A Surprise Award of Third Party Funding Costs

Written by Joanne Clarke

Third party funding is increasingly used by claimants in international arbitration even though the cost can be significant. To the surprise of many, the English Commercial Court recently held in *Essar v. Norscot*[1] that a winning claimant could recover from the losing respondent the cost of obtaining third party funding as a cost in the arbitration. So, what exactly is third party funding and what are the implications of *Essar v. Norscot* for parties involved in international arbitration?

What is third party funding?

Broadly speaking, it is funding provided to a claimant by a non-party to the arbitration to cover the claimant's legal fees and expenses incurred in the arbitration.

A claimant may seek third party funding out of necessity (if otherwise it cannot afford to bring its claim) or for commercial reasons (for example, to ease cash flow or to lay off risk).

In recent years the third party funding industry has grown and there are now many institutions, including specialised third party funders, banks and insurers, that provide finance to fund arbitration.

Many different types of funding arrangement have evolved. The basic arrangement involves a funder providing cash to a claimant in a one-off case for a return. This is typically a fixed percentage share of around 30-50% of any damages recovered, or a multiple of around three to four of the funding to be provided, or a combination of both. Third party funding therefore comes at a significant cost to the claimant although the funding is not repayable by the claimant if its claim fails.

Funders do not provide funding lightly. They generally conduct extensive due diligence including into (i) the merits of claims that they are asked to fund, (ii) the likelihood (or not) of the respondent being able to pay any damages awarded, and (iii) the possibility of successfully enforcing any award in the claimant's favour. In view of the risks involved, funders do not generally fund claims where the likely recovery is below €10 million.

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Costs awards in international arbitration

To put *Essar v. Norscot* into context, it is worth recalling the costs awards that may be made in international arbitration.

First, which party pays the costs of the arbitration? This can vary. The arbitral tribunal may direct each party to pay its own costs, or may direct that costs follow the event, i.e., that the losing party should pay or contribute towards the costs of the winning party in bringing (or successfully defending) a claim. A recent report by an ICC Commission on decisions on costs in

[1] *Essar Oilfields Services Limited v. Norscot Rig Management PVT Limited* [2016] EWHC 2361 (Comm)

international arbitration (the **ICC Report on Costs**) noted "Despite the fact that the ICC and at least half of the other major institutional rules contain no presumption in favour of the recovery of costs by the successful party, it appears that the majority of arbitral tribunals broadly adopt that approach as a starting point, thereafter adjusting the allocation of costs as considered appropriate."[2] There is also a range of awards that arbitral tribunals may make in between these two extremes.

Second, what sort of costs are recoverable? This depends on the law of the seat of the arbitration and the rules governing the arbitration but generally they include lawyers' fees and expenses, expenses relating to witness and expert evidence, arbitrator's fees and the costs of the arbitral institution such as the ICC, as well as "other costs" incurred by the parties for the arbitration court in *Essar v. Norscot* found that costs incurred by Norscot to obtain third party funding were "other costs" and that an arbitral tribunal had the power to order Essar to pay them.

The decision in *Essar v. Norscot*

Facts

Norscot brought an arbitration claim against Essar for repudiatory breach of an operations management agreement. The arbitration proceeded under ICC arbitration rules with a seat in England. Norscot obtained funding from a third-party funder, Woodsford, who advanced Norscot the sum of £647,000 to finance the arbitration. The funding agreement entitled Woodsford, in the event of Norscot succeeding in its claim, to a fee of 300% of the funding or 35% of the recovery, whichever was the higher.[3]

The arbitrator was highly critical of Essar's behaviour before and during the arbitration, finding that Essar "had set out to cripple Norscot financially" and that Norscot "had no alternative, but was forced to enter into the [third party] funding" if it was to "secure justice". The arbitrator accepted expert evidence that Woodsford's rates were market standard.

The sole arbitrator awarded Norscot damages and costs, including indemnity costs because of Essar's behaviour, so that, by the time the case came before the court, Essar was liable to Norscot for around US$12 million.

