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# Judging Third-Party Funding

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## JUDGING THIRD-PARTY FUNDING

Victoria A. Shannon<sup>†</sup>

*Third-party funding is an arrangement whereby an outside entity finances the legal representation of a party involved in litigation or arbitration. The outside entity – called a “third-party funder” – could be a bank, hedge fund, insurance company, or some other entity or individual that finances the party's legal representation in return for a profit. Third-party funding is a controversial, dynamic, and evolving phenomenon. The practice has attracted both national headlines and the recent attention of the Advisory Committee on the Federal Rules of Civil Procedure. The Advisory Committee recently declared that “judges currently have the power to obtain information about third-party funding when it is relevant in a particular case,” but the Committee did not provide any additional guidance regarding how to determine the relevance of third-party funding, what information to obtain, or from whom to obtain that information. This Article provides that needed guidance.*

*This Article sets forth reinterpretations of procedural rules to provide judges and arbitrators with disclosure requirements and a framework for handling known issues as they arise. By interpreting the existing rules as suggested in this Article, judges and arbitrators will be able to gain a better sense of the prevalence, structures, and impact of third-party funding and its effects (if any) on dispute resolution procedures. Over time, these observations will reveal the true systemic impact of third-party funding and contribute to developing robust third-party funding regulations.*

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I. INTRODUCTION: THIRD-PARTY FUNDING AS A PARADIGM SHIFT IN  
DISPUTE RESOLUTION

Law students around the country will have to relearn the Federal Rules of Civil Procedure after they sit for the bar examination. The Federal Rules Advisory Committee has proposed changes to eleven Federal Rules and the deletion of the Appendix of the Forms, which will take effect on December 1, 2015, unless the Supreme Court or Congress takes contrary action.<sup>1</sup> Far more interesting than the proposed changes,

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<sup>1</sup> For example, the Supreme Court may decline to prescribe the amendments before May 1, 2015 or, if the Supreme Court does prescribe the amendments, then Congress may enact legislation to reject, modify, or defer the amendments before

however, are the panoply of disruptive and paradigm-shifting revisions that the Advisory Committee has earmarked for future consideration.<sup>2</sup> The most monumental potential changes would address the controversial and growing phenomenon of third-party funding, which is an arrangement in which a party involved in a dispute seeks funding from an outside entity for its legal representation instead of financing its own legal representation.<sup>3</sup> The Advisory Committee stated in its December 2014 report that:

Discussion reflected concerns that third-party financing is a relatively new and evolving phenomenon. It takes many forms that may present distinctive questions. A study paper for the ABA 20/20 Commission on Ethics<sup>4</sup> expressed the hope that work will continue to study the impact of funding on counsel's independence, candor, confidentiality, and undivided loyalty. The Committee agreed that the questions raised by third-party financing are important. But they have not been fully identified, and may change as practices develop further. In addition, the Committee agreed that judges currently have the power to obtain information about third party funding when it is relevant in a particular case. An attempt to craft rules now would be

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December 1, 2015. If the Supreme Court transmits the amendments and Congress does not act, then by statute, the amendments will become law and take effect on December 1, 2015. *See infra* note 73 for a complete explanation of the rules revision process. *See also Summary of the Report of the Judicial Conference Committee on Rules of Practice and Procedure*, (Sep. 2014), 13, available at <http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Reports/ST09-2014.pdf> (quoting Rule 1). For a full discussion of the proposed revisions, *see id.* at 13-18 (summary of revisions), B-1 to B-77 (specific language of proposed revisions).

<sup>2</sup> Examples of such changes include implementing electronic filing and service of process for court documents and grappling with the question of whether attorney fees are appropriate sanctions in light of deep concerns about cost shifting under the "American Rule." *See* Hon. David G. Campbell, *Report of Advisory Committee on Civil Rules to the Standing Committee on Rules of Practice and Procedure*, (Dec. 2, 2014), 3-12, available at <http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Reports/CV12-2014.pdf>.

<sup>3</sup> *See* Advisory Committee Report, *supra* note 2, at 3-4.

<sup>4</sup> *See generally* AM. BAR ASS'N COMM'N ON ETHICS 20/20, INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES (2012), available at [http://www.americanbar.org/content/dam/aba/administrative/ethics\\_2020/201112\\_12\\_ethics\\_20\\_20\\_alf\\_white\\_paper\\_final\\_hod\\_informational\\_report.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/201112_12_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf) [hereinafter ABA WHITE PAPER] (describing how a lawyer would handle a third-party funding arrangement within the existing Rules of Professional Responsibility).

premature. These questions will not be pursued now.<sup>5</sup>

The Advisory Committee declared that federal judges clearly have the power to handle third-party funding under the existing rules but did not give any guidance on how to implement this mandate.<sup>6</sup> This monumental pronouncement generates a multitude of questions without providing ready answers. *What is third-party funding? What are federal judges' responsibilities under the Federal Rules with respect to third-party funding? Which aspects of the federal rules are affected by third-party funding? How should judges determine what information to obtain regarding third-party funding and from whom to obtain that information?* This article addresses these questions and provides guidance to federal judges regarding how to interpret the existing Federal Rules of Civil Procedure until the Advisory Committee decides to tackle the question of rule revisions. This article also provides guidance to arbitrators regarding how to handle third-party funding, since, as this article explains, arbitration and litigation are inextricably intertwined, and rules of arbitration procedure will likely not be revised any time soon either.<sup>7</sup> Finally, this article presents advice to the future Advisory Committee and arbitral bodies that would revise procedural rules to address third-party funding.

The remainder of this article proceeds as follows. Part II of this article introduces and defines third-party funding. Part III of this article addresses the problems that arise due to the Federal Rules not addressing third-party funding explicitly. Part IV of this article tackles the debate regarding whether to revise the Federal Rules or reinterpret the existing rules and concludes that the Advisory Committee's approach of leaving third-party funding to judicial interpretation is the most appropriate course of action at this time. Part V proposes reinterpretations of the existing Federal Rules that judges can implement immediately when encountering third-party funding in a case. Part VI provides advice to the Advisory Committee regarding how to revise the Federal Rules in the future.

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<sup>5</sup> See Advisory Committee Report, *supra* note 2, at 4 (internal footnote added by this article's author).

<sup>6</sup> See *id.* at 3-4.

<sup>7</sup> See *infra* notes 74-76 and accompanying text.

## II. THE PHENOMENON: WHAT IS THIRD-PARTY FUNDING?

Third-party funding<sup>8</sup> is an arrangement in which a party involved in a dispute seeks funding from an outside entity for its legal representation instead of financing its own legal representation.<sup>9</sup> The outside entity – called a “third-party funder” – finances the party's legal representation in return for a profit.<sup>10</sup> The third-party funder could be a bank, hedge fund, insurance company, or some other entity or individual.<sup>11</sup> If the funded party is the plaintiff, then the funder contracts to receive a percentage or fraction of the proceeds from the case if the plaintiff wins.<sup>12</sup> Unlike a loan, the funded plaintiff does not have to repay the funder if it loses the case or does not recover any money.<sup>13</sup> If the funded party is the defendant, then the funder contracts to receive a predetermined payment from the defendant, similar to an insurance premium, and the agreement may include an extra payment to the funder if the defendant wins the case.<sup>14</sup>

Third-party funding is rapidly increasing in prevalence around the world in both litigation and arbitration.<sup>15</sup> Increasingly, banks, hedge funds, and other financial institutions are funding the legal representation of parties to litigation and arbitration cases as a type of investment.<sup>16</sup> This phenomenon is growing in importance and is estimated to be a

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<sup>8</sup> The Advisory Committee used the terms “third-party funding,” “third-party financing,” and “third-party litigation financing” in its report. *See id.* Some scholars use the term “third-party litigation funding” or “litigation funding” to refer to this phenomenon. This article intentionally uses the term “third-party funding”—without the word “litigation”—because this article addresses funding of both litigation and arbitration, domestically and internationally.

<sup>9</sup> *See generally* Maya Steinitz, *Whose Claim Is This Anyway? Third Party Litigation Funding*, 95 MINN. L. REV 1268 (2011) (defining third-party funding). A party may also engage both a contingency fee attorney and a third-party litigation funder to work together on its case.

<sup>10</sup> *See* LISA BENCH NIEUWVELD & VICTORIA SHANNON, *THIRD-PARTY FUNDING IN INTERNATIONAL ARBITRATION* 4-11 (2012) (describing the players in third-party funding, the types of funding relationships, and the effect of the type of funder on the attorney-client relationship).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *See* Cassandra Burke Robertson, *The Impact of Third-Party Financing on Transnational Litigation*, 44 CASE W. RES. J. INT'L L. 159, 162, 180-181 (2011).

<sup>16</sup> *See generally* Fulbrook Management LLC, *Investing in Commercial Claims Nutshell Primer*, 22, (Nov. 13, 2012), <http://www.fulbrookmanagement.com/wp-content/uploads/2011/03/Nutshell-Primer.pdf>.

multibillion-dollar industry both domestically and internationally.<sup>17</sup> In addition, depending on the structure of the funding arrangement, the funder may legally control or influence aspects of the legal representation or may completely take over the case and step into the shoes of the original party.<sup>18</sup> The United States is home to dozens of funders of consumer disputes, like personal injury claims and other tort claims, and funders of large complex corporate disputes.<sup>19</sup> In light of its increasing prevalence, there is a fascinating debate regarding the place of third-party

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<sup>17</sup> See, e.g., Jennifer Smith, *Litigation Investors Gain Ground in U.S.*, WALL ST. J. (Jan. 12, 2014), <http://online.wsj.com/news/articles/SB10001424052702303819704579316621131535960> (several funders have several hundreds of millions of dollars in assets under management); Jennifer Smith, *Investors Put Up Millions of Dollars to Fund Lawsuits*, WALL ST. J. (Apr. 7, 2013), <http://online.wsj.com/news/articles/SB10001424127887323820304578408794155816934> (“...Gerchen Keller Capital LLC, a Chicago-based team that includes former lawyers ... has raised more than \$100 million and says there is plenty of room for newcomers given the size of the U.S. litigation market, which they put at more than \$200 billion, measuring the money spent by plaintiffs and defendants on litigation.”); Vanessa O’Connell, *Funds Spring Up to Invest in High-Stakes Litigation*, WALL ST. J. (Oct. 3, 2011), (“The new breed of profit-seeker sees a huge, untapped market for betting on high-stakes commercial claims. After all, companies will spend about \$15.5 billion this year on U.S. commercial litigation and an additional \$2.6 billion on intellectual-property litigation, according to estimates by BTI Consulting Group Inc., a Wellesley, Mass., research firm that surveyed 300 large companies in 2011.”); Excend, *Press Release: Excend Engaged as Advisory [sic] for Multi-Billion Dollar Judgment Litigation Funding*, (May 1, 2012), <http://www.excend.com/press/2012-05-09-Excend-Engaged-as-Advisor-for-Multi-Billion-Dollar-Judgment-Litigation-Funding.pdf>.

<sup>18</sup> See NIEUWVELD & SHANNON, *supra* note 1052, at 8 (explaining that some third-party funding arrangements are structured as an assignment in which the third-party funder becomes the claimant in the case and the original party is no longer involved). For an in-depth treatment of assignment and insurance policies in the third-party funding context, see generally, Anthony J. Sebok, *Betting on Tort Suits After the Event: From Champerty to Insurance*, 60 DEPAUL L. REV. 453 (2011); Paul Bond, *Making Champerty Work: An Invitation to State Action*, 150 U. PA. L. REV. 1297 (2002); Terrence Cain, *Third Party Funding of Personal Injury Tort Claims: Keep the Baby and Change the Bathwater*, 89 CHI.-KENT L. REV. 11 (2013); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329 (1987).

<sup>19</sup> Regarding consumer disputes, there are over 30 third-party funding companies funding consumer claims as members of the American Legal Finance Association (ALFA), <http://www.americanlegalfin.com/> (last visited Feb. 15, 2015), as well as several other third-party funding companies that are not members of ALFA funding consumer disputes. Regarding commercial disputes, see *supra* note 17.

funding both in the American legal system and in the context of international dispute resolution.<sup>20</sup>

There are four main drivers of the third-party funding industry worldwide. First, funders help individuals bring claims that they would not otherwise be able to bring, which supports the public policy ideal of increasing access to justice for indigent or disadvantaged persons.<sup>21</sup> Second, many insolvent companies and small companies are seeking a means to pursue valid claims that they could not otherwise afford to pursue and that are too risky for a contingency fee attorney to accept.<sup>22</sup>

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<sup>20</sup> See, e.g., Mariel Rodak, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement*, 155 U. PA. L. REV. 503, 504, 508, 513-523, 523 n.113, 526-527 (2006); Susan Lorde Martin, *Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 56-57, 68-69, 72, 74, 77 (2004); Susan Lorde Martin, *Litigation Financing: Another Subprime Industry That Has a Place in the United States Market*, 53 VILL. L. REV. 673, 673-685 (2008); Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 72 n.36, 139 (2011); Courtney R. Barksdale, *All That Glitters Isn't Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 REV. LITIG. 707, 735 (2007); Steinitz, *supra* note 9, at 1325-1336; Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 608-609 (2010); Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48, 74-75 (1935) (arguing for the regulation of contingency fees in a way similar to today's arguments for regulating third-party funding); Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 377-439 (2009) (proposing defense-side funding in the United States that would be similar to after-the-event insurance in Europe); Yifat Shaltiel & John Cofresi, *Litigation Lending for Personal Needs Act: A Regulatory Framework to Legitimize Third Party Litigation Finance*, 58 CONSUMER FIN. L. Q. REP. 347, 350-361 (2004) (proposing a statute to regulate third-party funding for individual consumers). See also *infra* note 116 and accompanying text.

<sup>21</sup> See David S. Abrams & Daniel L. Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 15 U. PA. J. BUS. L. 1075, 1076 n.3, 1077 n.6, 1077 n.7 (2013) (reporting the results of their study on public data on third-party funding available in Australia).

<sup>22</sup> See Raconteur Media, *Raconteur on Legal Efficiency*, THE TIMES (SUPPLEMENT), 7-9, (Mar. 25, 2010), <http://np.netpublicator.com/netpublication/n89269938>; Steinitz (2011), *supra* note 9, at 1275-1276, 1283-1284; Martin (2004), *supra* note 20, at 67 n.93; Martin (2008), *supra* note 20, at 685; James D. Dana & Kathryn E. Spier, *Expertise and Contingent Fees: The Roles of Asymmetric Information in Attorney Compensation*, 9 J.L. ECON. & ORG. 349, 365-366 (1993); Doug Jones, *Third-Party Funding of Arbitration*, paper given at Hot Topics in International Arbitration at SJ Berwin, 7 (London, Sep. 22, 2008) (on file with the author); Ralph Lindeman, "Third-Party Investors Offer New funding Source for Major Commercial Lawsuits," THE BUREAU OF NATIONAL AFFAIRS (BNA) DAILY REPORT FOR EXECUTIVES, vol. 0, no. 42, 1-8 (Mar. 5, 2010).



Third, many large companies that are constantly sued (such as insurance companies or manufacturers of dangerous products) are seeking a means to even out the litigation line item on their balance sheets, and funders can offer them a fixed payment system for managing their litigation costs as defendants.<sup>23</sup> Fourth, the worldwide market turmoil over the past several years has led many investors to seek investments not dependent upon the financial markets, stock prices, or company valuations.<sup>24</sup> Each litigation or arbitration matter is its own separate entity and is independent from market conditions in terms of the value of the underlying harm or liability.<sup>25</sup> This independence shields the third-party funder's investment and potential profit from the general uncertainty present in the global financial markets.<sup>26</sup>

Since litigation and arbitration have both become attractive investment vehicles, unsurprisingly, both reputable and unsavory third-

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<sup>23</sup> See, e.g., Fulbrook Capital Management, LLC, *Third-Party Litigation Funding*, FINANCIER WORLDWIDE, (May 2012), <http://www.fulbrookmanagement.com/third-party-litigation-funding/> (“Third-party funding offers corporate clients the opportunity to move the financial risk and cost of litigation off their balance sheets.”); Kevin LaCroix, *What’s Happening Now? Litigation Funding, Apparently*, THE D&O DIARY, (Apr. 9, 2013) <http://www.dandodiary.com/2013/04/articles/securities-litigation/whats-happening-now-litigation-funding-apparently/> (“Litigation funding proponents contend that the funding arrangements helps to level the playing field by allowing litigants to pursue lawsuits against better financed opponents, or simply allowing litigants to keep litigation costs off their balance sheet. It seems clear that as the litigation funding field grows, the funding companies are offering new approaches – for example, the defense side option that the Gerchen Keller firm will be offering, or the ‘defense costs cover’ that provided protection for prospective RBS claimants sufficient for them to be able to take on litigation in the U.K. notwithstanding the ‘loser pays’ litigation model that prevails there.”); David Lat, *Litigation Finance: The Next Hot Trend?*, ABOVEthELAW.COM, (Apr. 8, 2013) <http://abovethelaw.com/2013/04/litigation-finance-the-next-hot-trend/> (“Ashley Keller [of Gerchen Keller Capital]: You’re certainly right that a lot of these clients have balance sheet capacity and could fund out of pocket. Notwithstanding their balance sheet capacities, there might be institutional constraints. If a company has a \$5 billion claim, it will pursue it. But what if it has a \$50 million or \$100 million claim? If you’re a general counsel, a lot of C-suite executives are viewing your office as a cost center. It’s not that easy to walk to the CFO’s office and ask for \$5 million or \$10 million to finance offensive litigation. That will immediately hit the P&L of the company and affect earnings per share, but the outcome is uncertain and contingent. We think a fair number of meritorious claims are being left on the table notwithstanding balance sheet capacity.”).

