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Commentary: French Think Tank Releases Noteworthy Report On Third Party Litigation Funding

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RÉSUMÉ

Cet article présente une vue d'ensemble sommaire du récent rapport préparé par le Club des Juristes sur le financement des litiges par des tiers, un club français de réflexion juridique influent. L'auteur décrit les principales conclusions du rapport, en expliquant dans les grandes lignes les caractéristiques notables de celui-ci et de l'analyse nuancée de droit civil de ce phénomène et de ses implications pour la procédure d'arbitrage qui y est faite. Sur la question clé et controversée de la production de documents cependant, l'auteur se demande si la solution de compromis du rapport, soit la possibilité que les bailleurs de fonds eux-mêmes dépistent les conflits potentiels dans chaque affaire, est appropriée pour protéger l'intégrité de la procédure d'arbitrage international.

ABSTRACT

This article presents a summary overview of the recent report prepared on third party litigation funding by the Club des Juristes*, an influential French legal think tank. The author describes the report's key findings, outlining noteworthy features of the report's nuanced civil law-based analysis of the phenomenon and its implications for arbitral proceedings. On the key and controversial issue of disclosure, however, the author questions whether the report's compromise solution, which envisions the possibility that funders themselves would screen for potential conflicts in each case, is suitable to protect the integrity of international arbitration proceedings.*

In June 2014, an *ad hoc* Commission on Third Party Funding, organized under the auspices of the *Club des Juristes*, an influential French legal think tank (the "CDJ Commission"), released its report on Third Party Litigation Funding. [2] The report represents a noteworthy contribution to current thinking about third party litigation funding.

The Commission's thorough and well-reasoned report will be requisite reading for anyone interested in understanding the implications of third party funding under French law. On the key problem of disclosure, however, the final position adopted by the Commission raises a number of serious questions.

A. Overview of the CDJ Commission Report

In recent years, a body of literature regarding the phenomenon of third party funding and its consequences for international arbitration has developed. [3] The CDJ Commission stands out insofar as it represents what appears to be the first attempt on the part of a group of prominent members of a specific arbitration community, to establish consensus views and policy positions on a number of questions associated with third party funding.

While the CDJ Commission does not claim to speak on behalf of the French arbitration community, its members come from among its leading practitioners, arbitrators and academics, including, as President, a former member of France's *Cour de Cassation*. [4] The CDJ Commission's report is therefore, unsurprisingly, nuanced and persuasive in its analysis of the complexities that surround third party litigation funding. [5]

1. Problems of French Substantive Law and Ethics Addressed

Reflecting the civil law background of its authors, the report begins by asking how the third party funding relationship should be characterized under French law.

After considering a number of possibilities, including the *société en participation* and *société créée de fait*, *de facto* companies that resemble the "silent partnership" (*Stille Beteiligung*) characterization that has been adopted by certain German courts, [6] the authors conclude that the funding relationship does not fall into any existing form of

contractual relationship recognized under French civil law. Instead, the authors conclude that the funding relationship should be understood as a form of "*contrat composite*" (composite contract), which brings together elements of different services associated with existing forms of contract under French civil law. [7]

While the problem of characterization may appear somewhat theoretical to the common law lawyer, it is one that carries potentially far-reaching consequences under French law. By way of example, the possibility of characterizing the funder as a member of a *de facto* company or partnership with the funded party, if deemed correct by a court or an arbitral tribunal applying French law, could give rise to arguments that the true party to the proceeding is the corporate venture between the nominal claimant and the funder. If this were accepted, arguments could be made that the two members of the venture should be deemed parties to the arbitration, with all the attendant consequences.

After discussing characterization and certain regulatory questions related to third party funding, the report considers a number of the ethical issues associated with funding, approaching them from the vantage point of French rules of *déontologie* (professional ethics). This discussion offers a distinctly civilian perspective in a discussion which has hitherto been dominated by common law ethical principles. At the outset, the report recalls the fact that only *avocats* are authorized to give legal advice in France. Thus, funders will need to refrain from offering any form of guidance in France that could be construed as legal in nature, a restriction which could raise complications for funders seeking to share views on strategic questions that may be informed by their own legal analysis.