In relation to costs, the sole arbitrator noted that the principal sources of his jurisdiction were (1) the English Arbitration Act 1996 (the Act) including Section 59(1)(c) which defines the "costs of the arbitration" to include "the legal and other costs of the parties", and (2) the ICC Rules including Article 31(1) which defines the "costs of the arbitration" to include the "reasonable legal and other costs incurred by the parties for the arbitration".[4] The sole arbitrator found that the combined effect of the Act and the ICC Rules gave him wide discretion as to what costs he could award to the winning party.

Having found that Essar, by its unreasonable conduct, had forced Norscot into a position where it had no alternative but to obtain third party funding, the arbitrator awarded Norscot around £1.94 million in respect of the Woodsford funding costs as reasonable "other costs".

Essar applied to the English Commercial Court for the award to be set aside under Section 68(2)(b) of the Act because of "serious irregularity" which arose (Essar argued) because "other costs" in Section 59 did not include the cost of third party funding, so the arbitrator had no power to award them and had exceeded his jurisdiction by doing so.

Findings

His Honour Judge Waksman QC in the Commercial Court:

- Noted by reference to English case law that "serious irregularity" under Section 68(2)(b) of the Act only applies where a tribunal purports to exercise a power which it does not have, not where it erroneously exercises a power that it does have. The court found that the arbitrator had the power to award costs and therefore, even if he was wrong in his construction of "other costs",

[2] ICC Commission Report "Decisions on Costs in International Arbitration" in ICC Dispute Resolution Bulletin, 2015, Issue 2, paragraph 13.

[3] The judgment does not state expressly that the higher figure was payable but this appears to be the case (see the reference to Norscot's expert evidence at paragraph 25 of the judgment).

[4] The 2008 ICC Rules applied in the Essar and Norscot arbitration. The 2012 ICC Rules currently in force contain the same provision at Article 37.

there was no serious irregularity within the meaning of Section 68(2)(b).

- Regarded as "highly pertinent" statements in the ICC Report on Costs relating to the recovery of third party funding costs, including:

  "*The successful party will itself ultimately be out of pocket upon reimbursing such costs to the third party funder and may therefore be entitled to recover its reasonable costs, including what it needs to pay to the third party funder, from the unsuccessful party. The tribunal will need to determine whether these costs were actually incurred and paid or payable. …*"

  and

  "*The requirement that the cost be reasonable serves as an important check and balance in protecting against unfair or unequal treatment of the parties in respect of costs, or improper windfalls to third party funders. Tribunals have from time to time dealt with this when assessing the reasonableness of costs in general, sometimes including the success fee in the allocation of costs and sometimes not, depending on their view of the case as a whole.*"

- Found that the arbitrator had the **power** to award third party funding costs because "as a matter of language, context and logic" they fell within the definition of "other costs". The decision whether or not to award such costs then fell with the arbitrator's general costs **discretion**.

- Noted that the arbitrator's exercise of this discretion was subject to the check and balance of the overall requirement of "reasonableness". Further, although the exercise of such discretion was not under challenge:

  "*This was a case, perhaps unusual, where the arbitrator ruled in detailed and robust terms that Essar drove Norscot to this expensive litigation because of its own reprehensible conduct …. Norscot had no option, but to obtain this funding from this third party funder. As a matter of justice, it would seem very odd … if the arbitrator was not entitled under s. 59(1)(c) to include the costs of obtaining third party funding as part of "other costs" where they were so directly and immediately caused by the losing party.*"

- Dismissed Essar's application to set aside the award.

The implications of *Essar v. Norscot*

- How significant is a party's conduct?

  One of the reasons the arbitrator awarded Norscot is third party funding costs was that Essar's conduct resulted in Norscot having no choice but to seek third party funding to obtain justice. The court approved this exercise of the arbitrator's discretion to award costs, even though the exercise of this discretion (as opposed to the power to award such costs in the first place) was not under challenge.

