

THE PROBLEM OF COMMERCIALIZATION IN ARBITRATION: AN ANALYSIS OF THIRD-PARTY FUNDING

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Annotation: This report argues that the unregulated growth of Third-Party Funding (TPF) is commercializing international arbitration, introducing systemic "pathologies" that threaten the system's integrity. The author contends that TPF erodes party autonomy, creates hidden conflicts of interest, and treats legal claims as financial assets, thereby undermining the fairness of the arbitral process. The report criticizes the current fragmented regulatory landscape as inadequate and calls for a comprehensive framework. Key proposed reforms include mandatory disclosure of funding details, prohibiting funder control over litigation, clarifying rules on costs, and implementing stricter regulations for Investor-State Dispute Settlement (ISDS).

Keywords: *Third-Party Funding (TPF), International Arbitration, Commercialization of Arbitration, Investor-State Dispute Settlement (ISDS), Party Autonomy, Conflicts of Interest, Regulation, UNCITRAL, Costs in Arbitration, Commodification of Claims*

Introduction

Commercial arbitration has established itself as a cornerstone of global commerce, offering a private, streamlined, and often more efficient alternative to traditional court litigation for resolving business disputes. At its core, it is a process driven by party agreement, where neutral experts are chosen to render final and binding decisions on conflicts ranging from simple contract breaches to complex cross-border financial disagreements. However, a profound transformation is underway. The "commercialization" of arbitration now signifies more than its application to business matters; it describes the conversion of the dispute resolution process itself into a financial marketplace.

This metamorphosis is propelled by the mechanism of Third-Party Funding (TPF). TPF is a financial arrangement where an external entity—such as a specialized investment firm, hedge fund, or insurance company—covers a party's legal costs in exchange for a share of the proceeds if the claim is successful. This practice fundamentally reframes a legal claim,

transforming it from a question of rights and liabilities to be adjudicated into a financial asset to be invested in, managed for risk, and monetized for profit. The presence of a third-party funder, whose sole interest is a return on investment, transforms a justice system designed for impartial dispute adjudication into a marketplace where disputes are commoditized and traded. This report contends that this shift alters the very nature of arbitration, moving it from a service for resolving conflict to a platform for generating investment returns, with significant and potentially detrimental consequences for the system's integrity.

This report advances the thesis that the unchecked commercialization of arbitration through TPF introduces systemic dysfunctions—or "pathologies"—that threaten the integrity, fairness, and fundamental purpose of the arbitral process. The term "pathological" is borrowed from the lexicon of arbitration, where a "pathological clause" refers to a defective arbitration agreement that is drafted so poorly that it impedes or even prevents a workable arbitration. Just as such a clause can cripple a specific proceeding, the pathologies engendered by commercialization risk sickening the entire arbitral system.

This report will proceed as follows. First, it will diagnose the specific pathologies arising from TPF, including the erosion of party autonomy, the proliferation of conflicts of interest, the commodification of claims, distortions in cost allocation, and the unique problems in investor-state arbitration. Second, it will discuss the current, fragmented regulatory landscape, analyzing the divergent approaches of national legal systems and arbitral institutions. Third, it will prescribe a comprehensive and principled regulatory framework to cure these pathologies. Finally, it will offer a concluding reflection on the need to balance the potential benefits of TPF with the overriding imperative to protect the integrity of justice.

The Problem

The introduction of a third-party profit motive into what is fundamentally a bilateral dispute resolution process creates a series of interconnected dysfunctions. These pathologies are not isolated flaws but symptoms of an underlying condition: the misalignment of the funder's financial interests with the principles of procedural fairness and party-centric resolution that are the hallmarks of arbitration.

A foundational principle of arbitration is party autonomy—the right of the disputing parties to shape their own proceedings. TPF poses a direct threat to this principle. Because funders invest significant capital on a non-recourse basis, they have a powerful economic incentive to influence or control the conduct of the arbitration to protect their investment. This control is often formalized within the funding agreement, which can grant the funder substantial sway over critical strategic decisions.