<sup>24</sup> See Steinitz (2011), *supra* note 9, at 1283-1284.

<sup>25</sup> See NIEUWVELD & SHANNON, *supra* note 1052, at 12.

<sup>26</sup> *Id.*

party funders have flocked to this market.<sup>27</sup> However, despite the existence of so many funders, there is little regulation of the industry at present, and the existing regulations are not comprehensive.<sup>28</sup> The lack of regulation or guidelines is creating a situation in which potential clients of third-party funding have no way of knowing which funders are reputable and which are untrustworthy.<sup>29</sup> Market regulation would help inform consumers of the baseline requirements for a compliant third-party funder.<sup>30</sup> It would also inform noncompliant funders of what they need to do to become compliant if they do not want to lose the business of well-informed clients or want to avoid sanctions.<sup>31</sup> Scholars, legislators, judges, attorneys, and even funders themselves have called for regulation of the third-party funding industry.<sup>32</sup> As a first step, the Advisory Committee has charged judges with devising ways to handle issues that may arise with respect to third-party financing while also

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<sup>27</sup> For an example of a less savory third-party funding situation, see *Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc.*, 162 F. Supp. 2d 448, 450-42 (W.D.N.C. 2001) (federal district court awarded treble damages to a law firm against a third-party funder for tortious interference with the law firm's retainer agreement with its client due to the how the funder's compensation was calculated in the third-party funding agreement with the same client).

<sup>28</sup> See, generally, Heather Morton, *Litigation or Lawsuit Funding Transactions 2014 Legislation*, National Conference of State Legislatures, Jun. 4, 2014, <http://www.ncsl.org/research/financial-services-and-commerce/litigation-funding-transactions-2014-legislation.aspx> (listing proposed and passed legislation state by state); Richard A. Blunk, *Have the States Properly Addressed the Evils of Consumer Litigation Finance?*, A Model Litigation Finance Contract, <http://litigationfinancecontract.com/have-the-states-properly-addressed-the-evils-of-consumer-litigation-finance/> (describing the third-party funding statutes in Maine, Ohio, Nebraska and Oklahoma). As of June 2014, the states that have passed legislation either allowing or prohibiting third-party funding of consumer claims are Maine, Indiana, Ohio, Oklahoma, Nebraska, New York (allowed for large commercial disputes), and Tennessee. The states that have proposed legislation in this area are Alabama, Georgia, Illinois, Indiana (other bills proposed), Iowa, Kansas, Louisiana, Missouri, North Carolina, Rhode Island, South Carolina, and Vermont. Other states either have case law or attorney ethics opinions. See NIEUWVELD & SHANNON, *supra* note 1052, at 144-59 (51-jurisdiction survey of existing state laws as of early 2012).

<sup>29</sup> See generally, Victoria Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 101 (2015) (forthcoming in Feb. 2015) (explaining why existing regulations are insufficient and confusing and why the third-party funding industry needs harmonized regulations in three areas: the procedure, the transaction, and the ethics).

<sup>30</sup> See *id.* at 107-08.

<sup>31</sup> See *id.*

<sup>32</sup> See *supra* notes 3 and 20.

ensuring “the just, speedy, and inexpensive determination of every action and proceeding.”<sup>33</sup> However, an inequitable administration of the Federal Rules or of rules of arbitration could lead to undesirable inconsistencies, inefficiencies, and injustices. Thus, this article offers a template for interpreting and administering the rules of litigation and arbitration procedure to take into account the existence of third-party funding.

This article builds on prior scholarly work that proposes a harmonized regulatory framework for third-party funding in three categories: the procedural, the transactional, and the ethical categories.<sup>34</sup> A harmonized regulatory framework would include key regulation within each of those three categories and would link those regulations together through cross-references to create a harmonized regulatory framework.<sup>35</sup> This approach would weave a regulatory “safety net” of minimum standards for behaviors and interactions of the players in third-party funding arrangements.<sup>36</sup> It would also ensure the integrity of a dispute resolution system involving funders and the stability of any financial products that may derive from third-party funding.<sup>37</sup>

Regulations in the procedural category (set forth in this article) address the ways in which funders participate in or influence the procedure of litigation or arbitration, including the potential waiver of evidentiary privileges for information disclosed to a funder.<sup>38</sup> Regulations in the transactional category would address the viability of the funder as a business, including capitalization requirements, licensure, and other best practices, such as disclosures to potential clients of funders.<sup>39</sup> Regulations in the ethical category would address issues relating to the conflicts of interest that may arise during the negotiation of the funding arrangement, as well as the funder’s effect on the attorney-client relationship.<sup>40</sup> This article focuses on the procedural regulations and, specifically, suggests reinterpretations of litigation and arbitration rules and certain evidentiary privileges to take into account the existence and participation of third-party funders.

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<sup>33</sup> See *supra* note 1 (quoting Rule 1).

<sup>34</sup> See Shannon (2015), *supra* note 29, at 107-08.

<sup>35</sup> See *id.*

<sup>36</sup> See *id.*

<sup>37</sup> See *id.*

<sup>38</sup> See Shannon (2015), *supra* note 29, at 136-42; see also *infra* Part V.

<sup>39</sup> See *id.* at 129-36.

<sup>40</sup> See *id.* at 142-47.

### III. THE PROBLEM: RULES OF PROCEDURE ARE SILENT REGARDING THIRD-PARTY FUNDING

Third-party funders are indirect participants in litigation and arbitration, even if the decision maker (i.e., the judge, jury, or arbitrator), the opposing party, and the opposing party's attorney are unaware of the funder's participation.<sup>41</sup> Like other indirect participants in dispute resolution, funders should be subject to the rules of litigation and arbitration.<sup>42</sup> *How should judges treat the participation of a third-party funder in litigation or arbitration as a matter of procedure?* Funders do not fit neatly into any of the typical roles outlined in litigation or arbitration rules. Funders are intentionally not parties or co-parties (in order to avoid liability),<sup>43</sup> not legal counsel (although they are often

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<sup>41</sup> Parties often employ other entities to assist them in litigation without the opposing side's knowledge, such as non-testifying consultants, non-testifying experts, accountants, and other agents. Several types of such entities are listed as party "representatives" in FED. R. CIV. P. 26(b)(3)(B). See *infra* note 135 and accompanying text. Based on the substance of their activities during the litigation, funders fall with the definitions of those "representatives" enumerated in the rule in the rules. *Id.*

<sup>42</sup> See *supra* note 41. Since many entities that are not direct participants in litigation are enumerated or referenced in the Federal Rules of Civil Procedure, third-party funders should also be referenced, as discussed throughout this article.

<sup>43</sup> Furthermore, a third-party funder usually should not be joined as party. A claim-side funder is not a "real party in interest" under FED. R. CIV. P. 17, unless the funder buys the claim outright and takes an assignment. See FED. R. CIV. P. 17(a)(1) ("An action must be *prosecuted* in the name of the real party in interest.") (emphasis added). The rule requires that the party possessing the substantive right at issue must prosecute the case. The rule applies only to plaintiffs and is intended to prevent defendants from having to face multiple lawsuits over the exact same legal right or interest. See, e.g., *Curtis Lumber Co. v. Louisiana Pacific Corp.*, 618 F.3d 762, 771 (8th Cir. 2010) (stating that the purpose of FED. R. CIV. P. 17(a) is to ensure that the defendant will face only one suit and will obtain the benefit of *res judicata* against any future action based on the exact same legal interest); *Marina Mangement Services, Inc. v. Vessel My Girls*, 202 F.3d 315, 318 (D.C. Cir. 2000) ("Rule 17(a) protects a defendant against a subsequent claim for the same debt underlying a previously entered judgment."). If the funder takes an assignment of the claim, then the funder should be the plaintiff on record in the case. Since such a funder would pursue the claim or defense in its own name as the real party in interest, the funder in such an instance would be treated as a party already under the existing rules. Most funders, by contrast, take an interest only in the potential proceeds from the case (claim side) or receive periodic payments from the client similar to an insurance premium (defense side). Thus, FED. R. CIV. P. 17, as it is currently written, would apply in the context of a funder taking an assignment of a claim and does not need to be revised. The vast majority of third-party funders have absolutely no connection

lawyers),<sup>44</sup> and not witnesses (although disclosures of privileged information to a funder may make that information discoverable by the opposing side in jurisdictions that do not extend evidentiary privileges to disclosures made to funders).<sup>45</sup> Funders are not *amicus curiae* (since they do not make submissions, although they certainly support the position of the funded party in the case).<sup>46</sup> They are certainly not judges, arbitrators, courts or arbitral institutions (although they do make *prima facie* determinations about the case that may determine whether the case actually goes forward or not and, therefore, are similar to a judge or arbitrator ruling on a motions to dismiss).<sup>47</sup> Funders are not third-party beneficiaries of a contract, because they cannot enforce the funded party's claim independently of the funded party, unless they purchase the claim outright and become a party through assignment.<sup>48</sup> Unlike insurance companies, third-party funders usually do not agree to pay the underlying judgment, so the insurance analogy does not quite fit either.<sup>49</sup> Most funders think of themselves as investors, and an investor in litigation or arbitration is a new species of participant unanticipated in the existing rules of procedure.<sup>50</sup>

Although funders do not currently fit within any of the preexisting defined roles in litigation or arbitration, they often find themselves pulled into the proceedings either directly or indirectly.<sup>51</sup> For example, most sophisticated funders are already aware of jurisdictions that allow courts and arbitral tribunals to issue cost orders that can reach third parties or allow parties to join funders as parties in cost proceedings.<sup>52</sup> In some jurisdictions, funders view adverse costs orders or orders for security for costs as simply the cost of doing business in that jurisdiction.<sup>53</sup> In the

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whatsoever to the underlying substantive dispute; hence, they are not the “real party in interest” under FED. R. CIV. P. 17.

<sup>44</sup> Examples of third-party funders that have lawyers as leaders or principals include ARCA Capital Partners, BridgePoint Financial Services, Burford Capital Group, Calunius Capital, Fulbrook Management LLC, Gerchen Keller Capital, Harbour Litigation Funding Ltd., IMF (Australia) Ltd., Bentham IMF Ltd., IM Litigation Funding, The Judge Limited, Juridica Investments, and Therium.

<sup>45</sup> See *infra* note 109 and accompanying text.

<sup>46</sup> See *infra* note 212 and accompanying text.

<sup>47</sup> See *infra* note 127 and accompanying text.

<sup>48</sup> See *supra* note 18 and accompanying text.

<sup>49</sup> See *infra* note 111 and accompanying text.

<sup>50</sup> See, generally, Max Volsky, *INVESTING IN JUSTICE: AN INTRODUCTION TO LEGAL FINANCES, LAWSUIT ADVANCES AND LITIGATION FUNDING* (2013).

<sup>51</sup> See, e.g., *supra* note 27; *infra* note 215.

<sup>52</sup> See, e.g., NIEUWVELD & SHANNON, *supra* note 1052, at 27-28.

<sup>53</sup> *Id.*

United States, there are state long-arm statutes and a rather low threshold for personal jurisdiction in light of the e-commerce age.<sup>54</sup> Thus, the funder's actions while funding litigation in a United States court may create the "minimum contacts" that could subject it to the jurisdiction of a United States court hearing a funded case or ruling on the enforcement or annulment of a funded arbitral award.<sup>55</sup> Furthermore, arbitral tribunals have previously issued cost orders against funders based on the domestic rules of the procedural seat of arbitration, even though the funder has not signed the underlying arbitration agreement.<sup>56</sup> Courts and arbitral tribunals may also be able to exert jurisdiction over third-party funders under doctrines that allow jurisdiction over a non-signatory to the arbitration agreement or a non-signatory to the underlying contract who has a financial interest in the outcome of the dispute.<sup>57</sup>

Moreover, conflicts of interest may arise if a judge or arbitrator is somehow linked to the third-party funder.<sup>58</sup> However, if the identity of the funder is not disclosed at the outset, then the later revelation of the connection could create disastrous and costly results for the parties.<sup>59</sup> From the perspective of our legal system, the main purpose of the involvement of a third-party funder is to reduce the funded party's cost burden and risk of losing the case. However, nondisclosure of a funder's participation can lead to additional costs for that party later.<sup>60</sup> For example, additional costs may be incurred if a judge is accused of bias under 28 U.S.C. § 144 because of her connection to a funder or has to recuse herself under 28 U.S.C. § 455 because of her connection to a funder.<sup>61</sup> The funded party may also incur costs if an arbitral award or

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<sup>54</sup> See, generally, A. Benjamin Spencer, *Nationwide Personal Jurisdiction for our Federal Courts*, 87 DENV. U. L. REV. 325 (2009); Eric C. Hawkins, *General Jurisdiction and Internet Contacts: What Role, if any, Should the Zippo Sliding Scale Test Play in the Analysis?*, 74 FORDHAM L. REV. 2371 (2006).

<sup>55</sup> See *supra* note 54.

<sup>56</sup> See NIEUWVELD & SHANNON, *supra* note 10, *passim* (citing cases in Australia, the United Kingdom, the United States, and other countries in which an arbitral tribunal or court ordered a non-party funder to pay costs or provide security for costs); *infra* note 215.

<sup>57</sup> See generally STAVROS BREKOUKAKIS, *THIRD PARTIES IN INTERNATIONAL COMMERCIAL ARBITRATION* (2010).

<sup>58</sup> See *infra* Part III (discussing the potential conflicts of interest that could arise due to an undisclosed connection between a judge and a funder and the consequences of nondisclosure).

<sup>59</sup> *Id.*

<sup>60</sup> See *supra* note 58.

<sup>61</sup> See 28 U.S.C. § 144 (2012) (addressing bias or prejudice of a judge); 28 U.S.C. § 455 (2012) (addressing the disqualification a judge due to a financial conflict of interest).

court judgment is challenged based on the appearance bias of the judge or arbitrator because of some undisclosed connection with the funder, even if there was no actual bias. Reinterpreting rules of litigation and arbitration procedures to address the issue of the funder's hidden participation will inform the judge or arbitrator in the case that the funder is involved.

Currently, there are only two types of dispute resolutions procedures funded worldwide: litigation and arbitration.<sup>62</sup> Thus, regulating the participation of third-party funders in the process of dispute resolution would consist of reinterpreting or modifying the rules for both procedures. For the reasons discussed in Part IV, rule revisions are premature; thus, this article proposes reinterpreting rules of litigation and arbitration procedure to address issues raised by the growing phenomenon of third-party funding.<sup>63</sup> This article proposes pragmatic reinterpretations of the existing language of specific rules regarding discovery, disclosures, privileges, conflicts of interest, cost allocation, sanctions, class actions, and enforcement.<sup>64</sup> These reinterpretations will provide courts and arbitrators with disclosure requirements and a framework for handling conflicts of interest and other known issues as

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<sup>62</sup> Third-party funders only fund litigation and arbitration, because funders need a result that is enforceable in court in order to ensure that they will be able to collect the award or legal costs—in jurisdictions with a rule that the loser pays the legal costs—from the losing party. While a judge or arbitrator could convert a mediated settlement agreement into a judgment or award, there is no guarantee that a judge or arbitrator would be willing to do so or that the parties would want an enforceable result from mediation. Furthermore, a failure of the mediation process is essentially a financial stalemate, and the parties must still incur the cost of litigation or arbitrating their unresolved dispute. Funders are not attracted to pure mediation cases due to this uncertainty, even though mediation is often far cheaper than litigation or arbitration. However, funders may fund a case involving a multi-staged dispute resolution clause calling for mediation followed by litigation or arbitration if the mediation is unsuccessful.

<sup>63</sup> Why focus on the federal rules rather than state rules? State rules vary too widely for a realistic proposal of a model state rule. In addition, state court rules tend generally to follow trends in Federal Rules. The Federal Rules set an example and, to that end, are quintessentially “model” state rules. Nevertheless, state laws govern evidentiary privileges. *See infra* Part V.A.1 (discussing revisions to state laws governing the attorney-client privilege and the work-product doctrine).

<sup>64</sup> The author examined all the Federal Rules of Civil Procedure to determine whether the existence of third-party funding could have an effect on the administration of the rule. The author determined that rules relating to disclosure, discovery, privileges, sanctions, and class actions are the only rules that could potentially be affected by third-party funding. This article focuses on those rules only.

they arise.<sup>65</sup> If procedural problems with respect to third-party funding become prevalent or recurrent, then rule revisions may become necessary at that time. Meanwhile, by implementing the reinterpretations set forth in this article, courts, judges, arbitrators, arbitral institutions, and legislators will be able to gain a better sense of the prevalence of third-party funding and its effects (if any) on dispute resolution procedures.

#### IV. THE DEBATE: REVISE OR REINTERPRET PROCEDURAL RULES?

Although the Advisory Committee has hinted that rule revision will likely take place in the future, there are compelling arguments against revising the rules to address third-party funding at this time.<sup>66</sup> First, the Advisory Committee has correctly stated that third-party funding “takes many forms that may present distinctive questions” and that “the questions raised by third-party financing are important [b]ut ... have not been fully identified, and may change as practices develop further.”<sup>67</sup> Revising procedural rules is particularly difficult when new situations arise, particularly this early in the existence of the third-party funding industry.

For example, the Advisory Committee has been observing the growing number of courts allowing or requiring electronic filing of documents but has intentionally refrained (up to now) from revising the Federal Rules to address electronic filing.<sup>68</sup> Furthermore, the Advisory

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<sup>65</sup> See *infra* Part V (addressing issues relating to disclosure frameworks, privileges, sanctions, and class actions).

<sup>66</sup> See Advisory Committee Report, *supra* note 2, at 3-4.

<sup>67</sup> *Id.* at 4.

