A practitioner's guide to security for costs at the SCC

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Two years after the SCC added a provision on security for costs to its arbitration rules, ***Carl Persson*** *and* ***Bruno Gustafsson*** *of Roschier in Stockholm examine the criteria that tribunals must consider when assessing a request for such relief – and argue the analysis should be guided by international best practices.*

The mechanism of security for costs is gaining territory in international arbitration. In connection with the most recent rule revision in 2017, the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) introduced a provision explicitly recognising security for costs as an available form of provisional relief. The provision, article 38, enables arbitral tribunals to order security for costs subject to a set of specific criteria.

Several requests for security for costs have been filed with SCC tribunals since the introduction of the new provision. So far, SCC tribunals appear to have engaged in a restrictive approach (ie, shown a tendency to reject requests for security for costs). As will be described further below, this approach is consistent with international practice.

The general rule as to security for costs is set out in article 38(1) and stipulates that an arbitral tribunal may only grant security for costs in exceptional circumstances. The applicable criteria to order security for costs are stated in article 38(2) and require the arbitral tribunal to take due consideration to four criteria when assessing a request for security for costs. The four criteria that the arbitral tribunal shall have regard to when assessing a request are the following:

- the prospects of success of the claims, counterclaims and defences;
- the claimant's or counterclaimant's ability to comply with an adverse costs award and the availability of assets for enforcement of an adverse costs award;
- whether it is appropriate in all the circumstances of the case to order one party to provide security; and
- any other relevant circumstances.

This article discusses the criteria in article 38(1) and (2) of the SCC rules in light of international practice and doctrinal developments. The article aims to provide direction to legal counsel as well as arbitrators. It also aims to provide guidance to clients as to

when it may be warranted to submit a request for security for costs. The analysis is limited to arbitration proceedings with an international element.

Before analysing the criteria in depth, we will briefly address the background to article 38 of the SCC Rules and the relevant interpretative framework.

International best practices govern the interpretation of article 38

As is the case with legal interpretation in general, it is first vital to determine the legal framework and sources for arbitrators to rely upon when deciding on security for costs. Although article 38 itself sets out relatively detailed criteria, arbitrators inevitably resort to additional sources of law (ie, "secondary" or "soft" sources of law) for interpretive guidance.

We are of the view that Swedish procedural law should not be a factor in the assessment by SCC tribunals. The purpose of article 38 in the SCC rules was to explicitly permit security for costs orders such as the mechanism has developed in international practice (prior to the 2017 revision of the SCC rules, some legal commentators deemed it uncertain whether arbitral tribunals had the authority to order security for costs under the SCC rules). As stated by **Johan Sidklev**, member of the SCC board and partner at Roschier, "[w]hen an arbitral tribunal in an arbitration under the SCC Rules is confronted with an application for security for costs it can now look to the applicable rules for the relevant criteria for deciding on the request [...] [and] the criteria match international best practice".

Consequently, article 38 of the SCC rules was inspired by the rules and practice of other internationally recognised arbitral institutions such as the ICC and the LCIA, rather than principles of the Swedish Procedural Code governing interim measures in litigation. Notable examples of institutional arbitration rules that include provisions on security for costs include the LCIA's 2014 rules, SIAC's 2016 rules and the HKIAC's 2018 rules.

In sum, our analysis relies on the assumption that the application and interpretation of article 38 should not be guided by Swedish procedural law principles. Thus, we address the general criterion in article 38(1), and each of the four criteria in article 38(2), solely in light of international practice and doctrinal developments.

"Exceptional circumstances": security for costs may only be granted in the rarest of cases

According to article 38(1), security for costs may only be ordered in "exceptional circumstances". International practice and legal commentaries clearly show that this wording was not chosen to be included in the SCC rules by coincidence. On the contrary, it appears that a principal rule of restrictiveness in relation to ordering security for costs has cemented itself as commonplace among both arbitrators and legal commentators.

Indeed, as stated by Herbert Smith Freehills partner **Alastair Henderson**, "international commentators consistently assert that this power should only be exercised in international arbitration rarely or in exceptional circumstances or 'most sparingly'."

Article 38 appears to be aligned with an accepted international standard according to which arbitrators are inclined to reject requests for security for costs. Thus, Vinge partners **James Hope** and **Cecilia Möller Norsted**, who commented shortly after the 2017 SCC rules entered into force, were arguably correct in their prediction that "given the express requirement that such an order may only be made in exceptional circumstances, it is likely that security for costs will only be granted in the rarest of cases."

Arguably, the main reason for the restrictive view on security for costs relates to the imperative nature of security for costs compared to other forms of provisional relief and (perhaps most importantly) the interest of not stifling a genuine and legitimate claim from a party that is lacking sufficient funds. This will be elaborated further upon below when addressing the general appropriateness and other relevant circumstances of security for costs.