This influence is most acute in settlement negotiations. A funding agreement may reserve the funder's right to approve or reject a settlement offer. The funder's financial calculus—balancing the size of the offer against the risk and cost of continuing the arbitration—may diverge sharply from the interests of the funded party. A claimant might wish to accept a reasonable settlement to end a costly and distracting dispute, but a funder, seeking a higher multiple on its investment, could veto the agreement. Conversely, a funder might pressure a party to accept a lowball offer to guarantee a quick, albeit smaller, return. This creates a severe principal-agent problem where the funded party, the actual owner of the claim, loses ultimate control over its fate to an external financier who is not a party to the arbitration agreement and owes no fiduciary duty to the claimant.

The integrity of arbitration hinges on the independence and impartiality of the arbitrators. The introduction of a TPF provider—often a large, institutional repeat-player with a vast and opaque portfolio of investments—creates a dense and hidden web of potential conflicts of interest that can undermine arbitrator neutrality.

Conflicts can manifest in numerous ways. An arbitrator may unknowingly hold a financial interest in the funding entity, for example, by owning shares in a publicly traded funder. An arbitrator's law firm may have a broader business relationship with the funder, advising it on other matters or having its own cases funded by the same entity. A more subtle but equally corrosive conflict arises when an arbitrator is repeatedly appointed in cases backed by the same funder, creating a potential financial dependency and an incentive to render funder-friendly decisions.

This pathology is dangerously magnified by a lack of transparency. Funding agreements are typically confidential, and the funder's very existence in a case is often not disclosed to the opposing party or the tribunal. Even when institutional rules mandate disclosure, the requirement is often limited to the funder's name, not the terms of the agreement or the full scope of its financial relationships. This opacity makes it virtually impossible for parties, institutions, and the arbitrators themselves to conduct meaningful conflict checks. An undisclosed conflict discovered late in the proceedings or after an award is rendered can lead to costly challenges, the disqualification of an arbitrator, and the potential annulment of the final award, thereby defeating arbitration's goals of efficiency and finality.

TPF fundamentally alters the ethical and procedural landscape of a dispute by treating a legal claim not as a matter of right but as a tradable commodity. This commodification has several corrosive effects. First, it can compromise the lawyer's undivided duty of loyalty to the client. When a law firm's cases are financed through a portfolio funding arrangement—where

a funder bankrolls a slate of cases rather than a single one—the law firm develops a dual allegiance. It owes a duty to the individual client in a specific case, but also a business imperative to the funder financing its operations. The funder's interest in maximizing the overall portfolio's return may conflict with the best course of action for an individual client within that portfolio.

Second, commodification skews the focus of dispute resolution exclusively toward monetary outcomes. Since funders earn their return from the damages awarded, they are primarily interested in high-quantum monetary claims. This systematically devalues and discourages non-monetary remedies such as injunctions, specific performance, or declaratory relief, which may be more just or socially beneficial but offer no direct financial return to the investor.

Third, it distorts the system's ability to filter meritorious claims from unmeritorious ones. Proponents argue that funders, as sophisticated investors, will only back strong cases, thus filtering out frivolous claims. However, the reality is more complex. Funders filter for

commercial viability, not necessarily *legal merit*. A claim with a low probability of success but a spectacularly high potential payout might be an attractive high-risk, high-reward investment. Conversely, a legally sound claim with modest potential damages will likely be rejected as not commercially viable. This shifts the focus of justice from the redress of wrongs to the facilitation of profitable speculation.

TPF has created two new procedural battlegrounds that introduce significant uncertainty and strategic gamesmanship into the arbitral process: the recoverability of funding costs and applications for security for costs.

The first issue was brought to the fore by the English High Court's decision in *Essar v. Norscot*, which upheld an arbitral award ordering the losing party to pay not only the claimant's legal fees but also the multi-million-pound "success fee" owed to its third-party funder. This precedent, while not universally followed, raises the prospect of hugely inflated cost awards. Critics argue that a funder's premium is a cost of financing—an investment return—not a true "cost" of the arbitration, and making it recoverable unfairly penalizes the losing party for the claimant's business decision to seek funding.

The second issue is the mirror image of the first. Respondents increasingly argue that the presence of a non-recourse funder justifies an order for security for costs. The logic is that if the funded claimant loses, it may be an empty shell with no assets to satisfy an adverse costs award, while the funder, who orchestrated and financed the proceeding, is shielded from liability because it is not a party to the arbitration. This allows respondents to weaponize the

TPF arrangement, demanding that the claimant post a substantial bond as a condition of continuing the arbitration. Such an order can have a chilling effect, potentially stifling the very access to justice that TPF purports to facilitate if the claimant cannot afford to provide the security.