<sup>68</sup> *C.f.*, Advisory Committee on the Civil Rules Agenda Book, (Apr. 10, 2014), 29-30,

<http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Agenda%20Books/Civil/CV2014-04.pdf> (reflecting in the minutes of the Nov. 2013 meeting of the Advisory Committee a discussion regarding addressing electronic filings in the Federal Rules: “One reason for caution is the hope that courts and lawyers will be able to work together to develop sensible solutions to problems as they arise, and that this process will provide a better foundation for new rules than more abstract consideration. If there are no general calls for help, no widespread complaints that the rules need to be brought into the present and near future, perhaps there is no need to rush ahead on a broad basis.... A committee member suggested that it is worthwhile to look at these questions more thoughtfully, but not immediately. ‘There are issues out there, but they are not yet big issues. Time will bring more information.’ We should do the obvious things now, and find out whether lawyers are complaining about other things. A broader view noted that this discussion reflects a regular pattern in rulemaking. We often confront a choice. We could attempt to anticipate the future



Committee observed and assessed discovery disputes regarding electronically stored information (ESI) for several years under the current rules modified by local case law and local rules before proposing the current amendments to address e-discovery.<sup>69</sup> The amendments to the rules were intended to address directly problems with ESI that had arisen in the courts.<sup>70</sup> Thus, it is likely that the Advisory Committee plans to wait to see how judges and arbitrators handle third-party funding before revising the Federal Rules.

Similarly, arbitral institutions worldwide have refrained from revising their rules to address third-party funding in order to maintain the trans-substantivity of arbitration rules and avoid clashing with the applicable national laws regarding third-party funding chosen by the parties or the laws of the procedural seat of arbitration.<sup>71</sup> The International Bar Association (IBA) is the only organization that has revised any arbitration-related rules to address third-party funding.<sup>72</sup> The IBA Guidelines are optional rather than mandatory, however, so the systemic impact of their revisions remains uncertain. In essence, the

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and provide for it. Or we can wait and codify what the world has come to do, at least generally. ‘We do want to reflect what people are doing. But perhaps not just yet.’ States ‘may get ahead of us.’ And we can learn from them.”)

<sup>69</sup> *See id.* at 369-535 (detailing the history and arguments regarding Proposed Rule 37(e), which addresses evidentiary sanctions for electronically stored information).

<sup>70</sup> *See id.*

<sup>71</sup> Arbitration is supposed to transcend substantive laws, but also be compatible with those laws. Parties can choose arbitration and whatever substantive laws they prefer. In this way, arbitration is trans-substantive. Some countries or states prohibit third-party funding while others allow it. The arbitral institutions cannot adopt arbitration rules that conflict with either of those positions. Therefore, the arbitration institutions will likely remain neutral and not address third-party funding in their arbitration rules. Hence, for arbitration, there is no uniform way to address third-party funding. There are dozens of arbitration rules in use worldwide, and parties can even fashion their own arbitration procedure by agreement, if they prefer. The arbitration institutions will likely not change their arbitration rules to address third-party funding, because it would be too difficult to come to a consensus about what the new rule should be. Thus, the best vehicle to address third-party funding in arbitration is through guidelines or codes of best practices. *See* Jim Saksa, *Victoria Shannon Discusses The State of the Legal Funding Industry at Home and in International Arbitration*, LEGAL FUNDING CENTRAL – LFC360 BLOG (Jul. 31, 2014), <http://legalfundingcentral.com/lfc360/new/legal-funding-expert-victoria-shannon-discusses-state-industry-home-international-arbitration/> (last visited Feb. 15, 2015). *Cf. infra* note 257 regarding the debate over the trans-substantive nature of the Federal Rules of Civil Procedure.

<sup>72</sup> *See infra* note 89.

third-party funding industry is nascent and understudied in the United States and many other jurisdictions around the world, so rule revisions undertaken now would like not be well-informed.

Second, amending the Federal Rules<sup>73</sup> and amending rules of arbitration<sup>74</sup> are both complex, lengthy processes. As history indicates, revising even one rule in the Federal Rules of Civil Procedure or rules of arbitration may take years.<sup>75</sup> Most rules of arbitration are revised only once or twice within a decade, and the major arbitral institutions have adopted revisions to their rules recently enough for additional revisions to be many years away.<sup>76</sup>

Observing the effects of third-party funding in the litigation and arbitration systems would be ideal before proposing rule revisions; however, under the current rules, courts and arbitrators are not informed when third-party funding is involved in a case. As discussed in Part V, judges and arbitrators can interpret the existing the rules to mandate disclosure to the decision maker to ensure that decision makers are aware of the funder's involvement in cases they are hearing. Judges and arbitrators can then observe the case and develop a sense of what is working or not working about the funder's participation and observe how smoothly, efficiently, and fairly the case progresses to a resolution. If there are problems, judges can report this information to their districts' delegates to the Judicial Conference of the United States, established under 28 U.S.C. § 331, so that the Conference might consider future rule

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<sup>73</sup> For an overview of the rules revision process, see 28 U.S.C. § 2074-75; *Overview for the Bench Bar and Public*, <http://www.uscourts.gov/RulesAndPolicies/rules/about-rulemaking/how-rulemaking-process-works/overview-bench-bar-public.aspx> (explaining the entire rules revision process in detail); GUIDE TO JUDICIARY POLICY, VOL. 1, § 440, available at <http://www.uscourts.gov/RulesAndPolicies/rules/about-rulemaking/laws-procedures-governing-work-rules/rules-committee-procedures.aspx> (explaining the process of rule revision in the Standing Committee in detail); *About the Rulemaking Process*, <http://www.uscourts.gov/RulesAndPolicies/rules/about-rulemaking.aspx>; *Pending Rules Amendments* <http://www.uscourts.gov/RulesAndPolicies/rules/pending-rules.aspx> (describing the procedures for revising the Federal Rules).

<sup>74</sup> See, e.g., Jason Fry & Victoria Shannon, *The 2012 ICC Rules of Arbitration* in CONTEMPORARY ISSUES IN INTERNATIONAL ARBITRATION AND MEDIATION: THE FORDHAM PAPERS 2011, 187-201 (Arthur Rovine ed., 2012) (describing the complex process for revising the ICC Rules of Arbitration).

<sup>75</sup> See *supra* note 73; Fry & Shannon, *supra* note 74.

<sup>76</sup> For example, six of the most widely used sets of arbitration rules in the world were revised within the past five years: two were revised in 2014, two in 2013, one in 2012, and one in 2010. Cf. *infra* notes 148 and 184 citing provisions from those six sets of arbitration rules.

revisions to address such problems.<sup>77</sup> Arbitrators can report this information to the arbitral institution overseeing their cases.<sup>78</sup> This reporting will help educate those undertaking the lengthy rules revision processes long before amendments would actually be proposed.

Third, the Federal Rules authorize "construing" the Federal Rules and creating local court rules and judicially-created rules when needed, which may be sufficient to address issues relating to third-party funding.<sup>79</sup> Rule 1 provides that the rules "should be construed and administered to secure the just, speedy, and inexpensive determination of every action and proceeding," and a proposed revision to Rule 1 would put the same duty on the parties to each case.<sup>80</sup> Arbitration rules contain

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<sup>77</sup> See 28 U.S.C. § 331 (2012) (describing the function of the Judicial Conference of the United States, which includes "mak[ing] a comprehensive survey of the condition of business in the courts," "submit[ting] suggestions and recommendations to the various courts to promote uniformity of management procedures and the expeditious conduct of court business," "carry[ing] on a continuous study of the operation and effect of the general rules of practice and procedure now or hereafter in use as prescribed by the Supreme Court for the other courts of the United States pursuant to law," and "recommend[ing] [rule changes] from time to time to the Supreme Court for its consideration and adoption, modification or rejection, in accordance with law.")

<sup>78</sup> In the case of ad hoc arbitration, the arbitrator would report to the appointing authority, if there is one involved. If there is no appointing authority, then that particular arbitrator would likely not have a duty to report the involvement of the third-party funder to any outside entity. The arbitrator would have to report to the parties in the ad hoc arbitration if the arbitrator has a conflict of interest with respect to the third-party funder's participation.

<sup>79</sup> See *infra* notes 80 and 82.

<sup>80</sup> Note that a pending proposed revision to Rule 1 would add a duty on the parties to employ the rules in a cooperative manner. See *Advisory Committee on the Civil Rules Agenda Book*, *supra* note 68, at 92-93 ("The published proposal amends Rule 1 to direct that the rules 'be construed, ~~and~~ administered, and employed by the court and the parties to secure the just, speedy, and inexpensive determination of every action and proceeding.' ... Cooperation among the parties was a theme heavily and frequently emphasized at the Duke Conference. It has been vigorously urged, and principles of cooperation have been drafted by concerned organizations. There is little opposition to the basic concept of cooperation.... A more specific question, largely ignored in the comments, asks whether the parties should be directed to construe and administer the rules, as well as to employ them, to the desired ends. The rule could be written: "construed and administered by the court, and employed by the parties, to secure \* \* \*." But on balance it seems better to retain the hint that the parties should undertake to construe the rules for their intended purposes, and — to the extent that the parties commonly administer the rules, as in discovery — to administer them for the same purposes.") (cross out, underlining, and asterisks in original).

a similar provision.<sup>81</sup> Rule 83 authorizes the creation of new procedural rules at the grassroots level on an *ad hoc* basis to address new situations and needs.<sup>82</sup> For example, Rule 83(a) provides that district courts can make their own local rules if there is no preexisting federal rule on the subject, and Rule 83(b) states that “a judge may regulate practice in any manner consistent with federal law, rules adopted under 28 U.S.C. § 2072 [rules made by the U.S. Supreme Court], and § 2075 [bankruptcy rules], and the district’s local rules.”<sup>83</sup> Thus, the Federal Rules already provide district courts and judges with the authority to construe and apply the existing Federal Rules, or to create new local rules, to take into account third-party funding.

Some perceptive judges have occasionally asked parties outright when they suspect that a funder is involved in the case.<sup>84</sup> The disadvantage of this approach is that there could be conflicting judicial practices or local court rules regarding third-party funding in various jurisdictions, which would lead to confusion regarding how third-party funding is or should be handled by federal courts. As of now, there is insufficient data on the prevalence of third-party funding in U.S. litigation to determine whether conflicting rules among federal districts would actually create a problem. Standardizing regulation has costs as well as benefits, so standardization should be employed only if necessary to solve a particular problem. In arbitration, arbitrators have somewhat more flexible procedural standards and can devise procedures and rules tailored to the parties’ needs, but they must also be notified of the funder’s participation in order to disclose potential conflicts of interest, if any.<sup>85</sup>

Fourth, more instances of both effective and problematic funding need to be observed in the courts and arbitrations over a longer period before comprehensive rule revision proposals can be formulated. At present, potentially problematic funding arrangements are revealed in court or in an arbitration only when the funding agreement is disputed or challenged.<sup>86</sup> Satisfied parties and funders proceed with their arrangements silently under our current rules, so there is no mechanism

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<sup>81</sup> See, e.g., *infra* note 250.

<sup>82</sup> See FED. R. CIV P. 83 (authorizing district courts “to adopt and amend rules governing its practice” provided that “[a] local rule must be consistent with—but not duplicate—federal statutes and rules” and authorizing that “[a] judge may regulate practice in any manner consistent with federal law, [the Federal Rules of Civil Procedure, the bankruptcy rules], and the district’s local rules....”).

<sup>83</sup> See *supra* note 82.

<sup>84</sup> See, e.g., *infra* note 215.

<sup>85</sup> See *infra* note 192 and accompanying text.

<sup>86</sup> See, e.g., *supra* note 35; *infra* note 215.

for observing best practices to determine the appropriate behavior as the basis for formulating new or revised rules. Thus, formulating rules or revisions at this stage may be reactionary and would likely be based largely on addressing observed problems that may be outliers, rather than encouraging good behavior.<sup>87</sup> Without judges and arbitrators requiring disclosure of funding arrangements to the decision maker, however, courts and arbitral tribunals will not have the tools needed to identify and observe cases involving third-party funding to see whether the observed problems are widespread or isolated.

Fifth, writing an effective Federal Rule or rule of arbitration likely requires coming up with a definition of “third-party funding” or “third-party funder,” which has proved to be incredibly difficult.<sup>88</sup> An example of a recent attempt to define “third-party funder” can be found in the revised International Bar Association’s Guidelines on Conflicts of Interest in International Arbitration, addressing arbitrator conflicts of interest.<sup>89</sup> The explanation to one of the Guidelines states that a third-party funder “may have a direct economic interest in the award...” and would be “any person or entity that is contributing funds, or other material support, to the prosecution or defence [sic] of the case and that has a direct economic interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration.”<sup>90</sup> This definition was coined in the context of international arbitration, but it is relevant to litigation as well.

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<sup>87</sup> Cf. *Northern Securities Co. v. U.S.*, 193 U.S. 197, 400-01 (1904) (Holmes, J., dissenting) (“Great cases, like hard cases, make bad law. For great cases are called great, not by reason of their real importance in shaping the law of the future, but because of some accident of immediate overwhelming interest which appeals to the feelings and distorts the judgment. These immediate interests exercise a kind of hydraulic pressure which makes what previously was clear seem doubtful, and before which even well settled principles of law will bend.”); *Winterbottom v. Wright*, 10 M. & W. 109, 152 Eng.Rep. 402 (Ex. 1842) (“This is one of those unfortunate cases ... in which, it is, no doubt, a hardship upon the plaintiff to be without a remedy, but by that consideration we ought not to be influenced. Hard cases, it has frequently been observed, are apt to introduce bad law.”).

<sup>88</sup> See *infra* note 251 and accompanying text.

<sup>89</sup> See International Bar Association, *Guidelines on Conflicts of Interest in International Arbitration*, (Nov. 28, 2014) (including references to third-party funding as a “direct economic interest in the award to be rendered in the arbitration” in General Standards 6 and 7; the Explanations to General Standards 6 and 7; the Non-Waivable Red List § 1.2; the Waivable Red List § 2.2.3; the Orange List §§ 3.2.2, 3.4.3, and 3.4.4) available at [http://www.ibanet.org/Publications/publications\\_IBA\\_guides\\_and\\_free\\_materials.aspx](http://www.ibanet.org/Publications/publications_IBA_guides_and_free_materials.aspx) [hereinafter “IBA Guidelines”].

<sup>90</sup> *Id.* at Explanation to General Standard 6.

On the contrary, a definition of “third-party funding” or “third-party funder” may not be required in order to write an effective rule to address this phenomenon. For example, the U.S. constitutional “obscenity” test could be said to take a “know it when you see it” approach, which is likely appropriate for third-party funding as well.<sup>91</sup> Such a test would be easy to apply, because parties know when they are funded and funders know when they are funding, regardless of the structure of the arrangement. Thus, the rules could direct parties to disclose the existence of their funding arrangement without having to define “third-party funding” or “third-party funder” in the rules. For example, Rule 26(a)(1)(A)(iv) already requires disclosure of the defendant’s insurance arrangement where the insurer is potentially liable for paying for the judgment.<sup>92</sup> Yet, the Federal Rules do not define the word “insurance,” rightfully presuming that defendants know whether they are insured.<sup>93</sup> Similarly, Rule 26(b)(3)(A) limits disclosure of trial preparation documents and protects documents prepared by other representatives or entities assisting a party such as a “consultant, surety, indemnitor, insurer, or agent” without defining any of those terms.<sup>94</sup> This approach has proved successful. Thus, effective rules revisions may not require defining “third-party funder” or “third-party funding.” However, this question need not be answered definitively at this time, since rule revisions will not take place in the near future.

On balance, the Advisory Committee and arbitral institutions are probably correct to refrain from changing procedural rules while third-party funding is still growing and developing. It is better for judges and arbitrators to use their inherent powers to deal with the practice on an *ad hoc* basis unless or until systematic problems give rise to a need to address third-party funding directly in the procedural rules.<sup>95</sup>

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<sup>91</sup> See, e.g., *Miller v. California*, 413 U.S. 15, 39 (1973) (Douglas, J., dissenting) (“But even those members of this Court who had created the new and changing standards of ‘obscenity’ could not agree on their application. And so we adopted a per curiam treatment of so-called obscene publications that seemed to pass constitutional muster under the several constitutional tests which had been formulated. Some condemn it if its ‘dominant tendency might be to ‘deprave or corrupt’ a reader.’ Others look not to the content of the book but to whether it is advertised ‘to appeal to the erotic interests of customers.’ Some condemn only ‘hardcore pornography’; but even then a true definition is lacking. It has indeed been said of that definition, ‘I could never succeed in (defining it) intelligibly,’ but ‘I know it when I see it.’”) (internal footnotes and citations omitted).

<sup>92</sup> See FED. R. CIV. P. 26(a)(1)(A)(iv).

<sup>93</sup> *Id.*

<sup>94</sup> See FED. R. CIV. P. 26(b)(3)(A).

<sup>95</sup> See *supra* note 71.

V. THE SOLUTION: PROPOSED RULE REINTERPRETATIONS IN LIGHT  
OF THIRD-PARTY FUNDING

This Part answers the call of the Advisory Committee to give guidance to judges regarding how to interpret and administer the Federal Rules of Civil procedure when they encounter third-party funding in a case.<sup>96</sup> This Part also incorporates guidance to arbitrators regarding how to handle third-party funding, since, as mentioned earlier, rules of arbitration procedure will likely not be revised any time soon either.<sup>97</sup>

This Part addresses litigation and arbitration together for several reasons. First, at its foundation, arbitration is a quasi-judicial process; rules of litigation have informed the development and interpretation of rules of arbitration worldwide.<sup>98</sup> Second, arbitration relies on courts to perform many essential procedural functions either that arbitrators do not have the power to perform or that the parties choose to have the court perform instead, such as issuing subpoenas, attaching assets, issuing injunctions, enforcing an arbitration agreement, and recognizing or enforcing arbitral awards.<sup>99</sup> Thus, the two processes are never completely separate and dovetail at the enforcement stage, as discussed in Part V.D. Third, arbitration borrows privilege rules from litigation

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<sup>96</sup> See *supra* notes 3-5 and accompanying text.