Significance of the merits must be viewed in light of the interest of not prejudging the case

The first criterion of article 38(2) sets out that the arbitral tribunal shall have regard to "the prospects of success of the claims, counterclaims and defences" in determining whether to order security for costs.

From a policy perspective, one of the primary reasons that the prospects of success of the claims may constitute a relevant factor in the arbitral tribunal's assessment relates to the interest of averting frivolous claims. This is illustrated, inter alia, by ICC case 12035, in which the tribunal stated that "arbitrators overcome their normal reluctance to grant security for costs only in cases where the Claimant's case is abusive or extravagant".

However, the applicable requirement in article 38(2)(i) should not be interpreted so that the claim of the non-applicant must be frivolous or submitted in bad faith for security for costs to be granted. Rather, the strength of the merits of the case constitutes only one factor of a multi-varied analysis.

In this regard, **Weixia Gu** of the University of Hong Kong has stated that it is "obviously the case that if one party is *highly likely* to succeed or fail in the dispute, that may *be taken into account* in deciding whether security for costs should be granted" (emphasis added).

Consequently, if the applicant is unable to present sufficient evidence in support of the non-applicant's claim being frivolous, this does not necessarily prevent security for costs from being ordered if the applicant's case for security for costs is strong with respect to other aspects, for instance as concerns the non-applicant's ability to comply with an adverse costs award.

Similarly, it is important not to overstate the importance of the merits of the non-applicant's substantive claim considering that the arbitral tribunal's review is *prima facie*. As a request for security for costs is usually submitted at an early stage of the proceedings, the arbitral tribunal will be prevented from making a full assessment of the

merits as that would constitute a prejudgment of the substantive issues submitted to the arbitral tribunal for final resolution.

A *prima facie* assessment of this kind is naturally tainted with considerable uncertainties as to what the final outcome of the case will be. Thus, the risk that the arbitral tribunal prejudges the case when ordering security for costs based on the prospects of success of the claims triggers procedural concerns. As further stated by Gu, there is "a substantial risk in arbitration, in that if the arbitral tribunal considers the merits of the case before the substantive hearing, it may disqualify itself from proceeding further."

On this topic, WilmerHale partner **Gary Born** has stated that it is "doubtful that the likelihood of a party's success on the merits plays a significant role in determining whether it is appropriate to order security for costs."

In light of the above – and despite the fact that article 38 explicitly highlights the merits of the case as a valid factor to consider – the fear of prejudging the case may increase the hesitance of arbitrators to grant an order for security for costs in general, and in particular with reference to the strength of the merits of the requesting party's claim. In turn, this underlines that in order for security for costs to be granted, the applicant must demonstrate a strong case overall, ie, with due consideration to all applicable criteria and not only with respect to the merits of the claims.

Non-applicant's ability to comply with an adverse costs award

The second set of criteria that the arbitral tribunal needs to consider in its assessment is "the [non-applicant's] ability to comply with an adverse costs award and the availability of assets for enforcement of an adverse costs award". Below, we address three aspects that will typically be highly relevant to the arbitral tribunal in its assessment of these criteria: the non-applicant's state of impecuniosity; the location of the non-applicant's assets; and third-party funding.

The non-applicant's state of impecuniosity

Naturally, the financial situation of the non-applicant as well as the availability of attachable assets will be highly relevant in relation to the non-applicant's ability to comply with an adverse costs award. Thus, if the applicant can demonstrate the likely impecuniosity of the non-applicant, this will generally be a compelling argument in favour of the non-applicant's inability to comply with an adverse costs award.

Still, international practice suggests that the mere fact that the non-applicant is impecunious is not sufficient to warrant an order for security for costs. In *South American Silver v Bolivia*, the arbitral tribunal stated that:

the lack of assets, the impossibility to show available economic resources, or the existence of economic risk or difficulties that affect the finances of a company are not per se reasons or justifications sufficient to warrant security for costs.

Thus, while providing evidence indicating the non-applicant's state of impecuniosity is convincing to demonstrate inability to cover adverse costs, this will likely generally not be sufficient in itself to merit an order for security for costs.

Location of the non-applicant's assets

The location of the non-applicant's assets is relevant when determining whether the assets are "available for enforcement" under article 38(2)(ii). Regarding situations where the non-applicant's assets are located abroad, Born has stated the following:

In principle, the fact that a party is domiciled outside the arbitral seat, or has its assets abroad, should not be grounds for denying security. That is because of the generally liberal international regime for recognition and enforcement of foreign arbitral awards. However, if a party is domiciled or has its assets in a state that is not a party to the New York Convention (or a similar international agreement), then the case for security for costs relief is materially enhanced.