A Special Pathology: Exacerbating Asymmetry in Investor-State Dispute Settlement (ISDS)

While the foregoing pathologies affect all forms of arbitration, they are amplified in the unique and controversial context of Investor-State Dispute Settlement (ISDS). In ISDS, TPF does not merely introduce commercial pressures; it exacerbates a pre-existing systemic imbalance and raises profound public interest concerns.

The ISDS system is inherently asymmetric: investment treaties typically grant rights to foreign investors to bring claims against host states, but not vice-versa. States can generally only act as respondents. TPF supercharges this imbalance by equipping investors, often large multinational corporations, with enormous financial war chests to prosecute claims against sovereign states, particularly developing countries with limited public funds to mount an effective defense.

Unlike commercial disputes, where awards are paid by private entities, ISDS awards are paid from public treasuries. TPF thus facilitates a system where speculative finance can profit from claims challenging legitimate public interest regulations—in areas like environmental protection, public health, or labor rights—and results in a direct transfer of wealth from taxpayers to private, often offshore, funders. The "access to justice" rationale is at its weakest in this context. Claimants are rarely impecunious; they are sophisticated corporate actors using TPF as a risk management tool. In this light, critics persuasively argue that TPF in ISDS is not a tool for justice but an "exploitation mechanism" that profits from the system's structural flaws at the public's expense.

Discussion

The response to the rise of TPF has been inconsistent and uncoordinated, resulting in a fragmented global landscape characterized by divergent legal philosophies, a patchwork of institutional rules, and a growing potential for strategic maneuvering by sophisticated parties. This regulatory disarray creates uncertainty and undermines the predictability that is essential to international arbitration.

The global legal landscape for TPF is broadly split along the traditional divide between common law and civil law systems, each with different historical starting points and conceptual approaches.

Common law jurisdictions, particularly Australia, the UK, and the US, have been the primary incubators of the modern TPF industry. This is largely because they have progressively dismantled or judicially relaxed the historical doctrines of maintenance and champerty that once prohibited the practice. Consequently, TPF is a more mature and developed market in these countries. However, regulation often remains a patchwork of case law and specific rules rather than a comprehensive statutory framework. Even in a mature market like the UK, significant legal uncertainty can erupt, as demonstrated by the Supreme Court's 2023 decision in

R (PACCAR) v Competition Appeal Tribunal. This ruling unexpectedly classified many litigation funding agreements as "Damages Based Agreements," rendering them unenforceable under existing regulations and throwing the UK funding market into turmoil.

In contrast, civil law jurisdictions generally lack the specific historical prohibitions of champerty and maintenance. Instead, TPF arrangements are scrutinized under broader legal principles such as public policy, good faith, and prohibitions on unconscionable contracts. The adoption of TPF in these systems has been more cautious, often viewing it as a "legal transplant" from the common law world that must be carefully adapted to fit within stricter procedural codes and a different legal culture that may be more skeptical of the commercialization of justice.

The approach in the People's Republic of China provides a compelling case study of policy-driven legal adaptation. Chinese courts have demonstrated a clear dichotomy: they are permissive and even encouraging of TPF in the context of international arbitration, but highly restrictive and suspicious of it in domestic litigation. This dual approach appears strategic. A liberal stance on TPF in arbitration signals that China is a modern, pro-arbitration jurisdiction aiming to compete as a global seat for international disputes. Conversely, the restrictive approach in domestic litigation reflects a legal culture that prioritizes social harmony, favors mediation over adversarial conflict, and is wary of practices that might encourage frivolous lawsuits or allow non-litigants to interfere with the judicial process.

Institutional Responses: A Patchwork of Rules and Discretion

The world's leading arbitral institutions have responded to TPF in a strikingly divergent manner, creating a fragmented set of rules that leaves parties to navigate significant uncertainty. The lack of a uniform approach allows for strategic gamesmanship, where the choice of arbitral institution can become a tactical decision based on the favorability of its TPF rules. This phenomenon of "regulatory arbitrage"—where parties select a legal framework to gain a procedural advantage—undermines the goal of a level playing field. It creates competitive pressure among institutions to tailor their rules to either attract TPF-related business or brand

themselves as guardians of procedural integrity, leading to further fragmentation rather than convergence.