  What is now unclear is whether or not an arbitral tribunal may exercise its discretion to award third party funding costs if the funding was not strictly necessary for the claimant to bring the claim. What if a claimant has sufficient funds to pay its arbitration costs but seeks third party funding for commercial reasons? In this situation an arbitral tribunal may find third party funding costs unreasonable and refuse to award them.

- Costs or damages

  There is an argument that third party funding costs should not be claimed as costs at the end of the arbitration but instead as damages to be pleaded and proved in the arbitration itself. This has been the view of a task force of the International Council for Commercial Arbitration and Queen Mary University of London in a draft report issued before *Essar v. Norscot*.[5] For third party funding costs to be successfully claimed as damages, a claimant would at a minimum have to (1) disclose the funding arrangement early in the arbitration which may risk an application by the defendant for security for costs (the stage at which Norscot disclosed the existence of its agreement with Woodsford is not stated in the *Essar v. Norscot* judgment) and (2) successfully show causation and foreseeability. This might be possible if, for example, a claimant can show that it had no choice but to obtain third party funding because of the

[5] ICCA-QMUL Task Force on TPF in International Arbitration, Sub-committee on Security for Costs and Costs "Draft Report" 1 November 2015; see section [C] on page 9 and paragraph [2] on page 10.

claimant's conduct, but if the claimant has chosen to obtain third party funding for other commercial reasons, it may struggle to show causation and foreseeability. In this case, it may wish to rely on the decision in *Essar v. Norscot* but, as noted above, the precise circumstances in which an arbitrator may exercise discretion to award third party funding costs is unclear.

- Could other forms of funding be recovered as "other costs"?

  Depending on the jurisdiction in question, funding such as CFAs[6] and DBAs[7] may be available. Does *Essar v. Norscot* mean that the related costs are recoverable in international arbitrations seated in England as an "other cost"? This would be ironic since Lord Justice Jackson in his review of civil litigation costs in England and Wales found that CFAs were a major contributor to disproportionate costs and recommended that success fees should cease to be recoverable from unsuccessful opponents in civil litigation.[8]

- A warning for respondent parties.

  In international arbitration there is currently no general obligation for a funded party to disclose the fact of its funding arrangement to the arbitral tribunal or the opposing party although there are increasing demands for greater transparency in this regard. If the funded party chooses not to disclose the existence of funding during the arbitration but, at the end of the arbitration, claims the funding costs from the respondent as a cost of the arbitration, the respondent will face a significantly larger costs exposure than it may have anticipated. *Essar v. Norscot* may prompt respondent parties to request early disclosure of third party funding agreements.

Conclusion

The English Commercial Court in *Essar v. Norscot* held that an arbitrator in an ICC arbitration with a seat in England has the power to award a winning claimant its third party funding costs as a cost of the arbitration. The precise factual circumstances in which the arbitral tribunal may exercise its discretion to award such costs are unclear, but will likely include cases where a tribunal determines such costs to be reasonable and where, because of the respondent's conduct, the claimant has no choice but to seek third party funding to obtain justice.

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[6] In English law, a CFA is a conditional fee agreement under which the client pays a fee plus an increased percentage of this fee (but not a share of any recovery) depending on the outcome of the case.

[7] In English law, a DBA is a damages-based agreement which is similar to a CFA in that the amount the lawyer is paid depends on the outcome of the case, but the fee is calculated as a share of any recovery, i.e., as a percentage of the damages awarded to the client.

[8] The Right Honourable Lord Justice Jackson, "Review of Civil Litigation Costs: Final Report", December 2009, paragraphs 2.1 and 2.2. This recommendation was given effect to by Part 2 of the Legal Aid, Sentencing and Punishment of Offenders Act 2012 which came into force on 1 April 2013 (see Section 44(4)). Success fees under CFAs entered into from that date are not recoverable by a winning party from a losing party.