In the opinion of Born, the mere fact that the assets of the non-applicant are located in a country other than that in which the arbitration is seated should not be considered as an argument in favour of granting security for costs, unless the assets are located in a state which is not a signatory to the New York Convention.

Nonetheless, the mere fact that a state is a signatory to the New York Convention does not necessarily constitute a guarantee for successful enforcement. Thus, it should not be ruled out entirely that it may be viable for the applicant to present evidence to the arbitral tribunal proving difficulties in enforcement, and that the assets for that reason are not available for enforcement, even when the non-applicant's assets are located in a jurisdiction bound by the New York Convention. However, such statements should generally not resonate with the arbitral tribunal unless substantiated by factual circumstances (such as the contents of the statutes and case law of the relevant jurisdiction demonstrated, for example, in an expert opinion).

Thus, the existence of rumours or a general public opinion claiming enforcement difficulties in the jurisdiction in which the non-applicant's assets are located, should not be viewed as a valid argument in favor of the non-applicant's inability to comply with an adverse costs award, unless corroborated by evidence.

Third-party funding

It has frequently been argued that the fact that the non-applicant is receiving third-party funding *per se* constitutes a compelling argument for ordering security for costs. The reasoning behind this is two-fold:

- the general perception has historically been that most parties seeking funding do so because their precarious financial situation prevents them from funding arbitration proceedings themselves; and
- third-party funders generally do not commit through the funding agreement to cover any adverse costs for which the funded party may be held liable.

On the basis of these factors, it has been argued that funded parties generally can be expected to be unable to comply with an adverse costs award.

However, the view that third party funding *per se* is an argument in favour of security for costs has been nuanced through doctrinal discussions and public discourse, notably in the Queen Mary Task Force's report on third-party funding.

The report highlighted the fact that a significant amount of entities seeking third-party funding do so not because of lack of funds, but to limit the financial risks associated with pursuing arbitration:

[T]he assumption that a funded party is impecunious miscomprehends the current state of third-party funding. Most of the funders, including in the Task Force, suggest and arbitration practitioners confirm that third-party funding is increasingly used by large, solvent companies that simply wish to share risk and maintain liquidity.

Based on this, we conclude that the mere existence of a third-party funding is an argument neither for nor against granting security for costs. Rather, the crucial factors will be the non-applicant's financial situation and availability of assets viewed in light of whether or not the third-party funder has committed to cover adverse costs.

General appropriateness and other relevant circumstances

The last two criteria of article 38(2) sets out that the arbitral tribunal shall have regard to whether it is appropriate in all the circumstances of the case to order one party to provide security; and any other relevant circumstances. These two criteria are of a catch-all character, that is, aimed to cover any factors that may be relevant to the arbitral tribunal's assessment. Below, we touch upon two factors that in the majority of cases will be relevant for the arbitral tribunal to consider: access to justice considerations; and material deterioration of the non-applicant party's financial situation.

Access to justice considerations

The most prevalent explanation behind the restrictive view on security for costs that has emerged in international practice relates to access to justice concerns.

This issue is related to the imperious and far-reaching nature of security for costs as compared to other kinds of provisional relief. As a rule, compelling a party with limited resources to post security for costs at the outset or during an arbitral proceeding puts restraints on the party's ability to present its case and may even risk stifling the party's substantive claims.

The inferences in relation to arbitral access to justice of arbitral tribunals exercising a too open-ended view with regard to granting security for costs has been underlined in **Emmanuel Gaillard** and **John Savage**'s treatise on international commercial arbitration, where it is stated that:

The second question raised by requests for security for costs is whether such a measure should be granted in international arbitration. It would be particularly unfortunate if the granting of security for costs were to become the norm […]. Access to arbitral justice

would be *systematically obstructed*, which would be odd at a time when arbitration has become the normal means of resolving disputes in international commerce.

These concerns are also reflected in international practice. As described by Born: "tribunals not infrequently conclude that the burden imposed by a security for costs order on a party may interfere unduly with its opportunity to be heard, particularly in instances where the party lacks the financial means to post the required security".

What this means from a practical viewpoint is that the arbitral tribunal should carefully evaluate the applicant's interest of securing its legal costs in relation to the risk of stifling the non-applicant's claim.

On this topic, Redfern & Hunter states that "the tribunal must weigh the costs to a respondent of defending a claim in which there is a possibility of not recovering those costs even if successful against the risk of stifling a genuine claim by a claimant who is short of funds, possibly because of the very conduct of the respondent that has given rise to the arbitration."