This comparison reveals a clear trend towards mandatory disclosure of a funder's existence and identity, with the LCIA being a notable outlier. However, no institution mandates disclosure of the funding agreement's terms. Furthermore, only SIAC has taken the proactive step of directly regulating the timing of funding agreements to prevent late-stage conflicts. This patchwork approach creates a confusing and unpredictable environment for users of international arbitration.

Proponents of TPF, particularly the funders themselves, often argue that the market can effectively regulate itself. They contend that their rigorous due diligence process naturally filters out frivolous or unmeritorious claims, as they will only invest in cases with a strong likelihood of success. While it is true that funders conduct extensive analysis, their primary criterion is commercial viability and potential return on investment, not abstract legal merit or the pursuit of justice.

Furthermore, attempts at self-regulation through codes of conduct, such as the one established in Hong Kong, often lack teeth. These codes typically set out "minimum standards" for capital adequacy and managing conflicts but are voluntary and carry no legal liability for non-compliance. The fundamental conflict between the duty to maximize shareholder returns and the need to ensure procedural fairness and protect the interests of the funded party is too great to be managed by voluntary, unenforceable guidelines. The systemic pathologies identified previously—undue influence, hidden conflicts, and commodification—are direct results of the profit motive and are unlikely to be resolved by a market left to its own devices.

The most significant and coordinated effort to regulate TPF is currently underway within the United Nations Commission on International Trade Law (UNCITRAL), specifically through its Working Group III on ISDS Reform. This initiative reflects a growing consensus among states that the impact of TPF in the investor-state context is too significant to be left unregulated.

The Working Group's draft provisions on TPF are comprehensive and represent a potential blueprint for a global standard in ISDS. The draft proposes several potential regulatory models, ranging from an outright prohibition of TPF in ISDS to more nuanced "restriction models." These include an "access to justice model" permitting funding only when necessary for a claimant to bring a claim, and a "restriction list model" that would prohibit certain types of funding, such as those that are purely speculative or offer an excessive return to the funder.

Crucially, the UNCITRAL draft goes far beyond the current rules of most arbitral institutions. It mandates extensive disclosure, including the identity of the funder's beneficial owners and key terms of the funding agreement related to control and termination. It explicitly states that a TPF agreement does not constitute a protected investment and that a funder cannot be considered an investor. It also presents options for dealing with costs, including making security for costs mandatory or clarifying that funding costs are not recoverable. The UNCITRAL process is a landmark endeavor because it is driven by states and signals a potential shift away from the current patchwork of private rules toward a binding multilateral framework designed to protect the public interest in investment arbitration.

The Solution

Addressing the pathologies of commercialized arbitration requires more than piecemeal adjustments. It demands a holistic and principled regulatory framework that reasserts the core values of the arbitral process. The following proposals, drawn from best practices and emerging international consensus, offer a blueprint for reform.

Effective regulation begins with transparency. The current trend towards disclosure is positive but insufficient. A robust solution requires a mandatory, upfront, and continuous duty of disclosure that extends beyond merely naming the funder. Drawing from the comprehensive model proposed by the UNCITRAL Working Group III, this duty should include:

The existence of the funding agreement and the full legal name and address of the funder.

The identity of any entity with ultimate beneficial ownership or decision-making control over the funder, to unmask complex corporate structures.

A clear statement as to whether the funder has contractually agreed to cover any potential adverse costs award. This information is critical for applications for security for costs.

While requiring the disclosure of the entire funding agreement may raise legitimate concerns about commercial confidentiality, parties should be required to disclose any terms that grant the funder control over strategic decisions, including settlement and termination rights. This enhanced transparency is the essential first step to managing conflicts of interest and ensuring the integrity of the proceedings.

To cure the pathology of undue influence, regulations must explicitly prohibit funders from usurping the decision-making power of the parties. Arbitral rules and binding codes of conduct should render unenforceable any clause in a funding agreement that grants a funder the right to:

Veto a settlement offer that the funded party wishes to accept.

Compel a funded party to accept a settlement offer.

Direct the legal strategy of the case against the instructions of the funded party.

The ultimate authority to make strategic decisions must always remain with the party to the dispute, acting on the advice of their legal counsel, who owes a sole fiduciary duty to that party. This reform is critical to restoring the principle of party autonomy to its central place in the arbitral process.

