The Duty of Disclosure and Conflicts of Interest of TPF in Arbitration

Kluwer Arbitration Blog
December 23, 2017

Napoleão Casado Filho (Clasen, Caribé & Casado Filho Sociedade de Advogados)

Please refer tot his post as: Napoleão Casado Filho, 'The Duty of Disclosure and Conflicts of Interest of TPF in Arbitration', Kluwer Arbitration Blog, December 23 2017, http://arbitrationblog.kluwerarbitration.com/2017/12/23/duty-disclosure-conflicts-interest-tpf-arbitration/

Arbitration, especially in its international perspective, has experienced such a tremendous growth in the past few decades that it has now become a victim of its own success. Current debates are centered on the prohibitive costs, the difficulty in finding high-level arbitrators and conflicts of interests often exclusive to relatively diminished groups, demonstrating that themes once considered to be "hot topics", such as the separability of the arbitration agreement and competence-competence, are now slightly relegated to the past.

One of such controversial circumstances is the recent interest that arbitration has piqued in investors, who have suddenly found the frequently elevated costs of arbitral proceedings and the millionaire awards thereof to be an investment opportunity. It is the so-called Third-Party Funding, a phenomenon that was born in Australia, spread throughout Common Law jurisdictions and is today commonplace in countries that had never once imagined it, such as France, Brazil and Peru.

Wherein there is money, therein interests lie. It should come as no surprise that a desire for regulation has likewise surged. As soon as the topic gained relevance in 2014, the ICCA (International Council for Commercial Arbitration), alongside the prestigious Queen Mary University of London, created a joint Task Force to study the theme and propose best practices. For that, experts from all corners of the world were assembled. After three long years, an initial Draft was made available for public and professional scrutiny in September 2017.

The initiative warrants praise. Firstly, for assembling many relevant figures to debate a theme that, indeed, deserves attention from the international arbitration community.

Secondly, because the Task Force seems genuinely interested in listening to the market and its practitioners, as before publishing the Final Report, it made a preliminary iteration available for public debate. The debate has been intense and last month we had the opportunity to join it in the II Oxford Symposium on Comparative International Commercial Arbitration. The core of the dispute was an a apparent regulatory appetite from the members of the Task Force.

This regulatory appetite must, in our view, be slightly halted, lest we experience increases both in the duration of proceedings and in the costs of funding methods such as Third-Party Funding. If I may elaborate.

One of the Task Force's pressing wishes is to render a general duty to disclose the existence of a third-party funder in any and all arbitral proceedings. On Chapter 4 of the Report, entitled "Disclosure and Conflicts of Interest", the Task Force suggests two options:

[ALTERNATIVE A]: 1. A party should, on its own initiative, disclose the existence of a third-party funding arrangement and the identity of the funder to the arbitrators and an arbitral institution or appointing authority (if any), either as part of its first appearance or submission, or as soon as practicable after funding is provided or an arrangement to provide funding for the arbitration is entered into.

[ALTERNATIVE B]: 1. Arbitrators and arbitral institutions have the authority to, during the selection and appointment process, expressly request that the parties disclose whether they are receiving support from a third-party funder and, if so, the identity of the funder

The qualm seems to be centered on whether arbitrators should be given the power to order the disclosure of an investment or if it falls entirely upon a Party's own will. And yet, under both scenarios, a general and unrestricted duty of disclosure is established, even if an investor has no relation at all with the arbitrators. The ostensible consensus within the arbitral community that "it falls upon the arbitrator to analyze whether or not a conflict of interest exists" is adopted as a premise. In fact, this consensus is enshrined in the Report itself, when it says: "there is a general agreement that disclosure of the identity of a funder is necessary for an arbitrator to undertake analysis of potential conflict of interests". (pg. 78 ICCA-QMUL Report).

Generally, I am cautious of consensus and unanimities. I've had the opportunity of defending, when analyzing the Third-Party Funding phenomenon on a purely academic level, that it would be desirable to have some limits on the duty of disclosure [1]. In that opportunity, I had already defended that a breach of this duty should not amount to a presumed nullity of the arbitral award rendered in proceedings that had been funded, as it should instead be a burden of the party challenging the validity of the award to prove, for example, an effective conflict of interest between the investor and any of the arbitrators or experts.