As a natural consequence of these general concerns, the non-applicant's state of impecuniosity is likely not in and of itself sufficient to justify an order for security for costs. The applicant's case must be strong overall with due consideration to all applicable criteria.

Material deterioration of the non-applicant party's financial standing

It is often argued that, for security for costs to be granted, a substantial change in circumstances must have occurred between the conclusion of the arbitration agreement and the submission of the request for security for costs.

In ICC practice, this seems to have developed into an explicit criterion. As stated by Gu, "[f]or the ICC, legitimate concerns as to the exercise of the discretion to order security for costs has led to the requirement that there must be a substantial change in the situation since the basic agreement between the parties was entered into."

Applied in cases where the financial standing of the non-applicant is invoked as an argument in support of a lacking ability to comply with an adverse costs award, the requirement for material deterioration means that security for costs should not be ordered unless the financial situation of the non-applicant has materially deteriorated between the conclusion of the arbitration agreement and the submission of the request for security for costs.

In the legal doctrine, this has been linked to contractual principles. Thus, it has been argued that in cases where the financial standing of the non-applicant is invoked as grounds for security for costs, good faith considerations entail that security for costs should not be granted unless the financial situation of the non-applicant has materially deteriorated since the conclusion of the arbitration agreement. As explained by **Ali Yesilirmak**:

Such unavailability [of means to comply with an adverse costs decision] should be a result of changed circumstances following the entry into force of the parties' agreement.

Otherwise, basing on the unavailability to make a claim for security for costs would infringe the principle of good faith.

The good faith argument is at least in part related to what the requesting party must be considered to have accepted based on the circumstances that were at hand when the arbitration agreement was concluded. As stated by **Jeffrey Waincymer**:

The reason for this consideration is that, if the proposed subject's financial condition, however perilous, is substantially the same as at the time that the parties concluded the arbitration agreement, or has deteriorated in a manner that is not commercially unusual, the responding party could be taken to have accepted the risk of transacting with a financially unstable entity.

This is reflected in similar manner in the Chartered Institute of Arbitrators' guidelines on security for costs, which state that "if a party contracts with a shell company without obtaining some kind of financial guarantee, arbitrators may consider that its inability to pay was known, or ought to have been reasonably known, at the inception of the relationship and was an accepted consequence of doing business with it."

Notwithstanding the above considerations, it is noteworthy that article 38(2)(ii) of the SCC rules regarding the non-applicant's ability to cover an adverse costs award entails no explicit requirement for material deterioration. Thus, it is arguably not in conflict with article 38 for an arbitral tribunal to disregard the existence of any material deterioration.

Nonetheless, the convincing arguments that have emerged out of international practice as well as doctrinal developments entail that the existence of material deterioration can arguably still constitute an important factor in the arbitral tribunal's assessment of whether it is appropriate to order security for costs according to 38(2)(iii) or as a "relevant circumstance" under 38(2)(iv).

Four key conclusions

Through the introduction of article 38, SCC tribunals have been granted the explicit authority to order security for costs. Despite the fact that the criteria stated in article 38 are fairly detailed, the interpretation and proper application of a legal provision are always cumbersome to discern in the absence of a developed body of case law, or other guiding sources of interpretation.

Nevertheless, it is clear that article 38 of the SCC rules has emerged based on international best practices regarding security for costs. Thus, the rich selection of arbitration cases and doctrinal developments will function as the relevant interpretative framework for arbitral tribunals when deciding on requests for security for costs. Based on international best practices, we draw the following four conclusions regarding the standards for security costs in article 38 of the SCC rules.

First, it is clear that the notion in article 38(1) that an arbitral tribunal may only grant security for costs in "exceptional circumstances" is entirely in coherence with the generally accepted view in international practice. Thus, it cannot be disputed that security for costs under the SCC rules should only be ordered in the rarest of cases.

Second, while the arbitral tribunal is obligated to take into account the strength of each party's respective claims in the arbitration, the significance of the merits must always be viewed with caution in light of the interest of not prejudging the case.

Third, in relation to showing the non-applicant's inability to comply with an adverse costs award, merely presenting evidence indicating that the non-applicant is likely impecunious does not necessarily mean that the non-applicant is unable to cover adverse costs. Thus, the non-applicant's inability must be addressed with due consideration to all relevant circumstances, such as, for example, the existence of third-party funding and the location of the non-applicant's assets.

Fourth and last, it is important to note that the provisions of article 38(2)(iii) to (iv) are of a catch-all character and grant the arbitral tribunal considerable leeway to consider the specifics of each case. When assessing the circumstances specific to the case at hand, the arbitral tribunal should always have due consideration to access to justice concerns. The arbitral tribunal may also take into account the existence of any material deterioration that has taken place between the execution of the arbitration agreement and the submission of the request for security for costs.