The uncertainty surrounding costs must be resolved with clear, principled rules that discourage strategic gamesmanship. This requires a two-pronged approach:

The default rule, to be codified in arbitral rules, should be that a funder's success fee or premium is *not* recoverable as part of the "costs of the arbitration." Such fees are the funder's return on a speculative investment, not a legal expense incurred by the party in the course of the proceedings. Rejecting the

Essar v. Norscot approach as a matter of principle would prevent the imposition of punitive and unpredictable cost awards and restore a measure of fairness to cost allocation.

The mere existence of TPF should not, in itself, be sufficient grounds for an order for security for costs. To hold otherwise would be to penalize parties for using a legitimate financing tool. However, the presence of a funder is a relevant factor that a tribunal should consider as part of a multi-factor analysis. The key question should be whether there is credible evidence that the claimant would be unable to satisfy an adverse costs award. The existence of a non-recourse funding agreement, combined with a funder's refusal to provide an indemnity for adverse costs, could be a strong indicator justifying a security order. This approach balances the respondent's legitimate concern for cost recovery with the claimant's fundamental right to access justice.

Inspiration should be taken from the Hong Kong model and UNCITRAL discussions to develop a *binding* international code of conduct for third-party funders participating in arbitration. Self-regulation has proven inadequate. This code should be enforced by arbitral institutions as a condition of allowing funded claims to proceed. Key provisions should include:

Minimum capital requirements to ensure that funders have the financial capacity to meet their funding commitments for the life of a dispute and to cover adverse costs if they have agreed to do so.

Robust procedures for identifying and managing conflicts of interest between the funder, the funded party, counsel, and arbitrators.

A prohibition on funding claims that are manifestly frivolous, vexatious, or contrary to public policy.

Given the unique public interest dimension of ISDS, a higher level of regulation is warranted. The international community should seriously consider adopting the more restrictive models proposed by UNCITRAL to rebalance the system. These special regulations could include:

A complete prohibition on TPF for claims brought against the least-developed countries.

A cap on the percentage of a public treasury-paid award that a private funder can recover, preventing exorbitant profits at public expense.

An absolute and non-waivable rule that a funder's costs and premiums are not recoverable from a respondent state.

These measures are necessary to mitigate TPF's role as an "exploitation mechanism" and to safeguard the ability of sovereign states to regulate in the public interest without the threat of speculative, financially engineered litigation.

Conclusion

This report has argued that the rapid, largely unregulated growth of third-party funding has driven the commercialization of arbitration to a point where it threatens the system's foundational principles. The transformation of legal claims into financial assets has introduced a series of interconnected pathologies: the erosion of party autonomy through funder control; the creation of a hidden web of conflicts of interest that endangers arbitrator impartiality; the ethical degradation that accompanies the commodification of legal disputes; and the distortion of procedural fairness through battles over costs. In the sensitive context of ISDS, these problems are magnified, turning a dispute resolution system into a vehicle for speculative investment at the expense of the public interest.

The current regulatory landscape—a fragmented patchwork of divergent institutional rules, national laws, and judicial precedents—is inadequate to address these systemic challenges. It creates uncertainty and invites regulatory arbitrage, undermining the predictability and fairness that are arbitration's key selling points. A solution cannot come from the market itself, nor can it be achieved by institutions acting in isolation. What is required is a coordinated, top-down effort by states, arbitral institutions, and user communities to establish and enforce a coherent, principled regulatory framework. The ongoing work at UNCITRAL provides a critical opportunity and a potential venue for forging such a global consensus, at least in the vital area of ISDS.

Third-party funding is not inherently pernicious. In its original conception, it offered a valuable means of leveling the playing field and providing access to justice for those with meritorious claims but limited resources. That benefit, in certain circumstances, remains real.

However, the central challenge posed by the modern TPF industrial complex is that the goal of providing *access* to justice cannot be allowed to corrupt the *integrity* of the justice being accessed. An arbitration system dominated by speculative financial interests, where party autonomy is compromised, neutrality is in doubt, and outcomes are dictated by profit motives, is not a system worth accessing. The task for the international community is to harness the legitimate benefits of TPF while decisively neutralizing its pathological effects. This is the only way to ensure that international arbitration remains a respected forum for the fair and impartial resolution of disputes, not just another asset class for global finance.

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