<sup>97</sup> See *supra* notes 74-76 and accompanying text.

<sup>98</sup> See e.g., Eric E. Bergsten, *Module 5.1: International Commercial Arbitration: Overview*, in UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, COURSE ON DISPUTE SETTLEMENT IN INTERNATIONAL TRADE, INVESTMENT AND INTELLECTUAL PROPERTY, 19 (2005), [http://unctad.org/en/Docs/edmmisc232add38\\_en.pdf](http://unctad.org/en/Docs/edmmisc232add38_en.pdf) (“Most societies developed at an early date systems [sic] of ‘arbitration’ for the settlement of disputes. Disputes between private parties that are settled by arbitration might be of a family nature, concern labor relations or be between two commercial enterprises. In the past such disputes were almost exclusively domestic and the systems of arbitration that developed reflected the nature of the particular society. It is no surprise, therefore, to find vast differences between domestic arbitration in Continental Europe, Latin America, Islamic countries, the United States and China. In some countries, particularly in Latin America and in England, arbitration was traditionally seen as an extension of the State system of litigation. In such an atmosphere the procedure followed in arbitration was necessarily closely modelled on the procedure followed in litigation in the courts. Even where arbitration was not seen as an extension of the State system of litigation, and the law did not require the local court procedure to be followed in arbitration, the habits developed by lawyers in the courts were carried over into arbitration.”).

<sup>99</sup> See Shannon (2015), *supra* note 29, at 126-27 (describing the various essential functions that courts perform with respect to arbitration proceedings).

rules either from the seat of arbitration or chosen by the parties; there are no separate privilege rules for arbitration.<sup>100</sup> Fourth, both judges and arbitrators need disclosure from the funded party in order to carry out their duties with respect to handling conflicts of interests as they relate to third-party funding.<sup>101</sup> Fifth, many procedural devices that may be affected by third-party funding are used in both litigation and arbitration, such as class actions, cost sanctions, and attorney fee shifting.<sup>102</sup> Finally, courts enforce both judgments and arbitration awards; arbitrators and arbitral institutions have no power to enforce the awards they issue.<sup>103</sup> For the foregoing reasons, this Part provides a pragmatic set of reinterpretations of the existing rules of litigation and arbitration procedure regarding discovery, disclosures, privileges, conflicts of interest, cost allocation, sanctions, class actions, and enforcement in light of the third-party funding phenomenon.

#### A. Judging Discovery, Disclosures, and Privileges

##### 1. Litigation: Initial Disclosures, Pretrial Conferences, and Evidentiary Privileges

The overarching theme of all calls to regulate third-party funding is disclosure. However, many more questions are raised by the call to disclose than are answered. *When must information be disclosed? To whom must this information be disclosed: the decision maker or the opposing side? What information should be disclosed: the identity of the funder, a summary of the terms of the funding agreement, or the actual text of the agreement? Should evidentiary privileges extend to privileged information that parties disclose to funders or to work product created by funders?* This Section attempts to answer these questions by reinterpreting Rule 26, Rule 16, and privileges under U.S. common law.

The purpose of Rule 26 is to guide the parties through the process of

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<sup>100</sup> See generally Klaus Peter Berger, *Evidentiary Privileges: Best Practice Standards versus/ and Arbitral Discretion*, 22 ARB. INT'L 501 (2006); Richard M. Mosk & Tom Ginsburg, *Evidentiary Privileges in International Arbitration*, 50 INT'L & COMP. L.Q. 345 (2001); Jack M. Sabatino, *ADR as "Litigation Lite": Procedural and Evidentiary Norms Embedded Within Alternative Dispute Resolution*, 47 EMORY L.J. 1289 (1998). See also *infra* Part V.A.

<sup>101</sup> See *infra* Part V.B.

<sup>102</sup> See *infra* Part V.C.

<sup>103</sup> See *infra* note 242 and accompanying text; see also *infra* Part V.D regarding the enforcement of arbitral awards.



discovery and disclosure.<sup>104</sup> Rule 26(f) also instructs the parties to agree on a discovery plan during a pretrial conference separate from the conference required by Rule 16, although both conferences together may result in a joint plan for discovery and scheduling.<sup>105</sup> Rule 26(b)(1) limits discovery to any "nonprivileged matter that is relevant to any party's claim or defense."<sup>106</sup> Rule 26 does not define the term "relevant," but the Advisory Committee Notes to the 2000 amendments to Rule 26 state that the focus of discovery should be the actual claims and defenses in the action, and that discovery should not be used to develop new claims or defenses not already pled.<sup>107</sup> In light of this, the existence or terms of the funding arrangement would not be relevant or material to any of the pled claims and defenses relating to the merits of the case.<sup>108</sup> Funders are also not witnesses or experts subject to disclosure, as they will not testify at trial and are not employed as experts by the parties.<sup>109</sup> Thus, third-party funding ordinarily would not be subject to general discovery or initial disclosure under Rule 26.<sup>110</sup>

A potential exception is found in Rule 26(a)(1)(A)(iv), which requires a party in discovery to disclose any insurance agreement where the insurer is potentially liable for paying for or reimbursing the insured party for all or part of the judgment.<sup>111</sup> A court will likely view a funder that agrees to pay the underlying judgment (not just costs and attorneys' fees) as an insurer, which would subject the funding arrangement to this Rule.<sup>112</sup> This rule already applies to funding arrangements that cover the underlying the liability, without the need for revisions. However, in the

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<sup>104</sup> See *supra* note 118 and accompanying text.

<sup>105</sup> See FED R. CIV. P. 26(f); see *supra* note 139 (regarding the FED R. CIV. P. 16 pretrial conference).

<sup>106</sup> See FED R. CIV. P. 26(b)(1). A proposed revision to FED R. CIV. P. 26(b)(1) would include a proportionality element, but would not change the effect on third-party funding because the phrase "the parties' resources" would remain in the rule. See *Advisory Committee on the Civil Rules Agenda Book*, *supra* note 68, at 79-93, (discussing proposed revisions to Rule 26), 97-105 (presenting actual markup of revisions to Rule 26).

<sup>107</sup> See 2000 Advisory Committee Note to FED R. CIV. P. 26(b)(1).

<sup>108</sup> This is separate from the party disclosing this identity of the funder to the judge, *in camera*, under the proposed revisions to FED R. CIV. P. 7.1 and 28 U.S.C. § 455. See *infra* Part V.B.1.

<sup>109</sup> See FED R. CIV. P. 26(a)(3)(A) (regarding witnesses that must be disclosed) and FED R. CIV. P. 26(a)(2) (regarding experts that must be disclosed).

<sup>110</sup> See Advisory Committee Note to FED R. CIV. P. 26(b)(1) (stating that the parties cannot use discovery to develop new claims or defenses).

<sup>111</sup> See FED R. CIV. P. 26(a)(1)(A)(iv).

<sup>112</sup> *Id.*

vast majority of funding arrangements, the funder does not agree to pay the underlying liability. Thus, this rule is inapplicable to the vast majority of third-party funding arrangements.

Similarly, while the funding arrangement need not be disclosed or discoverable, the participation of a funder may be relevant to a court assessing "the parties' resources" when determining whether to limit the frequency and extent of discovery.<sup>113</sup> A judge could require the funded party to disclose the identity of the funder to the judge by reinterpreting Rule 7.1 or through implementing a local rule requiring such disclosure under Rule 83, so that the judge would know that the funder is participating.<sup>114</sup> The participation of the funder may indicate that the party has more "resources" for litigation costs – including discovery – than its personal financial status may suggest. Alternatively, if the term "resources" is not construed to include sources of third-party funding, then Rule 26(b)(2)(C)(iii) should be construed to include third-party funding.<sup>115</sup>

The portion of the Advisory Committee's report quoted in the introduction explained that the Advisory Committee declined to pursue further a formal proposal to amend Fed. R. Civ. P. 26(a)(1)(A) to require disclosure of third-party funding arrangements to the opposing party for inspection and copying.<sup>116</sup> Fed. R. Civ. P. 26(a)(1)(A) governs initial disclosures that parties must make to one another at the outset of their dispute.<sup>117</sup> The amendment does not align with purpose and goals of Rule 26 and may lead to satellite litigation.<sup>118</sup> The first three required initial

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<sup>113</sup> See FED R. CIV. P. 26(b)(2)(C)(iii); cf. Letter from the U.S. Chamber Institute for Legal Reform et al., to the Secretary of the Committee on Rules of Practice and Procedure, *RE: Proposed Amendment to FED. R. CIV. P. 26(a)(1)(A)*, (Apr. 9, 2014), at 4-5, available at <http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/cv-suggestions-2014/14-CV-B-suggestion.pdf> (last visited Feb. 15, 2015) [hereinafter *Letter*] (discussing the potential for cost-shifting for "complex discovery disputes" if a third-party funder is involved).

<sup>114</sup> See *supra* note 82 and accompanying text; *infra* Part V.B.1.

<sup>115</sup> For example, FED R. CIV. P. 26(b)(2)(C)(iii) could be revised to say "the parties' resources (including third-party funding)."

<sup>116</sup> See *supra* note 5 and accompanying text; see also *Letter*, *supra* note 113, at 8.

<sup>117</sup> See generally FED. R. CIV. P. 26(a)(1)(A) (outlining initial required disclosures that parties must make).

<sup>118</sup> See FED. R. CIV. P. 26(a)(1), Committee Notes (2000 Amendments) ("Purposes of amendments. The Rule 26(a)(1) initial disclosure provisions are amended to establish a nationally uniform practice. *The scope of the disclosure obligation is narrowed to cover only information that the disclosing party may use to support its position.* In addition, the rule exempts specified categories of proceedings from initial disclosure, and permits a party who contends that disclosure is not appropriate in the circumstances of the case to present its objections to the

disclosures listed under the existing rule all relate to witnesses or evidence that will be presented at trial, and the fourth required initial disclosure addresses insurance agreements that may be used to satisfy, indemnify, or reimburse all or part of the monetary judgment.<sup>119</sup> The funding agreement does not relate to witnesses or evidence that will be presented at trial, and the vast majority of non-party litigation funders do not agree to pay the underlying judgment.<sup>120</sup> In addition, as mentioned above, under Fed. R. Civ. P. 26(b)(1), the terms of the funding arrangement are not "relevant to any party's claim or defense," nor would disclosure of the terms of the funding agreement "lead to the discovery of admissible evidence."<sup>121</sup> Thus, this proposed amendment falls outside the purpose and goals of Rule 26, as a whole.<sup>122</sup> Furthermore, such an amendment would likely lead to satellite litigation over the terms of the funding arrangement or to the parties comparing and contrasting the terms of their funding arrangements, if both sides are funded in the

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court, which must then determine whether disclosure should be made.") (emphasis added); *infra* note 123 (listing sources discussing the dangers of satellite litigation over the funding arrangement).

<sup>119</sup> See FED. R. CIV P. 26(a)(1)(A)(i) (requiring disclosure of "the name ..., address and telephone number of each individual likely to have discoverable information ... that the disclosing party may use to support its claims or defenses..."); FED. R. CIV P. 26(a)(1)(A)(ii) (requiring disclosure of "a copy ... of all documents, electronically stored information, and tangible things that the disclosing party ... may use to support its claims or defenses..."); FED. R. CIV P. 26(a)(1)(A)(iii) ("a computation of each category of damages claimed by the disclosing party" and "the documents or other evidentiary material ... on which each computation is based, including materials bearing on the nature and extent of injuries suffered"); FED. R. CIV P. 26(a)(1)(A)(iv) (requiring disclosure of "any insurance agreement under which an insurance business may be liable to satisfy all or party of a possible judgment in the action or to indemnify or reimburse for payments made to satisfy the judgment.").

<sup>120</sup> If the funder has purchased an assignment of the claim or liability, then the funder has agreed to pay the underlying judgment (if any) and would be named as a party to the case. Most funders are not parties, however, and do not agree to pay the underlying judgment, even on the defense side. See Steinitz, *infra* note 9, at 1275-1276 (2011); NIEUWVELD & SHANNON, *supra* note 1052, at 5-6. This is different from a liability insurance arrangement in which the insurer does agree to pay the judgment. If a third-party funder does agree to pay the underlying judgment, then that arrangement would be subject to disclosure under the existing FED. R. CIV P. 26(a)(1)(A)(iv).

<sup>121</sup> See FED. R. CIV P. 26(b)(1) ("Parties may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense.... Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence.").

<sup>122</sup> See *supra* note 118.

case.<sup>123</sup> In sum, the proposed amendment was not the right solution and may distract the parties from pursuing the merits of their underlying dispute. Nevertheless, the authors of the letter have identified an important problem, namely that the decision maker needs to know about the participation of the third-party funder in the case, which is addressed in Part V.B, below.

Rule 26 also addresses privileges, which are another source of uncertainty in the rules of procedure with respect to third-party funding. The main privileges that would protect a party's documents and information in federal court would be the attorney-client privilege and the work-product doctrine.<sup>124</sup> Both privileges are subject to waiver by disclosure of the document or information to a third party, unless an exception to waiver applies.<sup>125</sup> The exceptions to waiver listed Federal

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<sup>123</sup> See, e.g., William Akel et. al., *Litigation funding*, <http://www.lexology.com/library/detail.aspx?g=a08905f5-f923-4fc8-ba98-dc9bdf8efe23> (Oct. 12., 2014) (“Strategically minded defendants are also interested in knowing about the plaintiffs’ funding arrangements, so as to be able to undermine them and potentially defeat even meritorious claims through satellite litigation.”); Law Council of Australia, *Regulation of third party litigation funding in Australia: Position Paper*, 3, <http://www.lawcouncil.asn.au/lawcouncil/images/LCA-PDF/a-z-docs/RegulationofthirdpartylitigationfundinginAustralia.pdf> (Jun. 2011) (“The purpose of the paper was to set out areas in which regulation may be required for consumer protection, to minimise [sic] conflicts of interest and put an end to expensive satellite litigation over the propriety of litigation funding agreements.”); Atherton Godfrey Solicitors, *Satellite Litigation*, <http://www.athertongodfrey.co.uk/satellite-litigation> (“Satellite litigation can take up more than an ‘appropriate share of the Court’s resources’, tends not to help with either expedition or the saving of expense and perhaps more than anything leads to disproportionality. Recent years have seen many of the issues arising from the last significant procedural and funding reforms gradually resolved, though not without much satellite litigation on the way. It would be regrettable if further proposed changes lead to a similar period of uncertainty, cost and delay.”).

<sup>124</sup> See FED R. EVID. 502(g) (defining “attorney-client privilege” and “work-product protection”). Other privileges – such as the doctor-patient, priest-penitent, and accountant-client privileges – would not apply to third-party funding. Also, note that FED R. EVID. 502 applies in diversity cases and in state courts. See FED R. EVID. 502(f).

<sup>125</sup> See FED R. EVID. 502 (stating that the exceptions to waiver of the attorney-client privilege and the work-product doctrine are: disclosure in a separate federal proceeding [502(a)], disclosure to a federal office or agency [502(a)], inadvertent disclosure [502(b)], disclosure in a separate state proceeding [502(c)], a court order stating that the privilege is not waived [502(d)]; an agreement among the parties stating that the effect of disclosure is not waiver of the privilege [502(e)]). Also, note that FED R. EVID. 502 applies in diversity cases and in state courts. See FED R. EVID. 502(f).

Rule of Evidence 502 generally do not apply to third-party funding.<sup>126</sup>

In order to determine whether to fund a case, funders may require parties to share information about their case that may be privileged under applicable law.<sup>127</sup> There is currently no rule including the funder within the exceptions to waiver; thus, a party's privileged documents or information may become discoverable by the opposing party after the funded party discloses such documents or information to the funder.<sup>128</sup> At least one federal district court has stated that a preexisting confidentiality agreement between the funder and the funded party may protect the disclosed information under the work-product doctrine, but not the attorney-client privilege.<sup>129</sup> In the absence of a clear rule, however, parties may be wary about seeking funding for fear that they will waive their privileges by sharing information with the funder.

The attorney-client privilege derives from sources other than the Federal Rules of Civil Procedure.<sup>130</sup> Thus, state legislatures or state supreme courts would have to amend the exceptions to waiver of the *common law* attorney-client privilege and work-product doctrine to extend to disclosures made to the funder. This solution would increase the security of confidential information that the party must share with the funder in order to obtain funding and prevent penalizing a party seeking funding by protecting against the potential waiver of its evidentiary privileges. In the interim, under Rules 16 and 26(f), parties can discuss and make an agreement regarding the applicability of evidentiary privileges to information disclosed to the funder.<sup>131</sup> The parties should also strongly consider asking the judge to memorialize their agreement in a court order.<sup>132</sup>

Although the privileges and protections for the funded party's documents and information are presently unclear, Rule 26 already protects documents and information prepared by the funder.<sup>133</sup> Rule

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<sup>126</sup> *Id.*

<sup>127</sup> See NIEUWVELD & SHANNON, *supra* note 1052, at 4-11.

<sup>128</sup> See *infra* note 129.

<sup>129</sup> See generally *Miller UK Ltd. and Miller International Ltd. v. Caterpillar, Inc.*, 17 F.Supp.3d 711 (N.D.Ill. 2014), (addressing attorney-client privilege and work product doctrine in the context of a party seeking third-party funding).

