm that initially represented the company.[26] "And that may be the most important legacy of the S&T spat with its erstwhile investor."[27] Maya Steinitz, an associate-in-law at U.S.-based Columbia Law School and expert on third-party funding, previously commented that S&T's "'allegations implicate the potential conflicts of interest that arise once lawyers have a relationship—indeed may be accountable to—an investment firm as well as to their clients.'"[28]

TPF in arbitration also raises the specter of conflicts of interest between the arbitrator and the parties to the arbitration. Although international rules governing arbitration "require an arbitrator be independent and to disclose any conflicts of interest, an arbitrator may not know that he has been indirectly appointed by the same third-party funder in multiple arbitrations."[29] "If the arbitrator does not know that a claimholder receives funding from a third party, he may not disclose his holdings in the third-party funding corporation or his law firm's involvement in cases funded by such corporations."[30] These conflicts of interest seldom come to light in arbitration given its "confidential nature."[31] But anecdotes involving similar types of conflicts in litigated cases have been publicized and are instructive.

One such example arose during a racketeering suit in the United States arising out of misconduct by Steven Donziger, who had helped secure an $18.2 billion judgment against Chevron Corporation on behalf of Ecuadorians allegedly harmed by the company's drilling practices.[32] During a deposition in that proceeding, Donziger was asked to identify the company that had helped finance the underlying suit against Chevron.[33] Upon being ordered to answer the question by the special master assigned to the case, Donziger disclosed that the funder was in fact Burford Capital.[34] The special master then disclosed that he was former co-

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[25] *S & T Oil Equip. & Mach., Ltd. v. Juridica Invs., Ltd.*, 456 F. App'x 481 (5th Cir. 2012).

[26] Nate Raymond, *New Suit Against Juridica Exposes Cracks in Litigation Funding Model*, The American Lawyer (Mar. 14, 2011).

[27] *Id.*

[28] *Id.*

[29] Trusz, *supra* note 3, at 1652.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.* at 1650.

[34] *Id.*

counsel with the founder of Burford, who at one time sent the special master a brochure about funding one of Burford's cases.[35] The special master also disclosed that he was friends with Burford's former general counsel.[36] The special master did not recuse himself from the racketeering litigation;[37] however, the example highlights the possibility of serious conflicts of interest between the various players in any form of dispute resolution, including arbitration. Indeed, "[a]ll signs . . . indicate that conflicts of interest are arising with greater frequency in the arbitral process due to the growth of the third-party funding industry."[38]

IV. What Can Be Done

In light of the dangers summarized above, any embrace of TPF in the arbitration context should be accompanied by concrete safeguards to protect the interests of both consumers and businesses who are parties to arbitration proceedings in Hong Kong. Specifically, any change in Hong Kong law authorizing the use of TPF in arbitration should include a robust disclosure requirement, as well as provisions prohibiting the exercise of control over arbitration proceedings by funders.

a. Disclosure Of TPF Arrangements

The starting point for any meaningful regulation of TPF in the arbitration setting is disclosure. Indeed, "[a] key distinction between funding in litigation cases versus arbitration cases is that the funding agreement may play a larger role (with its corresponding confidentiality provision) in arbitration than in litigation."[39] If third-party funding is to be part of Hong Kong's legal system at all, its use should be transparent. As such, whenever a third party invests in a claim in arbitration, the arbitrator(s) and the parties involved in the matter should be so advised. Notably, disclosure of TPF arrangements has received widespread support among members of the international arbitration bar. According to a 2015 international arbitration survey, 76% of respondents supported the disclosure of the use of third-party funding, and 63% of respondents supported the disclosure of the identity of the funder in arbitration proceedings.[40] This widespread support for disclosure should come as no surprise, as it serves multiple important purposes.

By identifying persons/entities with a stake in the outcome of an arbitration proceeding, the contemplated disclosures would allow arbitrators and counsel to

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.* at 1651.

[39] *See* Nieuwveld & Shannon, *supra* note 1, at 65.

[40] *2015 International Arbitration Survey, supra* note 4, at 48.

ensure compliance with ethical obligations. Many third-party funders are either publicly traded companies or companies supported by investment funds whose individual shareholders may include arbitrators. Thus, without disclosure of TPF, an arbitrator may unwittingly sit in judgment of a claim in which he or she has a financial interest, a scenario that creates an appearance of impropriety and may violate applicable ethics rules.[41] Further, counsel in the case may have investment or representational ties to a funding entity that they may need to disclose to their clients, consistent with their obligations to zealously represent those clients. For example, if a defendant's counsel is a shareholder in an entity that may profit from a claimant's victory in the arbitration, that counsel would need to appropriately address that conflict with his/her client. A requirement that TPF arrangements be disclosed at the outset of an arbitration, including the identity of the funder, would thus aid in the identification of potential ethical issues and thereby protect the integrity of arbitration proceedings.

Disclosure of TPF arrangements in arbitration would also guard against the erosion of a claimant's control over his or her claim throughout the arbitration proceeding. As previously discussed, third-party funders seek to control their investments by managing strategic decisions in arbitrations they finance. As a result, TPF undermines the bedrock principle that the parties to an arbitration proceeding have the ultimate decision-making authority with respect to that proceeding. By shining much-needed light on TPF arrangements in arbitration, funders will be less likely to meddle in these key decisions, thereby preserving the sacrosanct relationships between clients and their counsel.

b. Prohibiting Funder Control Over Arbitration Proceedings

Any change in Hong Kong law authorizing TPF in arbitration proceedings should simultaneously prohibit any attempt by TPF investors to control the arbitration they are financing. All decisions must be made independently by the claimant, with the advice of his or her lawyer, consistent with governing ethics rules. The interests of TPF investors are not necessarily aligned with those of the claimants. TPF investors' incentives are to maximize the amount of their recovery, even at the expense of the claimant's wishes. A provision expressly proscribing funders' control over the strategic decisions made in an arbitration proceeding will mitigate one of the core dangers posed by third-party funding of arbitration.

In addition to an outright bar on the exercise of control by funders, the Commission should adopt measures that guard against funders' indirect influence on arbitration proceedings. To this end, Hong Kong law should provide that TPF companies may not be owned by law firms or have membership interests in law firms. There is a substantial risk that non-lawyer owners of firms would focus only

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[41] *See* Nieuwveld & Shannon, *supra* note 1, at 65 ("With arbitration the likely reason to require disclosure may be limited to potential conflict of interests with an arbitrator.").

on their own profit and not on client interests or the advancement of the legal profession (of which they are not a part) and attempt to dominate arbitrated matters in which their law firms are involved. For similar reasons, non-lawyer involvement in law firm management would threaten to dilute the role of the client in the Hong Kong legal system because lawyers may feel pulled by the interests of influential investors more than the interests of their clients.

V. Conclusion

ILR understands the impetus for recommending the adoption of TPF in arbitration in Hong Kong – namely, the desire to keep Hong Kong competitive as a major international financial and arbitration center. However, ILR does wish to emphasize that TPF poses serious concerns and challenges even when limited to arbitration, including the erosion of a party's control over the conduct of an arbitral proceeding and conflicts of interest between the parties thereto. In light of these significant problems, the Commission should ensure that any amendment to Hong Kong law allowing TPF in arbitration is accompanied by provisions that require the disclosure of TPF at the outset of an arbitration proceeding. In addition, Hong Kong law should expressly prohibit funder control over arbitrated matters, and should preclude any circumvention of this provision by barring TPF companies from owning law firms and vice versa.

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