However, practical experience denotes that even my once-defended extension of the duty of disclosure must be relativized. What we have observed on case-by-case analyses wherein disclosure does in fact occur is the outbreak of extremely complex and unnecessary procedural challenges. Effective due diligence on the investor is thus initiated, entailing devastating effects on arbitral practice itself.

The establishment of a general duty of disclosure, regardless of potential conflicts of interest with the investor, seems to be misguided, as it overlooks the economic consequences of such a duty and fails to foresee the practical effects thereof.

Investment funds have increased their investments in arbitral proceedings. In addition to individual investments, portfolio investments comprising all cases of a given law firm are ever more common, even amongst some of the largest global firms. This is the solution that the arbitral system has found to provide further access to a means of dispute resolution that would otherwise not concern itself with such access.

In creating such a general duty, the cost of compliance will fatally upsurge, forcing parties to disclose, under ALL circumstances and at the very first moment, information that may have been disclosed anyway in a near future, that is, upon enforcing an award that has possibly favored the funded Party.

Another practical consequence will be an increment of notorious "guerrilla tactics", also highly debated and faced by modern arbitration. After all, Respondents are usually the ones to employ these delaying tactics. With the establishment of such an overarching duty, these Parties will be awarded with yet another reason to seek information on the investor, trying to pierce multiple levels of the corporate veil until finding the very individuals backing the investment, as to maximize their procrastinating maneuvers. The result will inevitably be a greater delay in the conclusion of arbitral proceedings.

With longer proceedings and higher expenses for the investor to fulfill a duty of disclosure, an increase in the costs of such investment is certain, as these are upscale from the outset, often reaching ten times the value of the original investment. It is market price. And the market follows a rather clear logic: increase the risks and the costs, and prices shall follow.

Another nefarious consequence of a general duty of third-party investment disclosure is that, in breaching this duty, the Party and the investor are presumed to be tainted by some irregularity, which may make life easier for a losing Respondent seeking to annul the arbitral award.

Therefore, it must be pondered: would it not be the case of rethinking this ostensible consensus that it falls upon the arbitrator to effect a preliminary analysis on whether a conflict of interest exists?

In the context of Third-Party Funding, the Party interested in an enforceable award, not subject to challenges, is precisely the investor. He is fully capable of ascertaining if an arbitrator, in the case that may be invested, has any relation to the Fund itself, its members and relevant parties. This relation may, in fact, render the investment prima facie unfeasible. If any relation exists, it would then seem that a duty of disclosure should be placed upon the Arbitral Tribunal, so that it may analyze the effects of this relation on its independence and impartiality.

Should the funded Party remain silent and the other Party come to know of some ulterior motive behind the funding (for instance, if the funder and an arbitrator are relatives), the consequences are obvious: any award issued in this proceeding would be null and void, for being rendered by one who could not be an arbitrator (art. 32(II) Brazilian Arbitration Act), which would also probably warrant grounds for non-recognition of the award in other jurisdictions, as per art. 5(1)(d) New York Convention.

However, in the absence of any such relation between investor and arbitrators, what would be the reason for disclosure? It seems to be a relevant obstacle that promotes no real protection or safeguard for any of the parties concerned.

It would thus seem that the Task Force should halt its regulatory ambitions and instead adopt a path similar to that of Brazil's leading Arbitral Institution: the CAM-CCBC. Last year, the Center issued a Recommendation on the disclosure of Third-Party Funding, a mere recommendation that is not encompassed by the institution's Procedural Rules. Something that does not oblige ALL Parties (and currently their lawyers) to indistinctly disclose their financial strategies; and yet, should it remain unfulfilled when ulterior motives in fact existed, it shall bolster any ostensible wrongfulness that may amount to the nullity of the arbitral award.

To regulate a market is always a complex task, with potentially terrible consequences. Almost 100 years ago, Lord Keynes stated that "[c]ontemporary experience of trade restrictions in post-war Europe offers manifold examples of ill-conceived impediments on freedom which, designed to improve the favorable balance, had in fact a contrary tendency." May this attempt to regulate a market still in its infancy, that has promoted access to the arbitral system, not be faced with a similar fate.

[1] In this sense, see CASADO FILHO, Napoleão. Acesso à Justiça e Arbitragem: o novo Paradigma do Third Party Funding, São Paulo: Editora Saraiva, 2017 – pg. 211.