The report then turns to the important issue of *secret professionnel* (professional secrecy/confidentiality), which is a rule of public policy in France, breaches of which may carry criminal sanctions. Whereas the sharing of privileged information with third party funders in common law jurisdictions raises concerns as to the preservation of attorney-client privilege, the preoccupation in France, with its arguably more protective regime of *secret professionnel*, [8] is directed toward restrictions on the ability of the *avocat* to communicate with the funder, even if authorized to do so by the funded party. Thus, international lawyers involved in providing advice to a party based in France, which is in receipt of funding for an arbitration, would be well advised to take guidance from French counsel as to how appropriately, if at all, to communicate with the party's funders regarding the dispute.

The CDJ Commission also addresses conflicts of interest, emphasizing the need for the *avocat* to keep in mind at all times that his client's interests, and not necessarily those of the funder, are the only ones that he is authorized to defend. Finally, the Commission asks whether the funding relationship can be analogized to the *pacte de quota litis* (pure contingency fee arrangement), which is prohibited in France in relation to domestic court and domestic arbitration proceedings. The authors conclude that the relevant proscription against pure contingency fee arrangements should not apply. [9]

2. Specific Problems of Arbitration Law Considered

Having addressed matters of French civil and regulatory law, the CDJ Commission considers the procedural ramifications of the use of third party funding in international arbitration. The core question addressed in the Commissions' report is whether any form of disclosure obligation does or should exist in relation to third party funding under French law and, if so, how it should be structured. [10]

B. The CDJ Commission's Position on Disclosure

1. The Problem of Disclosure

The question of whether parties in receipt of funding have an obligation to disclose such funding when initiating or defending an international arbitration is one which has given rise to debate. The importance of this issue is tied to the serious problems that can result from the non-disclosure of funding relationships. These include, but are not limited to, the risk of disruption from late-stage arbitrator challenges and, under French law, the risk that an arbitral award procured without the appropriate disclosures having taken place could be subject to annulment, if it transpires that there is an actual or potential conflict of interest with an arbitrator.

Debate on the question of whether third party funding must be disclosed tends to be heated because the risks associated with non-disclosure need to be balanced against the increased costs that would likely result from requiring systematic disclosure. As critics of disclosure observe, requiring automatic disclosure in all cases could lead to increased procedural incidents related to funding, such as requests for further disclosure related to the terms of funding, arbitrator challenges and applications for security for costs. If the risk materialized, this would increase costs and delay, something most wish to avoid. An additional concern, which is embraced by the CDJ Commission,

is based upon the view that a company's decision to take funding is one that could be considered to be confidential in nature. Striking the right balance between these competing concerns is not a simple task.

Under prevailing principles of French law related to conflicts of interest, an arbitrator must disclose any direct or indirect relationship which could give rise to reasonable doubts as to that arbitrator's independence or impartiality. An arbitrator has a duty to behave diligently in identifying potential conflicts of which he might not have actual knowledge, but of which he should be aware.

It is clear under French legal norms that certain of the relationships that can and do exist between arbitrators and funders could give rise to disclosure obligations on the part of the arbitrator. These would arguably include, by way of example, cases in which the funder is funding another claim, handled by the arbitrator or the arbitrator's law firm. However, since there is no regime under French law specifically requiring the disclosure of third party funding, such contacts will often remain undisclosed and undetected during all or part of the arbitral proceeding. This is problematic because, unless and until the presence of the funder is revealed, the arbitrator will be unable to consider whether he has an obligation to disclose any relationship with the funder.

If disclosure should occur after the arbitration is already underway, the result may be recusal or disqualification and the need for the repetition of certain parts of the arbitral procedure by a newly constituted tribunal. Where disclosure occurs only after the arbitration has concluded, the validity of the award may be called into question if it can be shown that the relationship between arbitrator and funder would give rise to reasonable doubts as to the arbitrator's independence or impartiality. Thus, the CDJ Commission finds that there is an element of risk inherent in the evolving role of third party funding in international arbitration (at least, from the vantage point of the French *lex arbitri*).

2. The CDJ Commission's Proposed Solution for Structuring Disclosure

Under French law, one obstacle that stands in the way of the full disclosure of problematic indirect conflicts is the fact that the obligation to disclose potential conflicts of interest rests exclusively with the arbitrator. Since, as noted above, an arbitrator will not usually know whether a party is being funded, let alone the identity of the funder behind the claim, the question becomes whether the party receiving funding has a legal obligation to reveal its funding to the arbitrator.

To resolve this question, the CDJ Commission looks to the duty of *loyauté* (which can be translated as the duty to act fairly), which is recognized under and has been formally codified into French arbitration law.[11] The CDJ Commission reasons that the duty of *loyauté*, which is derived from the principle of good faith, requires the parties to bring to the attention of an arbitrator all information necessary to enable that arbitrator to perform his obligations effectively, including the arbitrator's duty to disclose relationships with third party funders that could give rise to reasonable doubt as to the arbitrator's independence or impartiality.