<sup>130</sup> See FED. R. EVID. 501 (stating that federal common law governs privileges in federal court, unless the Constitution, a federal statute or the Supreme Court provides otherwise; in diversity cases, “for which state law supplies the rule of decision,” state law governs privileges in federal court; Federal Rules of Civil Procedure do not govern privileges in those cases).

<sup>131</sup> See FED R. CIV. P. 16; FED R. CIV. P. 26(f).

<sup>132</sup> See FED R. CIV. P. 26(f)(3)(D).

<sup>133</sup> See *supra* note 94 and accompanying text.

26(b)(3)(A) prohibits discovery of “documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representatives,” except in exigent circumstances.<sup>134</sup> Furthermore, the rule states that the term “representatives” includes a “consultant, surety, indemnitor, insurer, or agent.”<sup>135</sup> A funder surely falls within one or more of these categories. Rule 26(b)(3)(B) protects the representatives’ “mental impressions, conclusions, opinions, or legal theories.”<sup>136</sup> Thus, the funder's documents and information with respect to a potential or current funded party would be already protected under the existing rule.<sup>137</sup> The existing protections for the funder's trial preparation materials also bolster the idea that the exceptions to waiver of the common law attorney-client privilege and work-product doctrine should be amended to extend to disclosures made to the funder.

Despite the unclear status of evidentiary privileges for documents disclosed to funders, the parties can make an enforceable agreement during their pretrial conference regarding how such information will be handled in their case.<sup>138</sup> Rule 16 gives the court the authority to order the parties to hold a pre-trial conference to work out many issues, including disclosures, scheduling, and other issues before trial.<sup>139</sup> Many local court rules explicitly require the parties to participate in this pretrial conference. Rule 16 further stipulates, among other things, that parties may make an agreement to modify the extent of discovery,<sup>140</sup> honor claims of privilege over documents or protection over trial preparation materials,<sup>141</sup> and handle “other appropriate matters” as they agree.<sup>142</sup> In addition, courts may “consider and take action” on “facilitating in other ways the just, speedy, and inexpensive disposition of the action.”<sup>143</sup> Courts may also impose sanctions under Rule 16(f)(1)(C) against a party or a party's attorney (but not a funder) for “fail[ure] to obey a scheduling or other pretrial order.” This is reasonable, because the funder does not appear or present documents or testimony in the case.

Under the existing Rule 16, the parties can make an agreement regarding how the disclosure of the funding arrangement will be handled

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<sup>134</sup> See FED R. CIV. P. 26(b)(3)(A).

<sup>135</sup> *Id.*

<sup>136</sup> See FED R. CIV. P. 26(b)(3)(B).

<sup>137</sup> See *supra* note 129 and 133.

<sup>138</sup> See FED R. CIV. P. 16; See FED R. CIV. P. 26.

<sup>139</sup> See FED R. CIV. P. 16(a) (“the court may order the attorneys and any unrepresented parties to appear for one or more pretrial conferences”).

<sup>140</sup> See FED R. CIV. P. 16(b)(3)(B)(ii).

<sup>141</sup> See FED R. CIV. P. 16(b)(3)(B)(iv).

<sup>142</sup> See FED R. CIV. P. 16(b)(3)(B)(vi).

<sup>143</sup> See FED R. CIV. P. 16(c)(2)(P).

and whether documents shared with or prepared by funders would be protected under the attorney-client privileges and the work product doctrine.<sup>144</sup> Such an agreement may be memorialized in a discovery plan under Rule 26(f)(3).<sup>145</sup> The parties are most likely willing to make such an agreement when funders back both sides. If the agreement is memorialized in a scheduling order, then the party or the party's attorney could be sanctioned by the court for noncompliance.<sup>146</sup> While the existing wording of Rule 16 provides a catch-all that would cover third-party funding,<sup>147</sup> it would be clearer to add language referencing funding to list under Rule 16(b)(3)(B) ("permitted contents of a scheduling order") and the list under Rule 16(c)(2) ("matters for consideration at a pretrial conference"). Even without rule revisions, the existing language of Rule 16, in combination with local court rules, will suffice. If the parties make no agreement under Rule 16 regarding the treatment of documents disclosed to and prepared by the funder, then the default position for federal courts regarding those documents should be that they are privileged in the absence of an express waiver by the funded party.

## 2. Arbitration: Evidentiary Disclosures and Privileges

Currently no rules of arbitration require disclosure of the participation of a third-party funder to the opposing party as a matter of general evidentiary disclosure. The arbitrators, in consultation with the parties and in compliance with the arbitration clause, govern all rules of evidentiary disclosure and privileges in each individual arbitration proceeding.<sup>148</sup> The arbitrators determine on a case-by-case basis whether

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<sup>144</sup> See *Advisory Committee on the Civil Rules Agenda Book*, *supra* note 68, at 91 (discussing additions to Rule 16(b)(3): "The proposal also adds two subjects to the list of contents permitted in a scheduling order: the preservation of ESI, and agreements reached under Evidence Rule 502. Parallel provisions are added to the subjects for discussion at the parties' Rule 26(f) conference."); 96-97 (presenting the markup of the revisions to Rule 16 and the Committee Notes, which state "The [scheduling] order also may include agreements incorporated in a court order under Evidence Rule 502 controlling the effects of disclosure of information covered by attorney-client privilege or work-product protection, a topic also added to the provisions of a discovery plan under Rule 26(f)(3)(D).").

<sup>145</sup> See *supra* note 144.

<sup>146</sup> See FED R. CIV. P. 16(f)(1)(C).

<sup>147</sup> See *supra* note 142.

<sup>148</sup> See, e.g., London Court of International Arbitration, *LCIA Arbitration Rules*, Art. 22.1(vi) (2014), [http://www.lcia.org/Dispute\\_Resolution\\_Services/lcia-arbitration-rules-2014.aspx](http://www.lcia.org/Dispute_Resolution_Services/lcia-arbitration-rules-2014.aspx) [hereinafter *LCIA Rules*] (tribunal has the authority "to

privileged information disclosed to a third-party funder is admissible and whether the disclosure waived any applicable evidentiary privileges.<sup>149</sup> Creating an arbitration rule regarding the effect of third-party funding on the waiver of evidentiary privileges would infringe on the parties' right to choose an evidentiary regime in which disclosure to a third-party funder either waives or does not waive an applicable evidentiary privilege. Thus, creating such a rule would be unwise and may even violate the parties' freedom to choose – if they wish to do so – the evidentiary rules that will apply to their arbitration proceedings.

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decide whether or not to apply any strict rules of evidence (or any other rules) as to the admissibility, relevance or weight of any material tendered by a party on any issue of fact or expert opinion; and to decide the time, manner and form in which such material should be exchanged between the parties and presented to the Arbitral Tribunal”); International Centre for Dispute Resolution, *International Dispute Resolution Procedures*, Art. 20(6) (2014), [https://www.icdr.org/icdr/faces/i\\_search/i\\_rule/i\\_rule\\_detail?\\_afWindowId=exo0mv9ra\\_68&\\_afLoop=1768552008878792&doc=ADRSTAGE2025301&\\_afWindowMode=0&\\_adf.ctrl-state=exo0mv9ra\\_71](https://www.icdr.org/icdr/faces/i_search/i_rule/i_rule_detail?_afWindowId=exo0mv9ra_68&_afLoop=1768552008878792&doc=ADRSTAGE2025301&_afWindowMode=0&_adf.ctrl-state=exo0mv9ra_71) [hereinafter *ICDR Rules*] (“The tribunal shall determine the admissibility, relevance, materiality, and weight of the evidence.”); *ICDR Rules*, Art. 22 (“The arbitral tribunal shall take into account applicable principles of privilege, such as those involving the confidentiality of communications between a lawyer and client. When the parties, their counsel, or their documents would be subject under applicable law to different rules, the tribunal should, to the extent possible, apply the same rule to all parties, giving preference to the rule that provides the highest level of protection.”); Hong Kong International Arbitration Centre, *Administered Arbitration Rules*, Art. 22.2 (2013), <http://www.hkiac.org/en/arbitration/arbitration-rules-guidelines/hkiac-administered-arbitration-rules-2013> [hereinafter *HKIAC Rules*] (“The arbitral tribunal shall determine the admissibility, relevance, materiality and weight of the evidence, including whether to apply strict rules of evidence.”); Singapore International Arbitration Centre, *Arbitration Rules of the Singapore International Arbitration Centre*, Art. 16.2 (2013), <http://www.siac.org.sg/our-rules/rules/siac-rules-2013> [hereinafter *SIAC Rules*] (“The Tribunal shall determine the relevance, materiality and admissibility of all evidence. Evidence need not be admissible in law.”); *SIAC Rules*, Art. 24(p) (arbitral tribunal has the power to “determine any claim of legal or other privilege”); Arbitration Institute of the Stockholm Chamber of Commerce, *2010 Arbitration Rules*, Art. 26(1) (2010), [http://www.sccinstitute.com/media/40120/arbitrationrules\\_eng\\_webbversion.pdf](http://www.sccinstitute.com/media/40120/arbitrationrules_eng_webbversion.pdf) [hereinafter *SCC Rules*] (“The admissibility, relevance, materiality and weight of evidence shall be for the Arbitral Tribunal to determine.”); *SCC Rules*, Art. 26(3) (tribunal may order the production of evidence relevant to the outcome of the case, which would usually not be the third-party funding agreement).

<sup>149</sup> See *supra* note 148.



## B. Judging Conflicts of Interest of the Decision Maker

### 1. Litigation: Corporate Party Disclosure Statements to Judges

In order for a judge to check for financial conflicts of interest, the parties must disclose to the judge their relevant corporate relationships.<sup>150</sup> Rule 7.1 requires that corporate parties make disclosures regarding their corporate ownership in order to assist judges in determining whether they may have a potential conflict of interest mandating disqualification under 28 U.S.C. § 455 and the Code of Conduct for United States Judges.<sup>151</sup> Rule 7.1 was modeled after Appellate Procedure Rule 26.1.<sup>152</sup> The purpose of both rules is to provide financial disclosures to facilitate judicial recusal decisions in circumstances where automatic financial interest disqualification is required under 28 U.S.C. § 455.<sup>153</sup>

The influence of third-party funders raises similar concerns as corporate influence, as both types of non-party entities may attempt to exert similar amounts of control over the proceedings. Therefore, the purpose of the disclosure statement applies to third-party funders, especially funders organized as corporations. The timing of the corporate disclosure – at the party's first contact with the court, in person or in writing – is the appropriate timing for disclosing the identity of the third-party funder as well.<sup>154</sup> In addition, parties must "promptly" file a supplemental disclosure if circumstances change, which would be appropriate in the context of a third-party funder beginning to fund a pending case or withdrawing from funding a case.<sup>155</sup> Furthermore, courts have applied wide-ranging sanctions when a party persistently does not file the disclosure statement, even after the court has directly requested the party to file the disclosure.<sup>156</sup> The threat of sanctions ensures that

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<sup>150</sup> See FED. R. APP. P. 26.1, Advisory Committee Notes (1989 addition); 28 U.S.C. § 455; Code of Conduct for United States Judges at Canon 3C(1)(c).

<sup>151</sup> *Id.*

<sup>152</sup> FED. R. CIV. P. 7.1, Advisory Committee Notes (2002 Adoption).

<sup>153</sup> *Id.*

<sup>154</sup> See FED R. CIV. P. 7.1(b)(1) (“[must] file the disclosure statement with its first appearance, pleading, petition, motion, response or other request addressed to the court”).

<sup>155</sup> See FED R. CIV. P. 7.1(b)(2) (“[must] promptly file a supplemental statement if any required information changes.”).

<sup>156</sup> See, e.g., *American Gen. Life Ins. Co. v. Lawson Bros. Trucking Co.*, 2008 WL 4899425, at \*1 (S.D.Ill. 2008) (holding attorney-of-record in contempt and directly a \$100 per day fine to accrue against the attorney until the disclosure statement was filed); *Curtis v. Illumination Arts, Inc.*, 2013 WL 1148802, at \*2 (W.D.Wash. Mar

parties will make the required corporate and third-party funding disclosures.

The Advisory Committee referenced Rule 7.1 in its December 2014 report when rejecting the aforementioned proposal to revise Rule 26.<sup>157</sup> The Advisory Committee’s statement supports this article’s assertion that Rule 7.1 would be the appropriate Federal Rule in which to require that parties supported by third-party funding must disclose to the judge the identity of litigation funder.<sup>158</sup> Rule 7.1 explicitly orders corporate parties to file a disclosure statement, so, until revisions are accomplished, a local court rule should be implemented to include all parties, including are natural persons or unincorporated associations for the purpose of checking conflicts of interest relating to third-party funders.<sup>159</sup> The purpose would be to notify the judge of the participation of the funder so that he or she may determine if any conflicts of interest exist.<sup>160</sup>

The Advisory Committee Notes accompanying Rule 7.1 suggest that the disclosure is intended to be very limited—only enough to notify the judge as to whether financial conflicts exist.<sup>161</sup> This disclosure will be particularly crucial if consumer investment portfolios – such as pensions and mutual funds – begin to include third-party funding as an alternative investment source.<sup>162</sup> Such consumer investment in litigation is already

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19, 2013); *Medmarc Cas. Ins.Co. v. Sterling & Dowling PC*, 2010 WL 3747754, at \*1 (S.D.Ill. Sept. 20, 2010) (threatening non-compliant party with dismissal of the case); *Hanratty v. Watson*, 2010 WL 3522996, at \*1 (S.D.Ill. Sept. 2, 2010) (threatening party with striking appearance and jury demand); *Feezor v. Big 5 Corp.*, 2010 WL 308751, at \*1-\*3 (E.D.Cal. Jan. 15, 2010) (imposing modest monetary sanction on non-disclosing defendant).

<sup>157</sup> See Advisory Committee Report, *supra* note 2, at 3 (“[Disclosure] will protect against unknown conflicts of interest by ensuring judges have access to information, not provided by Rule 7.1 disclosures, identifying third-party financing entities in which the judge may have an interest.”).

<sup>158</sup> *Cf id.*; see also U.S. Chamber Institute for Legal Reform, *Stopping the Sale on Lawsuits: A Proposal to Regulate Third-Party Investments in Litigation* (Oct. 2012), at 14, [http://www.instituteforlegalreform.com/uploads/sites/1/TPLF\\_Solutions.pdf](http://www.instituteforlegalreform.com/uploads/sites/1/TPLF_Solutions.pdf) (suggesting that FED. R. CIV. P. 7.1 be revised to require parties to disclose third-party funding to the judge).

<sup>159</sup> See FED R. CIV. P 7.1(a) (currently mandating that “[a] nongovernmental corporate party” must file a disclosure statement; not referencing any other type of parties, such as natural persons or unincorporated associations).

<sup>160</sup> See *supra* note 61.

<sup>161</sup> See *Connelly v. Bender*, 36 F. Supp. 368 (E.D. Mich. 1941).

<sup>162</sup> If all judges in a particular jurisdiction would be disqualified on the basis of their consumer or retirement investments having a connection to the funder, then the “rule of necessity” would intervene to allow a conflicted judge to hear the case to ensure that a funded plaintiff would still have a forum. See *U. S. v. Will*, 449 U.S.

possible under Title II and Title III of the 2012 Jumpstart Our Business Startups (JOBS) Act, which allow individuals to make equity investments in startups, which can include financing litigation.<sup>163</sup> For example, there is already one litigation funding company brokering third-party funding arrangements under Title II of the JOBS Act between high-net worth individual investors and plaintiffs who have already filed their cases.<sup>164</sup> Such high-net worth individual investors could be anyone – including judges, attorneys, or jurors.<sup>165</sup>

Rule 7.1 does not state whether the disclosure statement must be

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200, 213 (1980) (“However, in the highly unusual setting of these cases, even with the authority to assign other federal judges to sit temporarily under 28 U.S.C. §§ 291–296 (1976 ed. and Supp. III), it is not possible to convene a division of the Court of Appeals with judges who are not subject to the disqualification provisions of [28 U.S.C.] § 455. It was precisely considerations of this kind that gave rise to the Rule of Necessity, a well-settled principle at common law that, as Pollack put it, “although a judge had better not, if it can be avoided, take part in the decision of a case in which he has any personal interest, yet he not only may but must do so if the case cannot be heard otherwise.” F. Pollack, *A First Book of Jurisprudence* 270 (6th ed. 1929).”) (quotation marks and citations in original). Furthermore, potential jurors may also have a connection to the funder through their consumer or retirement investments as well as their potential status as a former funded litigant. *See, e.g., Letter, supra* note 113, at 2-3 (stating that individual jurors may be shareholders of a funder). A judge who has been notified regarding the participation of the funder under FED. R. CIV. P. 7.1 can then determine whether it would be appropriate to question the jurors under FED. R. CIV. P. 47(a) regarding their potential connections to third-party funders. *See* FED. R. CIV. P. 47(a) (authorizing “the court ... to examine prospective jurors ... itself”).

<sup>163</sup> *See* Jumpstart Our Business Startups (JOBS) Act, Pub. L. 112-106, Apr. 5, 2012, 126 Stat. 306 (2012) (amending Securities Exchange Act of 1934, 15 U.S.C. §§ 77-78, 7213, 7262); *see generally* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, (Dec. 17, 2014 draft), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2539786](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2539786).

<sup>164</sup> *See* LexShares, *How does the JOBS Act impact LexShares?*, <https://lexshares.desk.com/customer/portal/articles/1543554-how-does-the-jobs-act-impact-lexshares-> (last visited Feb. 15, 2015) (“The interests offered for sale through LexShares rely upon an exemption under Rule 506(c) enabled by Title II of the JOBS Act which went effective on September 23, 2013. This exemption permits an issuer to engage in general solicitation or general advertising of the offering and selling of securities pursuant to Rule 506, provided that (1) all purchasers of the securities are accredited investors and (2) the issuer takes reasonable steps to verify that such purchasers are accredited investors.”)

<sup>165</sup> *See supra* note 162.

served on the opposing party.<sup>166</sup> On one hand, at least one court has ruled that Rule 7.1 does not require serving the disclosure statement on the opposing party.<sup>167</sup> On the other hand, at least one observer of the industry has proposed amending the Federal Rules of Civil Procedure to include a requirement that funding relationships be disclosed to the opposing party.<sup>168</sup> The argument that funding should be disclosed to the other side rests on the assumption that a secretly funded party may have a tactical advantage in the litigation.<sup>169</sup> This is not a compelling reason, however, for disclosing funding to the other side. Parties have all sorts of tactical advantages in litigation for which disclosure to the other side is not required simply in the name of leveling the playing field. The source of funding – whether from a third-party funder or otherwise – is not discoverable information, because the participation of the funder is not relevant or material to the merits of the case.<sup>170</sup> Rule 26(a)(1)(A)(iv) is the sole exception, requiring a defendant to disclose its liability insurance.<sup>171</sup> The rule contemplates insurers who would pay the underlying judgment if the defendant loses.<sup>172</sup> In most instances, however, defense-side third-party funding would not be discoverable under this rule, because the vast majority of funders that fund defendants only fund legal expenses and costs, not the underlying judgment against a losing defendant. In the rare instance in which a funder does agree to pay the underlying judgment, then the funding arrangement would rightly be classified as liability insurance and subject to disclosure under Rule 26(a)(1)(A)(iv).<sup>173</sup> Nevertheless, this interpretation would not require any change to the existing federal rule on disclosing the defendant's liability insurance, nor would it require disclosure of other types of funding arrangements to the opposing side.

In sum, the disclosure under the amended Rule 7.1 should be limited to disclosure, *in camera*, of the identity of the funder to the judge only, not to the other side, at the same time as the party's first appearance in or communication with the court, as currently stated in the existing rule. If

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<sup>166</sup> See FED. R. CIV. P. 7 (discussing only the content (and timing of the disclosure; nothing about to whom the disclosure must or may be shared).

<sup>167</sup> See, e.g., *Plotker v. Lamberth*, 2008 WL 4706255, at \*12 (W.D.Va. 2008) (holding that service is not required because the statements are only to assist judges in determining whether must be disqualified from hearing the case).

<sup>168</sup> See *supra* note 116 and accompanying text.

<sup>169</sup> *Id.*

<sup>170</sup> See *supra* note 118 and accompanying text.

<sup>171</sup> See FED. R. CIV. P. 26(a)(1)(A)(iv).

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

a funder enters or withdraws from a pending case, the party would be required to notify the judge of this changed circumstance under the existing language of Rule 7.1(b)(2).<sup>174</sup> The judge should not share this information with the other party, as the existing rule does not require such a disclosure.<sup>175</sup> If there is a financial conflict of interest, the judge will recuse himself or herself and the other side does not need to know the reason.<sup>176</sup> This disclosure is enough to prevent the situation in which a later conflict of interest requires the judge to recuse herself or a losing party challenges the final judgment on the same basis.<sup>177</sup> Yet, it is not enough to create a situation in which parties are required to disclose their funding sources to each other (except for the defendant's liability insurance).<sup>178</sup> Courts may also implement local rules requiring more extensive disclosures than those enumerated in Rule 7.1.<sup>179</sup> Such local rules can implement these proposed reinterpretations in advance to bridge the gap between the existing Rule 7.1 and a potential future amendment.

Furthermore, disclosure of the identity of the funder to the judge is sufficient; the actual terms of the funding arrangement need not be disclosed. The purpose of the disclosure is to avoid additional costs for the party by identifying judicial conflicts of interest before pursuing the case through to a judgment that may be challenged because of undisclosed conflicts of interest.<sup>180</sup> The identity of the funder is key for determining conflicts of interest, not the terms of the funding arrangement.<sup>181</sup> At least one observer has suggested that a particularly unscrupulous funder could try to fund both sides of a case in order to hedge its investment.<sup>182</sup> Under my proposed reinterpretation, since all funded parties would have a duty to disclose the identity of their funders to the judge, the judge would learn whether the same funder is funding more than one side of the case. In that specific situation, given the potential for a single funder secretly to manipulate both sides of a case to achieve a certain outcome, the judge could rightly notify both funded parties regarding the identity of their common funder.

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<sup>174</sup> See *supra* note 155.

<sup>175</sup> *Id.*

<sup>176</sup> The “rule of necessity” will ensure that the case will be heard if all judges in a given jurisdiction or court have a relationship to the funder. See *supra* note 162.

<sup>177</sup> See *supra* notes 61 and 176.

<sup>178</sup> See *supra* note 171 and accompanying text.

<sup>179</sup> See FED R. CIV. P. 7.1, Advisory Committee note (2002 amendments).

<sup>180</sup> See *supra* note 61 and accompanying text.

<sup>181</sup> See *supra* note 61 and accompanying text.

<sup>182</sup> This observation was made by a participant at the Washington and Lee Roundtable on Third-Party Funding of Litigation and Arbitration on November 7-8, 2013.

## 2. Arbitration: Arbitrator Disclosure Statements to Parties

One of the major distinctions between litigation and arbitration is that arbitrators go through a two-step process of nomination and confirmation before they see any of the documents filed in the case, whereas the plaintiff in litigation cannot typically vet the judge before filing the case with the court. The two-step process for appointing arbitrators gives parties and arbitral institutions the opportunity to detect potentially problematic conflicts of interest before the case has gone too far into the merits and before the parties have spent much money on the case.<sup>183</sup> The nomination and confirmation process seeks to identify potential independence and impartiality issues, which parties can either waive (in most instances) or use to disqualify the arbitrator from consideration for that particular case.<sup>184</sup> A similar procedure exists to

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<sup>183</sup> See, e.g., Jennifer A. Trusz, Note, *Full Disclosure? Conflicts of Interest Arising from Third-Party Funding in International Commercial Arbitration*, 101 Geo L.J. 1649, 1666-67 (2013) (discussing the procedure for disqualifying a potential arbitrator or challenging a sitting arbitrator under the major rules for international commercial arbitration).

<sup>184</sup> See, e.g., International Court of Arbitration of the International Chamber of Commerce (ICC), *Arbitration Rules*, Art. 11(2)-(3) (2012), <http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/> [hereinafter *ICC Rules*] (potential arbitrator must “disclose in writing to the Secretariat any facts or circumstances which might be of such a nature as to call into question the arbitrator’s independence in the eyes of the parties, as well as any circumstances that could give rise to reasonable doubts as to the arbitrator’s impartiality” and has an ongoing obligation to disclose any such circumstances that arise during the course of the arbitration); *LCIA Rules*, *supra* note 148, at Art. 5.4-5.5 (potential arbitrator must disclose “any circumstances currently known to the candidate which are likely to give rise in the mind of any party to any justifiable doubts as to his or her impartiality or independence” and has an ongoing obligation to disclose any such circumstances that arise during the course of the arbitration); *ICDR Rules*, *supra* note 148, at Art. 13.2-13.3 (potential arbitrator must “disclose any circumstances that may give rise to justifiable doubts as to the arbitrator’s impartiality or independence and any other relevant facts the arbitrator wishes to bring to the attention of the parties” and has an ongoing obligation to disclose any such circumstances or facts that arise during the course of the arbitration); *HKIAC Rules*, *supra* note 148, at Art. 11.1 (“An arbitral tribunal confirmed under these Rules shall be and remain at all times impartial and independent of the parties.”); *HKIAC Rules*, *supra* note 148, at Art. 11.4 (potential arbitrator must “disclose any circumstances likely to give rise to justifiable doubts as to his or her impartiality or independence” and has an ongoing obligation to disclose any such circumstances that arise during the course of the arbitration); *SIAC Rules*, *supra* note 148, at Art. 10.4-10.5 (potential arbitrator must disclose “any circumstance that may give rise to justifiable doubts as to his impartiality or

some extent for judges when one of the parties is a corporate entity that must file a disclosure statement under Federal Rule 7.1. The main difference is the timing; the judge is already in place at the time of the Rule 7.1 filing, so the appropriate course of action in the event of a conflict of interest would be for the judge to recuse herself.<sup>185</sup> There is also a “rule of necessity,” meaning that if all judges in a particular jurisdiction would be disqualified from the same reason, then any judge can hear the case.<sup>186</sup>

In order to cause the least disruption and cost for the parties, ideally, any conflicts of interest relating to the funder’s involvement should be addressed before the appointment of the arbitrator.<sup>187</sup> Otherwise, the arbitrator may be challenged and (if the challenge is successful) replaced, increasing the time, cost, and inconvenience of the parties to the case.<sup>188</sup> Thus, the arbitrator should disclose connections, if any, that it has to the third-party funder in the case prior to the arbitrator’s confirmation.<sup>189</sup>

One source of guidance regarding arbitrator disclosure obligations is the International Bar Association’s (IBA) revised Guidelines on

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independence as soon as reasonably practicable” and has an ongoing obligation to disclose any such circumstances that arise during the course of the arbitration); *SCC Rules*, *supra* note 148, at Art. 14(2)-(3) (potential arbitrator must disclose “any circumstances which may give rise to justifiable doubts as to his/her impartiality or independence” and has an ongoing obligation to disclose any such circumstances that arise during the course of the arbitration).

<sup>185</sup> See *supra* note 61.

<sup>186</sup> See *supra* note 162.

<sup>187</sup> See Trusz, *supra* note 183 at 1652 (“Because of the potential disruption of the arbitration and the possibility of annulment, nonrecognition, and non-enforcement of the award, conflicts of interest should be addressed prior to the appointment of the arbitrator.”)

<sup>188</sup> See, e.g., *ICC Rules*, *supra* note 184, at Art. 14(1) (a sitting arbitrator may be challenged “for an alleged lack of impartiality or independence, or otherwise”); *LCIA Rules*, *supra* note 148, at Art. 10.1 (sitting arbitrator may be challenged if “circumstances exist that give rise to justifiable doubts as to that arbitrator’s impartiality or independence”); *ICDR Rules*, *supra* note 148, at Art. 14.1 (“A party may challenge an arbitrator whenever circumstances exist that give rise to justifiable doubts as to the arbitrator’s impartiality or independence.”); *HKIAC Rules*, *supra* note 148, at Art. 11.6 (“Any arbitrator may be challenged if circumstances exist that give rise to justifiable doubts as to the arbitrator’s impartiality or independence...”); *SIAC Rules*, *supra* note 148, at Art. 11.1 (“Any arbitrator may be challenged if circumstances exist that give rise to justifiable doubts as to the arbitrator’s impartiality or independence...”); *SCC Rules*, *supra* note 148, at Art. 15(1) (sitting arbitrator may be challenged “if circumstances exist which give rise to justifiable doubts as to the arbitrator’s impartiality or independence”).

<sup>189</sup> See *supra* note 89.

Conflicts of Interest in International Arbitration, which took effect on November 28, 2014.<sup>190</sup> These guidelines are not mandatory in any arbitration proceedings; parties or arbitrators can choose to reference them or ignore them altogether. The IBA revised several of its guidelines to require arbitrators to disclose to parties their connections with third-party funders in order to check for potential conflicts of interest.<sup>191</sup> The IBA revised one of its guidelines to require funded parties to disclose the identity of their third-party funder to the arbitrator, so that the arbitrator may assess potential conflicts of interest.<sup>192</sup> The explanatory statement to one of the guidelines defines a “third-party funder” as “any person or entity that is contributing funds, or other material support, to the prosecution or defence [sic] of the case and that has a direct economic interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration.”<sup>193</sup>

Arbitral institutions and rules may wish to borrow or reference the IBA’s definition of third-party funder in the guidance that they provide with their instructions to arbitrators regarding disclosures pursuant to a nomination, so that arbitrators under their auspices will know what type of relationships to disclose, even if the parties have not agreed to use the IBA Rules.<sup>194</sup> Similarly, the arbitrator needs to know about the involvement of the third-party funder in order to disclose any potential conflicts of interest, so arbitral institutions should require parties to disclose the identity of their third-party funders to their arbitrator.<sup>195</sup> Thus, arbitration rules should implement a corporate party disclosure rule similar to this article’s proposed reinterpretation of Federal Rule 7.1; such an arbitration rule would require a funded party to disclose the identity of its third-party funder to the arbitrator.<sup>196</sup> This would enable the arbitrator to make the appropriate disclosures to avoid conflicts of interest.<sup>197</sup> At

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<sup>190</sup> See generally IBA Guidelines, *supra* note 89.

<sup>191</sup> See *id.* at General Standard 6; the Explanation to General Standard 6; the Waivable Red List § 2.2.3; the Orange List §§ 3.2.2, 3.4.3, and 3.4.4 (requiring an arbitrator to disclose its connections to third-party funders, defined as entities with a “direct economic interest in the award to be rendered in the arbitration”).

<sup>192</sup> See *id.* at General Standard 7 (requiring a funded party to disclose its connection to a third-party funder, defined as an entity with a “direct economic interest in the award to be rendered in the arbitration”).

<sup>193</sup> *Id.* at Explanation to General Standard 6.

<sup>194</sup> *Id.*

<sup>195</sup> See Trusz, *supra* note 195183, at 1655 (discussing how an arbitrator cannot disclose a connection with a third-party funder unless the arbitrator is made aware of the funder’s participation in the case).

<sup>196</sup> See *supra* Part V.B.1.

<sup>197</sup> See *supra* note 89.



least one scholar has proposed changing international arbitration rules to address arbitrator conflicts of interest within the existing institutional arbitration rules.<sup>198</sup>

Except for mandatory disclosures relating to conflicts of interest, arbitrators have wide latitude to tailor the proceedings to the parties' needs, which may include choosing to ignore the participation of a third-party funder.<sup>199</sup> For example, unlike in United States litigation, arbitral

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<sup>198</sup> See Trusz, *supra* note 195183, at 1652, 1673 (“The four-prong proposal begins with a duty by the arbitrator to disclose any past and current relationships with third-party funders to the institution. Second, the arbitral rules should provide that any party receiving outside funding must disclose to the institution that relationship and any potential conflicts involving the third-party funder. Third, the arbitral rules should require automatic review of potential third-party funding conflicts that are triggered by the party’s disclosure of a funding relationship. The institution would be required to keep all funding information confidential. Finally, in order to incentivize third-party funders to disclose the relationship, the arbitral rules should provide that such relationships cannot be considered in tribunal decisions for awards on costs or security for costs. The proposal is then slightly modified to adapt to ad hoc arbitration under the UNCITRAL Rules.”); see also Marc J. Goldstein, *Should the Real Parties in Interest Have To Stand Up?—Thoughts About a Disclosure Regime for Third-Party Funding in International Arbitration*, 8 TRANSNAT’L DISP. MGMT., Oct. 2011, at 4, 8 (suggesting that institutions could “require parties and counsel to disclose the identity of any financier involved, and require arbitrator nominees to disclose to the institution the identity of any financiers with whom they or their law firms have relationships” so that if a conflict of interest exists, “the institution could decline to confirm the arbitrator, without disclosure of the reasons to the parties”).

<sup>199</sup> See, e.g., *ICC Rules*, *supra* note 184, at Art. 22(1)-(2) (“The arbitral tribunal and the parties shall make every effort to conduct the arbitration in an expeditious and cost-effective manner, having regard to the complexity and value of the dispute. In order to ensure effective case management, the arbitral tribunal, after consulting the parties, may adopt such procedural measures as it considers appropriate, provided that they are not contrary to any agreement of the parties.”); *LCIA Rules*, *supra* note 148, at Art. 14.4(ii) (arbitral tribunal has “a duty to adopt procedures suitable to the circumstances of the arbitration, avoiding unnecessary delay and expense, so as to provide a fair, efficient and expeditious means for the final resolution of the parties’ dispute.”); *LCIA Rules*, *supra* note 148, at Art. 14.5 (“The Arbitral Tribunal shall have the widest discretion to discharge these general duties, subject to such mandatory law(s) or rules of law as the Arbitral Tribunal may decide to be applicable; and at all times the parties shall do everything necessary in good faith for the fair, efficient and expeditious conduct of the arbitration, including the Arbitral Tribunal’s discharge of its general duties.”); *ICDR Rules*, *supra* note 148, at Art. 20.1 (“Subject to these Rules, the arbitral tribunal may conduct the arbitration in whatever manner it considers appropriate, provided that the parties are treated with equality and that each party has the right to be heard and is given a fair opportunity to present its case.”); *HKIAC Rules*, *supra* note 148, at

tribunals generally refrain from allowing the revelation of a third-party funder to sway their decision regarding awarding costs or ordering security for costs.<sup>200</sup> However, if an arbitral tribunal did decide to consider the participation of the third-party funder, then it would have the power to allocate costs for or against a particular party on that basis.<sup>201</sup>

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Art. 13.5 (“The arbitral tribunal and the parties shall do everything necessary to ensure the fair and efficient conduct of the arbitration.”); *HKIA Rules*, *supra* note 148, at Art. 13.1 (“Subject to these Rules, the arbitral tribunal shall adopt suitable procedures for the conduct of the arbitration in order to avoid unnecessary delay or expense, having regard to the complexity of the issues and the amount in dispute, and provided that such procedures ensure equal treatment of the parties and afford the parties a reasonable opportunity to present their case.”); *SIAC Rules*, *supra* note 148, at Art. 16.1 (“The Tribunal shall conduct the arbitration in such manner as it considers appropriate, after consulting with the parties, to ensure the fair, expeditious, economical and final determination of the dispute.”).