However, since the party receiving funding usually cannot know if its funder has a relationship with the relevant arbitrator, the CDJ Commission argues that there are two basic alternatives for ensuring that the arbitrator will receive the information he needs. The first, and most obvious, would be to require any party receiving funding to disclose this fact to the arbitrator, who could then decide if he should disclose any existing relationship with the relevant funder. The second proposes that the duty to check for potential conflicts could be placed, in the first instance, with the funder itself.

Under the second approach, it would only be in the event that the funder were to identify a relationship with an arbitrator, that the party would need to evaluate whether that relationship should be identified to enable the arbitrator to evaluate his own disclosure obligations. The CDJ Commission argues that funders will have an interest in performing the relevant conflicts check diligently, since they have no interest in seeing awards undermined, and suggests that funding contracts could be encouraged (for example, under best practice guidelines), to contain provisions imposing a legal duty upon the funder to perform the conflict screening function.

3. Desirability of the Funder-Based Screening Solution

The CDJ Commission has taken an important step in affirming the existence of a good faith duty on the part of the funded party to inform the arbitrator of the identity of its funder, where such information is necessary to enable the arbitrator to fulfill his disclosure obligations. This view would no doubt resonate in many other civil legal systems and find support in broader principles of good faith. However, it is fair to question whether allocating the conflicts screening function to the third party funder, at least in the first instance, represents a desirable approach to the structuring of disclosure.

First, while many funders will no doubt perform the screening function diligently, the CDJ Commission's assumption that this will usually be the case, is open to debate. The need for reticence in this regard is seen in recent controversies in the London market and the related cries for enhanced self-regulation by reputable members of the funding industry there. [12] The potential for mischief in this setting is real. For example, an unscrupulous funder might very well wish to conceal potential conflicts in the hope of keeping its preferred arbitrator in place or of avoiding the substantial and immediate additional legal costs that can be associated with the need to replace an arbitrator. Thus, if the goal is to create an effective risk-mitigating regime for disclosure, it is questionable whether outsourcing conflicts screening to the third party funder will work.

Second, if the goal is to create a system that conforms to the requirements of good faith that are imposed upon the parties to the arbitral proceeding under French law, one wonders whether this can be realized by an approach that would place the integrity of disclosure – in the first instance – in the hands of a third party with no legal duties to the opposing party or the arbitral tribunal. While funders who do not perform their screening obligations correctly could, in theory, face claims (whether under contract or in tort) or risk seeing their investment undermined, the deterrence created by these threats will vary widely.

As the increased calls on the London market for enhanced capital adequacy requirements suggest, many funders are undercapitalized. Thus, faced with an obvious conflict, the unscrupulous controllers of a thinly-capitalized, off-shore funder might decide not to reveal the existence of a relationship with the arbitrator, believing that the existence of a conflict will never be detected and knowing that, even if detected, it will be very difficult for any aggrieved party to recover against the controllers' assets. It is therefore fair to ask whether the funder-based screening process envisioned by the CDJ Commission will be sufficiently protective of the needs of the opposing parties and arbitrators to fulfill the funded party's duty of *loyauté*. The most reasonable means for the funded party to fulfill its duty of *loyauté* toward the arbitrator would be to reveal the identity of its funder. This would allow the opposing party to raise questions and the arbitrator to make any necessary disclosures.

The CDJ Commission agrees that systematic disclosure would be the most effective approach for eliminating the risk of undisclosed conflicts, but suggests that a systematic disclosure requirement could strike the wrong balance between the funded party's interest in keeping the fact of its funding confidential and the potential need for disclosure. However, even if there were a theoretical interest in preserving the confidentiality of the funding relationship (the Commission never really explains the basis for or contours of its apparent view that such an interest exists under French law), parties accepting funding necessarily do so subject to their obligation to behave in good faith when participating in an arbitral proceeding. If requiring the party to disclose its use of funding is the most reasonable means of protecting the integrity of the arbitration, it is not clear why the funded party should expect to be able to conceal this information as a putative business secret. Likewise, while the CDJ Commission fears the additional costs that could result from systematic disclosure of funding (in the form of procedural incidents), it is not clear that such costs would be greater than the costs of non-disclosure or inadequate disclosure, which could be far greater and include annulment.