<sup>200</sup> Compare Trusz *supra* note 1 at 1677-79 (discussing arbitral tribunals declining to consider the participation of a third-party funder when awarding costs or ordering security for costs, although some funders choose to incorporate security for costs into their business arrangements as a matter of good governance or cost of doing business) with *Abu-Ghazaleh v. Chaul*, 36 So. 3d 691, 693-94 (Fla. Ct. App. 2009) (holding that the litigation funder was a “party” under Florida law for the purpose of allocating costs, because the funder had substantially “controlled” the litigation).

<sup>201</sup> See, e.g., *ICC Rules*, *supra* note 184, at Art. 37(3) (“At any time during the arbitral proceedings, the arbitral tribunal may make decisions on costs, other than those to be fixed by the Court, and order payment.”); *ICC Rules*, *supra* note 184, at Art. 37(5) (“In making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner.”); *LCIA Rules*, *supra* note 148, at Art. 25.1-25.2 (arbitral tribunal has the power “to order any respondent party to a claim or cross-claim to provide security for all or part of the amount in dispute, by way of deposit or bank guarantee or in any other manner,” to order a “cross-indemnity,” and to order “security for Legal Costs and Arbitration Costs”); *LCIA Rules*, *supra* note 148, at Art. 28.2 (“The Arbitral Tribunal shall decide the proportions in which the parties shall bear such Arbitration Costs.”); *LCIA Rules*, *supra* note 148, at Art. 28.3 (“The Arbitral Tribunal shall also have the power to decide by an award that all or part of the legal or other expenses incurred by a party (the “Legal Costs”) be paid by another party.”) (parentheses and quotation marks in original); *LCIA Rules*, *supra* note 148, at Art. 28.4 (“The Arbitral Tribunal shall make its decisions on both Arbitration Costs and Legal Costs on the general principle that costs should reflect the parties’ relative success and failure in the award or arbitration or under different issues, except where it appears to the Arbitral Tribunal that in the circumstances the application of such a general principle would be inappropriate under the Arbitration Agreement or otherwise.”); *ICDR Rules*, *supra* note 148, at Art. 20(7) (“The arbitral tribunal may allocate costs, draw adverse inferences, and take such additional steps as are necessary to protect the efficiency and integrity of the arbitration.”); *ICDR Rules*,

### C. Judging Cost Allocation and Sanctions

#### 1. Litigation: Fee Shifting, Sanctions, and Class Action Litigation

Since funders pay upfront the attorney fees, filing fees, evidentiary fees, and other costs of the funded party, many questions arise regarding how the participation of the funder should affect the allocation of costs, if at all. *Should the funder pay the penalty for conduct by the funded party or its attorney that the court sanctions under Rule 11 or Rule 37? Should the funder be reimbursed if the funded party would be entitled to reimbursement of attorney fees under Rule 54? Should the funder of a successful class action receive a portion of the judicially-approved attorney fees under rule 23?* This Section addresses the impact of third-party funding on fee shifting, sanctions, and class action litigation.

Rule 54(d)(2)(B)(iv) requires that, in order for a winning party to recover attorney's fees, the party must "disclose, if the court so orders, the terms of any agreement about fees for the services for which the claim

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*supra* note 148, at Art. 34 ("The arbitral tribunal shall fix the costs of arbitration in its award(s). The tribunal may allocate such costs among the parties if it determines that allocation is reasonable, taking into account the circumstances of the case."); *HKIAC Rules*, *supra* note 148, at Art. 24 ("The arbitral tribunal may make an order requiring a party to provide security for the costs of the arbitration."); *HKIAC Rules*, *supra* note 148, at Art. 33.2 ("The arbitral tribunal may apportion all or part of the costs of the arbitration referred to in Article 33.1 between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case."); *HKIAC Rules*, *supra* note 148, at Art. 33.3 ("With respect to the costs of legal representation and assistance ..., the arbitral tribunal, taking into account the circumstances of the case, may direct that the recoverable costs of the arbitration, or any part of the arbitration, shall be limited to a specified amount."); *SIAC Rules*, *supra* note 148, at Art. 24(k)-(l) (tribunal may order a party to pay security for costs or security for all or part of the amount in dispute); *SIAC Rules*, *supra* note 148, at Art. 31.1 ("Unless the parties have agreed otherwise, the Tribunal shall determine in the award the apportionment of the costs of the arbitration among the parties."); *SIAC Rules*, *supra* note 148, at Art. 33 ("The Tribunal shall have the authority to order in its award that all or a part of the legal or other costs of a party be paid by another party."); *SCC Rules*, *supra* note 148, at Art. 43(5) ("Unless otherwise agreed by the parties, the Arbitral Tribunal shall, at the request of a party, apportion the Costs of the Arbitration between the parties, having regard to the outcome of the case and *other relevant circumstances.*")(emphasis added); *SCC Rules*, *supra* note 148, at Art. 44 ("Unless otherwise agreed by the parties, the Arbitral Tribunal may in the final award upon the request of a party, *order one party to pay any reasonable costs incurred by another party, including costs for legal representation*, having regard to the outcome of the case and *other relevant circumstances.*")(emphasis added).

is made.”<sup>202</sup> The language “if the court so orders” highlights that judge must decide whether any such fee agreement must be divulged.<sup>203</sup> Since the essence of the funding agreement is paying attorney’s fees, the funding agreement is an “agreement about fees for the services for which the claim is made.”<sup>204</sup> Thus, a winning funded party seeking reimbursement for attorney fees would be required to disclose the existence of the funding arrangement, “if the court so orders,” in order to recover those attorney’s fees.<sup>205</sup> Enforcement of this requirement could be accomplished under the existing language of Rule 54(d)(2)(B)(iv) or by appending the phrase “including third-party funding” to the end of the sentence. Local rules may also supply specific requirements regarding the disclosure of the third-party funding agreement in the context of a claim for attorney’s fees.<sup>206</sup>

In addition to making the winning party whole, an award of attorney fees is commonly used to sanction a party.<sup>207</sup> The fundamental question with regard to sanctions is whether a funder should be liable for sanctions imposed on the funded party or the funded party’s attorney if the funder directed or condoned the sanctioned conduct. Sanctioning the party or its attorneys increases the litigation costs. Presumably, those costs would be borne by the funder under the terms of the funding arrangement, as long as the sanctioned action was within the bounds of the funding arrangement.<sup>208</sup> Regardless, as currently worded, Rules 11 and 37 likely do not reach third-party funders directly, but rather indirectly by punishing the funded party or its attorney and incurring additional costs for the funder.<sup>209</sup>

Rule 11 sanctions misconduct relating to papers presented to or filed with the court.<sup>210</sup> Rule 11(c)(1) authorizes a court to sanction attorneys,

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<sup>202</sup> See FED R. CIV. P. 54(d)(2)(B)(iv).

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> See FED R. CIV. P. 54(d)(2) (“By local rule, the court may establish special procedures to resolve re-related issues without extensive evidentiary hearings.”)

<sup>207</sup> See e.g., Advisory Committee Report, *supra* note 2, at 6 (referring to FED. R. CIV. P. 68, which currently provides for the plaintiff to pay the defendant’s attorney fees if the plaintiff rejects the defendant’s settlement offer and the fails to obtain a better judgment).

<sup>208</sup> *Cf.* Shannon, *supra* note 29, at 115 n.71 and accompanying text.

<sup>209</sup> *Id.*

<sup>210</sup> See FED R. CIV. P. 11(a) (stating that if a paper is not signed, “[t]he court must strike any unsigned paper unless the omission is promptly corrected after being called to the attorney’s or party’s attention); FED R. CIV. P. 11(b) (“an attorney or unrepresented party certifies that to the best of the person’s knowledge, information

law firms, or parties; the rule does not list any other persons.<sup>211</sup> Rule 11 should not be revised to apply to funders, because funders take no direct action in court and make no representations to the court.<sup>212</sup> The Advisory Committee notes state that, in appropriate circumstances, courts may impose sanctions on the "person" – other than the party or attorney – found to be responsible for the violation of Rule 11.<sup>213</sup> This could apply directly to the funder if there were proof that the funder directed the action or if the funder takes a very active role in the litigation. However, the funder's actions would have to be directly tied to the paper or document in question.<sup>214</sup> There has been at least once case in which the funder was so involved in the case that court treated the funder as a party for the purpose of allocation cost, but not for sanctions under Rule 11.<sup>215</sup> The funding agreement may address payment for monetary sanctions and would probably govern the disposition of sanctions-related issues that arise between funders and funded parties.<sup>216</sup> As such, the court may consider the participation of the funder if the court wishes to take into account the financial status of the funded party or its attorney when assessing monetary sanctions against them.<sup>217</sup>

Rule 37 governs sanctions for failure to cooperate with discovery

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and belief," the "pleading, written motion, or other paper" presented to the court meets the four conditions listed in the rule).

<sup>211</sup> See FED R. CIV. P. 11(c)(1) ("[T]he court may impose an appropriate sanction on any attorney, law firm, or party that violated the rule or is responsible for the violation.")

<sup>212</sup> The sole exception is if the funder has taken an assignment of the claim and is the named party in the dispute.

<sup>213</sup> See FED R. CIV. P. 11, Advisory Committee Notes (1993 Amendments) ("When appropriate, the court can make an additional inquiry in order to determine whether the sanction should be imposed on such persons, firms, or parties either in addition to or, in unusual circumstances, instead of the person actually making the presentation to the court. For example, such an inquiry may be appropriate in cases involving governmental agencies or other institutional parties that frequently impose substantial restrictions on the discretion of individual attorneys employed by it.")

<sup>214</sup> See *supra* note 210 and accompanying text.

<sup>215</sup> See *Abu-Ghazaleh v. Chaul*, *supra* note 200, at 693-94 (holding that the third-party funder was a "party" under Florida law for allocating costs, because the funder had substantially "controlled" the litigation); see also *Letter*, *supra* note 113, at 6. The vast majority of funders are very careful not to control the litigation in order to avoid causing attorneys to violate rules of professional responsibility, so the *Abu-Ghazaleh* is considered an outlier.

<sup>216</sup> Cf. Shannon, *supra* note 29, at 115 n.71 and accompanying text.

<sup>217</sup> Cf. *id.*

requests.<sup>218</sup> Rule 37 authorizes sanctions on a deponent,<sup>219</sup> a witness, a party, an officer or employee of a party, or a party's attorney; the rule does not list any other persons.<sup>220</sup> Thus, like Rule 11, the wording of Rule 37 does not contemplate sanctioning a third-party funder. The funder does not participate directly in discovery, so it would be inappropriate to revise Rule 37 to authorize sanctioning the funder directly.<sup>221</sup> If the opposing party can demonstrate that the fault lies with the funder – for example, if the party cannot perform certain discovery functions due to the funder's refusal to pay for a particular document production or witness travel – it may be possible to require the funder to pay the party's discovery sanctions.<sup>222</sup> However, it would likely be very difficult to prove that the funder is at fault and may require additional discovery that would needlessly increase the time and cost of the litigation. As mentioned above, the funding agreement may address payment for monetary sanctions and would probably govern the disposition of sanctions-related issues that arise between funders and funded parties.<sup>223</sup>

Finally, there is a potential for third-party funding to have an impact on class actions, although class actions are not a very attractive market for funders in the United States. Rule 23 governs class action

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<sup>218</sup> See generally, FED R. CIV. P. 37.

<sup>219</sup> A deponent is the person who is to be questioned during a deposition.

<sup>220</sup> See FED R. CIV. P. 37(b)(1) (sanctioning a “deponent”); FED R. CIV. P. 37(b)(2)(A) (sanctioning “a party’s officer, director or managing agent – or a witness designated under Rule 30(b)(6) or 31(a)(4)”); FED R. CIV. P. 37(b)(2)(B) (sanctioning “a party”); FED R. CIV. P. 37(b)(2)(C) (requiring “a disobedient party, the attorney advising that party, or both to pay the reasonable expenses, including attorney’s fees, caused by the failure”); FED R. CIV. P. 37(c)(1) (sanctioning “a party”); FED R. CIV. P. 37(c)(2) (sanctioning “a party”); FED R. CIV. P. 37(d)(1)(A)(i) (sanctioning “a party or a party’s officer, director or managing agent – or a person designated under Rule 30(b)(6) or 31(a)(4)”); FED R. CIV. P. 37(f) (sanctioning “a party or its attorney”).

<sup>221</sup> See FED R. CIV. P. 37(b)(1) (sanctioning a “deponent”); FED R. CIV. P. 37(b)(2)(A) (sanctioning “a party’s officer, director or managing agent – or a witness designated under Rule 30(b)(6) or 31(a)(4)”); FED R. CIV. P. 37(b)(2)(B) (sanctioning “a party”); FED R. CIV. P. 37(b)(2)(C) (requiring “a disobedient party, the attorney advising that party, or both to pay the reasonable expenses, including attorney’s fees, caused by the failure”); FED R. CIV. P. 37(c)(1) (sanctioning “a party”); FED R. CIV. P. 37(c)(2) (sanctioning “a party”); FED R. CIV. P. 37(d)(1)(A)(i) (sanctioning “a party or a party’s officer, director or managing agent – or a person designated under Rule 30(b)(6) or 31(a)(4)”); FED R. CIV. P. 37(f) (sanctioning “a party or its attorney”).

<sup>222</sup> Cf. *supra* note 221.

<sup>223</sup> See *supra* note 216.

proceedings.<sup>224</sup> While funders in other jurisdictions frequently fund the class itself, funders in the United States have shied away from directly funding the class representative for a variety of reasons that are beyond the scope of this article.<sup>225</sup> More commonly, funders back the law firm representing the class instead of funding the class directly.<sup>226</sup> Given the extensive judicial oversight over class actions – including approving the class certification, the class counsel, the settlement, and the amount of attorney fees awarded – there is not yet a need to revise the class action rule to take into account third-party funding.

Rule 23(h), in conjunction with Rule 54(d)(2)(C), govern the prevailing party's recovery of attorney's fees in a class action case.<sup>227</sup> Regardless of the structure of the arrangement, the funder has actually paid the litigation costs, including the attorney's fees.<sup>228</sup> Thus, having the entire amount of the attorney's fees awarded to the law firm would be unjust enrichment under contract law. The funder would be paid from the attorney's fees awarded, so judges already, in essence, have oversight over the funder's fee. The funder should be reimbursed at least the amount actually spent on attorney's fees. However, the funder's entitlement to payment would be founded on its contractual rights through the funding arrangement rather than an entitlement to receive reimbursement for attorney's fees under Rule 23. Given the attorney ethical prohibition on fee sharing, the attorney would likely not be able to pay the funder directly from its judicially awarded fee. Thus, since the judge already has broad oversight over the attorney's fee, the judge should have discretion over the amount of the fee allotted from the class award that would go to the funder.

In the future, it may be appropriate to state explicitly that judges have oversight over the participation of funders in class action litigation. However, direct funding of class actions is not yet very prevalent in the United States, so amending Rule 23 to address the issue would be

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<sup>224</sup> See generally FED R. CIV. P. 23.

<sup>225</sup> See e.g., NIEUWVELD & SHANNON, *supra* note 10, at 74-84 (discussing funding of class and group actions in Australia), 120-21 (mentioning that class action litigation and class arbitration are nonexistent in the United States), 180-81 (discussing funding under the "Class Action Act" in the Netherlands), 185-86 (discussing class action funding in Canada).

<sup>226</sup> For an in-depth treatment of lawyer lending, see, e.g., Nora Freeman Engstrom, *Re-Re-Financing Civil Litigation: How Lawyer Lending Might Remake the American Litigation Landscape, Again*, 61 UCLA REV. DISC. 110 (2013); Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377 (2014).

<sup>227</sup> See FED R. CIV. P. 54(d)(2)(C) and FED R. CIV. P. 23(h).

<sup>228</sup> See NIEUWVELD & SHANNON, *supra* note 10, at 4-11.

premature. Courts already have complete control over the awarding of attorney's fees in the class action context.<sup>229</sup> At present, the judge's influence over the creation and maintenance of class action suits demonstrates that the judge would have control over relationships formed between class clients and their "representatives," including funders.<sup>230</sup>

## 2. Arbitration: Cost Shifting, Security for Costs, and Class Arbitration

The disclosure of the third-party funder typically arises in relation to cost allocation, either before or after the arbitration proceedings. In situations in which the third-party funder is disclosed voluntarily (or accidentally), the opposing non-funded party sometimes then petitions the arbitral tribunal to order security for costs.<sup>231</sup> Furthermore, if the non-funded party wins, then it may request that the tribunal order payment of costs by the funded party or even the funder directly.<sup>232</sup> A few international arbitration tribunals have ordered funders to post security for costs in advance of the proceedings, and some third-party funders view paying security for costs as a simply a cost of doing business in jurisdictions that follow the English ("loser pays") cost allocation rule.<sup>233</sup> Some jurisdictions allow funders to be joined to cost proceedings and for funders to issue cost orders against funders.<sup>234</sup> Thus, with respect to disclosure to the opposing party, the existing practice appears to be for arbitral tribunals to address the issue when allocating costs on a case-by-case basis. Given the trend in arbitration rules worldwide of giving arbitrators wide discretion in determining cost allocation, adopting a specific cost allocation rule addressing third-party funding would be counterproductive.

Finally, class arbitration is funded in several jurisdictions worldwide but not in the United States for reasons beyond the scope of this paper.<sup>235</sup>

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<sup>229</sup> See FED R. CIV. P. Rule 23(g)(1)(D).

<sup>230</sup> For the definition of "representatives," see *supra* note 135 and accompanying text.

<sup>231</sup> See NIEUWVELD & SHANNON, *supra* note 10, at xix-xx, 4, 12-13, 23-24, 27-28, 30, 33 n.16, 61, 74-75, 82-83 (discussing examples of how security for costs and adverse costs orders under the English rule of cost allocation may be addressed in the funding agreement).

<sup>232</sup> See *id.*

<sup>233</sup> See *id.*

<sup>234</sup> See *supra* note 215.

<sup>235</sup> Third-party funding of class actions is not yet prevalent in the United States, but the practice is widespread in other leading third-party funding jurisdictions such as Australia, Canada, and the Netherlands. See, e.g., Deborah R. Hensler, *The Future*



In all the jurisdictions outside the United States in which class action funding is allowed, the participation of the funder is usually disclosed to the decision maker and the opposing side, although the terms of the funding agreement need not necessarily be disclosed.<sup>236</sup> Class arbitration is not prevalent in the United States in light of recent Supreme Court jurisprudence making class arbitration jurisdiction nearly impossible to create.<sup>237</sup> Thus, third-party funding for class arbitrations seated in the United States is likely to continue to be nonexistent.

#### D. Judging Enforcement

Enforcement is where litigation and arbitration converge, and successful enforcement is required for the third-party funder to receive any payment. Both litigation judgments and arbitral awards are enforced by courts, because arbitrators do not have the power to enforce their own awards.<sup>238</sup> In both litigation and arbitration, there is no requirement that the judgment or award reference the participation of a third-party funder, and there is no requirement of disclosure that the proceedings were funded in order for enforcement to be effective. The Full Faith and Credit Clause of the United States Constitution requires all states to honor the judgments of the courts of other states.<sup>239</sup> Thus, enforcing a funded state court judgment—even in another state that disallows third-party funding—should not be difficult.

In arbitration, a winning party may encounter difficulties, however, when trying to enforce a funded arbitral award in a jurisdiction that has

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*of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306 (2011); Jasminka Kalajdzic, Peter Cashman & Alana Longmoore, *Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding*, 61 AM. J. COMP. L. 93 (2013); Michael Legg & Louisa Travers, *Necessity is the Mother of Invention: The Adoption of Third-Party Litigation Funding and the Closed Class in Australian Class Actions*, 38 COMMON L. WORLD REV. 245 (2009); Michael J. Legg, *Shareholder Class Actions in Australia—The Perfect Storm?*, 31 U. NEW S. WALES L.J. 669 (2008); Ianika N. Tzankova, *Funding of Mass Disputes: Lessons from the Netherlands*, 8 J.L. ECON. & POL'Y 549 (2012).

<sup>236</sup> See *supra* note 225.

<sup>237</sup> See *e.g.*, *Stolt-Nielsen, S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662 (2010) (ruling that class arbitration jurisdiction is not proper unless class arbitration is expressly written into all of the parties' signed arbitration agreements, including every single class member).

<sup>238</sup> See *infra* note 242.

<sup>239</sup> See U.S. CONST. art. IV, §1.

express laws or a public policy against funding, but only if the enforcing court finds out about the funder's involvement or that some of the awarded money will go to a funder. Many jurisdictions find distasteful the idea that some money from the award or judgment will go to a private entity that became involved in the case solely for profit, even if the practice was legal at the procedural seat of the arbitration and under the applicable substantive law.<sup>240</sup>

The New York Convention has a public policy exception by which an enforcing court can decline to enforce an otherwise valid arbitral award if the award somehow violates public policy in that court's jurisdiction.<sup>241</sup> For example, the United States has implemented the New York Convention domestically through Chapter 2 of the Federal Arbitration Act ("FAA"). Notably, the FAA incorporates by reference key provisions of the New York Convention, such as in 28 U.S.C. § 207, which states that, "the court shall confirm the award unless it finds one of the grounds for refusal or deferral of recognition or enforcement of the award specified in the said Convention."<sup>242</sup> This language refers to the

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<sup>240</sup> See generally, Catherine A. Rogers, *Gamblers, Loan Sharks & Third-Party Funders*, in CATHERINE A. ROGERS, *ETHICS IN INTERNATIONAL ARBITRATION* (2014); W. Bradley Wendel, *Alternative Litigation Finance and Anti-Commodification Norms*, 63 DEPAUL L. REV. 655 (2014).

<sup>241</sup> See, e.g., Trusz *supra* note 183 at 1668 (discussing the grounds for vacating an arbitral award under Section 10 of the Federal Arbitration Act due to the "partiality" or "corruption" of the arbitrators); Trusz *supra* note 183 at 1669 (discussing grounds for non-enforcement of an arbitral award under the New York Convention relating to an arbitrator's connection to a third-party funder); *United Paperworkers Int'l Union, AFL-CIO v. Misco, Inc.*, 484 U.S. 29, 42 (1987) ("A court's refusal to enforce an arbitrator's award under [an arbitration] agreement because it is contrary to public policy is a specific application of the more general doctrine, rooted in the common law, that a court may nonrefuse to enforce contracts that violate law or public policy.").

<sup>242</sup> See e.g., 9 U.S.C. §§ 9, 207 (2012) (Federal Arbitration Act sections on enforcing arbitration awards). In addition, the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, commonly known as the "New York Convention," is the main vehicle for enforcement of arbitration awards worldwide. At the time of this writing, 154 countries have signed the New York Convention. For a current list of signatories to the New York Convention, see *Status: Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958)*, UNCITRAL, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html) (last visited Feb. 15, 2015). Third-party funding is also prevalent in investor-state arbitration, which is typically authorized by a treaty and most often takes place under the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, also known as the "ICSID Convention" or the

“public policy” exception found in Article V.2.b of the Convention, which states that the court may *sua sponte* deny enforcement if “the recognition or enforcement of the award would be contrary to the public policy of that country [where enforcement is sought].”<sup>243</sup>

Some jurisdictions, like Hong Kong, explicitly allow third-party funding in international arbitration while generally prohibiting the practice in domestic litigation.<sup>244</sup> In contrast, other jurisdictions, like Singapore, currently prohibit third-party funding in all forums, including international arbitration.<sup>245</sup> Most countries fall somewhere in between. The current regulatory landscape in the United States is unclear at best, but it appears that the laws in roughly two-thirds of the states would allow third-party funding in international arbitration.<sup>246</sup> Given the limited grounds for vacating or setting aside an international arbitration award under the Federal Arbitration Act, addressing third-party funding in international arbitration through domestic arbitration laws would be unnecessary.<sup>247</sup> As mentioned in Part V.B.2, one of those grounds for refusing enforcement of an arbitral award is the revelation of an undisclosed conflict of interest that leads to the appearance that the

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“Washington Convention,” which presently has 159 signatories. For a current list of signatories to the ICSID Convention, see Member States, ICSID, <https://icsid.worldbank.org/apps/ICSIDWEB/about/Pages/Database-of-Member-States.bak.aspx> (last visited Feb. 15, 2015).

<sup>243</sup> See *supra* note 242.

<sup>244</sup> NIEUWVELD & SHANNON, *supra* note 10, at 227–31 (addressing the laws on third-party funding in Hong Kong).

<sup>245</sup> *Id.* at 237–38 (addressing the laws on third-party funding in Singapore); *but see*, “Review of the International Arbitration Act: Proposals for Public Consultation,” Ministry of Law of the Singapore Government, <http://www.mlaw.gov.sg/content/dam/minlaw/corp/assets/documents/linkclickf651.pdf> (soliciting public comment on a proposed amendment to allow third-party funding in international arbitration cases over 1 million Singapore dollars, subject to certain restrictions and requirements).

<sup>246</sup> See NIEUWVELD & SHANNON, *supra* note 10, at 144–159 (presenting a state-by-state survey of the laws regarding third-party funding, including all 50 states and the District of Columbia).

<sup>247</sup> See *generally*, 9 U.S.C. § 10 (2012); New York Convention, *infra* note 242.

For international arbitration, promulgating guidelines at the international level through arbitral institutions and international bar associations would most effective. For an example of a global effort to create such guidelines for international arbitration, see Third-Party Funding Task Force, *infra* note 251.

arbitrator is biased.<sup>248</sup> Thus, any relationship between an arbitrator and a third-party funder should be disclosed at the outset.<sup>249</sup>

Given the privacy of arbitration, the author has yet to hear of an example of a court declining to enforce an arbitral award purely due to the involvement of a third-party funder, but there is a possibility that it may have happened in private already or that it will happen in the future. In addition, arbitral institutions and arbitrators have a duty to work to ensure the enforceability of arbitral awards to the extent that enforceability is within their control.<sup>250</sup> If we have clear standards for the involvement of third-party funders throughout the conduct of the dispute resolution procedures to allay concerns regarding due process and undue interference, then a court will be less likely to decline to enforce a judgment or award in the future simply on the basis of a funder's involvement.

## VI. CONCLUSION: JUDGING THE FUTURE OF THIRD-PARTY FUNDING

Through the foregoing rule reinterpretations, judges and arbitrators will position themselves to identify and observe instances of third-party funding in their "natural habitat" – during the litigation or arbitration proceedings. Furthermore, they will be able to observe ordinary, routine third-party funding instances, which will likely lead to more universal regulatory insights than the few outlier third-party funding instances revealed by accident or through a party's settlement strategy. Over time,

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<sup>248</sup> See Trusz, *supra* note 183, at 1652 (discussing how an undisclosed arbitrator conflict of interest with a funder may cause the award to be annulled or denied recognition or enforcement).

<sup>249</sup> See IBA Guidelines, *supra* note 89, and accompanying text.

<sup>250</sup> See, e.g., *ICC Rules*, *supra* note 184, at Art. 41 ("In all matters not expressly provided for in the Rules, the Court and the arbitral tribunal shall act in the spirit of the Rules and shall make every effort to make sure that the award is enforceable at law."); *LCIA Rules*, *supra* note 148, at Art. 32.2 ("...the LCIA Court, the LCIA, the Registrar, the Arbitral Tribunal and each of the parties shall act at all times in good faith, respecting the spirit of the Arbitration Agreement, and shall make every reasonable effort to ensure that any award is legally recognised and enforceable at the arbitral seat."); *HKIAC Rules*, *supra* note 148, at Art. 13.8 ("The arbitral tribunal shall make every reasonable effort to ensure that an award is valid."); *SIAC Rules*, *supra* note 148, at Art 37.2 ("...the President, the Court, the Registrar and the Tribunal shall act in the spirit of these Rules and shall make every reasonable effort to ensure the fair, expeditious and economical conclusion of the arbitration and the enforceability of any award."); *SCC Rules*, *supra* note 148, at Art. 47 ("...the SCC, the Arbitral Tribunal and the parties shall act in the spirit of these Rules and shall make every reasonable effort to ensure that all awards are legally enforceable.").

these observations will answer many of society's pressing questions to reveal the true systemic impact of third-party funding. *How prevalent is third-party funding? What is the effect of third-party funding on parties, counsel, procedures, and outcomes in dispute resolution? What benefits and problems can we identify? Are those benefits and problems different or the same as we predicted or surmised? Should those benefits be incentivized and those problems be regulated, and if so, how?* We currently cannot answer these questions without more data. Thus, the rule reinterpretations proposed in this article should be viewed as an interim regulatory structure with the goal of gleaning more data about the prevalence, structures, and impact of third-party funding within litigation and arbitration through disclosure and observation. This data would inform the next step of regulation, such as correcting, tailoring, or revising existing rules.

Although rule revisions are far off, this article concludes by providing a few suggestions for revisions for the Advisory Committee on the Federal Rules of Civil Procedure and arbitral institutions to consider in the future. First, a working definition of a “third-party *funder*” and “third-party *funding*” would be very helpful. Funders and funding take so many different forms, however, that proposed uniform definitions may be over- or under-inclusive.<sup>251</sup> Still, defining these two terms is likely crucial to any comprehensive regulatory effort. In addition, regulations should incorporate the same definitions of these two terms to clarify the type of arrangement to which all the regulations are referring. This will create cohesion and uniformity within the proposed regulatory scheme. An example of a potentially useful definition can be found in the revised International Bar Association's Guidelines on Conflicts of Interest in International Arbitration.<sup>252</sup> The definition states that a third-party funder “may have a direct economic interest in the award...” and would be “any person or entity that is contributing funds, or other material support, to the prosecution or defence [sic] of the case and that has a direct economic

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<sup>251</sup> This comment was made during the February 12, 2014 and February 12, 2015 meetings of the Third-Party Funding Task Force ([http://www.arbitration-icca.org/projects/Third\\_Party\\_Funding.html](http://www.arbitration-icca.org/projects/Third_Party_Funding.html)). The international arbitration community hopes to devise a set of guidelines or rules for the practice. *See also* IBA Guidelines, *supra* note 89 and accompanying text.

<sup>252</sup> *See* IBA Guidelines, *supra* note 89, at Explanation to General Standard 6(b), (“Third-party funders and insurers in relation to the dispute may have a direct economic interest in the award, and as such may be considered to be the equivalent of the party. For these purposes, the terms ‘third-party funder’ and ‘insurer’ refer to any person or entity that is contributing funds, or other material support, to the prosecution or defence [sic] of the case and that has a direct economic interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration.”).

interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration.”<sup>253</sup>

Second, the rules should be revised to require funded parties to make disclosures to the decision maker. The funded party should be required to disclose to the judge or arbitrator the identity of the third-party funder, so that the judge or arbitrator can determine whether he or she has a connection to the funder that would require recusal. A funded party should be required to disclose the third-party funding arrangement to the judge or arbitrator if that party claims attorney fees under applicable law and if the judge or arbitrator orders disclosure of any fee arrangements. Disclosure of third-party funding to the opposing side should not be mandatory, because the participation of the funder is not material to the merits of the underlying dispute.<sup>254</sup> However, the parties may come to an enforceable agreement during the pretrial conference regarding the disclosure or confidentiality of funding arrangements.<sup>255</sup> Furthermore, in order to prevent waiver of evidentiary privileges for information shared with the funder, funders should be included within the exceptions to the waiver of evidentiary privileges, which would require amending the common law rather than the Federal Rules.<sup>256</sup> Arbitration borrows evidentiary privileges from national laws around the world based on the preferences of the parties and arbitrators, so revising arbitration rules to address evidentiary privileges would be unnecessary and would likely violate the trans-substantive principle of litigation and arbitration rules of procedure.<sup>257</sup>

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<sup>253</sup> *Id.*

<sup>254</sup> *See supra* Part V.A.1.

<sup>255</sup> *See* FED. R. CIV. P. 16; FED. R. CIV. P. 26.

<sup>256</sup> *See supra* Part V.A.1.

<sup>257</sup> Compare Robert M. Cover, *For James Wm. Moore: Some Reflections on a Reading of the Rules*, 84 YALE L.J. 718, 718 (1975) (“We have become so transfixed by the achievement of James Win. Moore and his colleagues in creating, nurturing, expounding and annotating a great trans-substantive code of procedure that we often miss the persistent and inevitable tension between procedure generalized across substantive lines and procedure applied to implement a particular substantive end. There are, indeed, trans-substantive values which may be expressed, and to some extent served, by a code of procedure. But there are also demands of particular substantive objectives which cannot be served except through the purposeful shaping, indeed, the manipulation, of process to a case or to an area of law. What follows is by no means an attempt to denigrate or undermine the ongoing trans-substantive achievement of the Federal Rules of Civil Procedure. Rather it is an exploration to rediscover the feel of a tension.”) with Geoffrey C. Hazard Jr., *Discovery Vices and Trans-Substantive Virtues in the Federal Rules of Civil Procedure*, 137 U. PA. L. REV. 2237, 2244 (1989) (“The second principal criticism of the Federal Rules is that they indiscriminately govern all kinds and types of

This article has suggested various reinterpretations of and revisions to the Federal Rules of Civil Procedure and rules of arbitration procedure to address issues relating to the phenomenon of third-party funding. Rule revisions are likely not to happen anytime soon, but fortunately, the existing Federal Rules and rules of arbitration provide a framework for judges and arbitrators to handle potential third-party funding issues as they arise. In addition, both litigation and arbitration rules provide for the judge or arbitrator to use local procedural rules and devise case-by-case solutions to novel problems for which there is no formal rule on point. These existing features of dispute resolution will help ensure that decision makers can address any issues that may arise, even without revisions to the procedural rules. As the third-party funding industry grows and matures, rule revisions may be needed, particularly in the context of funded class action litigation under Federal Rule 23 and funded class arbitration, if those phenomena become more prevalent. Careful observation and documentation of the participation of third-party funders in the dispute resolution system will be an integral and essential part of any future consideration of relevant revisions to litigation or arbitration rules.<sup>258</sup> In the meantime, this article has demonstrated that decision makers already have the tools that they need to begin observing and addressing issues of third-party funding by reinterpreting existing framework of litigation and arbitration rules.

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litigation, whereas civil procedure rules properly constructed would be shaped to the needs of specific categories of litigation. This critique contemplates separate sets of rules for civil rights cases, antitrust cases, routine automobile cases, and so on. The criticism has been expressed perhaps most incisively by Professor Robert Cover, esteemed colleague prematurely gone from us. Yet despite the great respectability of its source, the ‘trans-substantive’ critique seems misguided to me. It overstates the reach of the Federal Rules and underestimates the technical and political difficulties of trying to tailor procedures to specific types of controversies.”). *Cf. supra* note 71 regarding the trans-substantivity of arbitration.

<sup>258</sup> *Cf., Advisory Committee on the Civil Rules Agenda Book, supra* note 68, at 79 (“The Conference also prompted a project launched by the Committee and the National Employment Lawyers Association to develop protocols for initial discovery in individual employment cases. The protocols were developed by a team of lawyers evenly balanced between those who commonly represent employees and those who commonly represent employers. The protocols have been adopted by numerous District Judges; experience with the protocols has led to calls for more widespread adoption, and the hope that similar protocols might be developed for other categories of litigation. These programs of education and innovative pilot projects continue.”).