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As noted above, the Commission's final policy statement on the issue of disclosure offers two options, either systematic, party-based disclosure or the funder-based screening approach. The Commission's final statement presents this recommendation as a "compromise solution". As anyone familiar with the views of the Commission's membership will realize, it is not surprising that the Commission was unable to endorse one specific approach on the divisive question of disclosure.

While the funder-based approach suggested by the Commission is novel, only time will tell whether it is one that the arbitration community will be prepared to accept. For the reasons explained above, there is reason to question whether such an approach will be sufficiently protective of the integrity of arbitral proceedings and as to whether it will ultimately be the most efficient one. The extent to which third party funding grows as a source for financing for arbitration proceedings will likely have an impact on the arbitration community's perception of its options in this context, with the perceived need for systematic disclosure likely to increase should funding become more common over time. [13]

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1 1. These comments reflect the views of the author alone and should not be construed as representing those of the law firm with which he is affiliated or its clients.

2 2. The report, which is dated June 2014, may be found at www.leclubdesjuristes.fr

3 3. The reader is referred to the CDJ Commission report, which is thorough in its presentation and discussion of existing views on this subject.

4 4. The CDJ Commission membership was as follows: Jean-Pierre Ancel (President), Philippe Pinsolle and Maximin de Fontmichel (Rapporteurs), Louis d'Avout, Jean-Georges Betto, Thomas Clay, Louis Degos, Jean-Yves Garaud, Jean-Pierre Grandjean, Marc Henry, Emmanuel Jeuland, Laurent Levy (a Swiss national).

5 5. Certain aspects of the Commission's analysis which are less essential from the perspective of arbitral procedure have been omitted from this summary overview. They include issues such as the regulatory status of third party funding under French banking law (the Commission concludes that funding should not be considered as falling under the relevant regulatory regime) and analysis of certain potentially problematic clauses in funding contracts, such as provisions granting excessive control to the funder.

6 6. The one French court to have formally characterized a third party funding contract was required to consider the status of the contract under German law since the relevant instrument was subject to German law. *See CA Versailles, 1st June 2006, Sté Véolia Propreté c/ Foris AG*. The Versailles Court of Appeals observed that the funding contract is characterized as a form of *de facto* company under German law, but that it is unknown and *sui generis* from the perspective of French law. The CDJ Commission rejects this characterization on the grounds that the funder and funded company will generally lack the *affectio societatis* (a subjective criterion based upon the will to associate), which is requisite to form a company under French law.

7 7. Additional characterizations considered but rejected are the following: *jeu et pari*, *assurance*, *prêt* and *cession de créance* (gaming or wagering, insurance, loan and assignment of debt).

8 8. The regime is arguably more protective in the sense that, unlike in common law jurisdictions, there is no rule of waiver whereby the protection, once attached, may be lost. Thus, if a party seeking funding structures its communications regarding its case with the funder strictly through *avocats* as intermediaries, *secret professionnel* should attach and it should not be possible for a third party, such as an opposing litigant, to obtain access to the relevant communications.

9 9. The Paris Court of Appeal has held that the prohibition does not apply in relation to international arbitration proceedings. *See CA Paris*, 10 July 1992, *Société International Contractors Group c. Me X, D*.

10 10. The second principal procedural subject addressed is that of the potential impact of third party funding on the nationality of investors claiming protection under investment treaties. On the question of nationality, the CDJ Commission proposes that arbitral tribunals verify, for purposes of determining jurisdiction, whether an assignment of the litigation claim has taken place between any party receiving funding and its funder. Because the subject of disclosure is of general interest for all forms of international arbitration and is clearly the more controversial of the two subjects addressed, this commentary focuses on disclosure.

11 11. *See Article 1464, paragraph 3* of the French Code of Civil Procedure *(« Les parties et les arbitres agissent avec célérité et loyauté dans la conduite de la procédure. »*).

12 12. *See* e.g. K. Beioley, "Litigation Funding: Cutting up rough", *The Lawyer*, Feb. 17, 2014.

13 13. Interestingly, funders are not necessarily opposed in principle to disclosure. *See e.g.* A. Goldsmith, M. Scherer, C. Fléchet, "Third Party Funding in International Arbitration in Europe, RDAI/IBLJ Roundtable 2012", *Revue de Droit des Affaires Internationales* No. 2-2012, 217-218. Assuming that disclosure requirements are defined in a reasonable manner that does not unfairly single out professional funders from other sources of support that may be available to parties, disclosure could play a helpful role for the industry's image.