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The Dos and Don'ts of security for costs in international commercial arbitration

The present article throws a glance at recent trends and developments in the field of security for costs applications – such as, for example, the rise of third-party funding in arbitration – and provides parties with a simple to use checklist of «Dos and Don'ts» from the conclusion of the arbitration agreement to the preparation of the request for security for costs.

1. Security for costs – What are we talking about?

The costs parties incur in international commercial arbitration are twofold. On one hand the administrative costs of the institution as well as the fees and expenses of the arbitral tribunal accrue, on the other hand each party incurs legal and other costs in relation to the arbitration (so-called party costs). It is common that the losing party has to compensate the winning party for the latter's party costs.

While arbitration might well have started, once upon a time, as the «gentlemen's way» to resolve a dispute, ungentlemanly tactics such as «hit and run arbitration» are on the raise, meaning that a party – or its arbitration funder – has to pay (party) costs because losing the arbitration trying to evade such duty. Regarding the estimated administrative costs of the institution as well as the fees and expenses of the arbitral tribunal, many arbitration rules provide for an advance deposit on these costs being lodged in order to eliminate the risk of not getting paid.[1]

Security for costs applications, if successful, aim for the same goal regarding the legal and other costs incurred by a party which has successfully defended itself against a claim. Procedurally, orders for security for costs are considered a special form of interim measure, serving to temporarily – i.e., until a decision on the merits is handed down – protect a (procedural) claim for compensation from being frustrated.

[1] See for example Art. 4(b) of the ICC Rules.

Therefore, security of costs can in general terms be described as a form of collateral which the (counter-) claimant must provide under certain circumstances in respect of its counterparty's costs in the arbitration proceedings.

2. What are the conditions for an arbitral tribunal ordering security for costs?

2.1 Authority of the arbitral tribunal to order security for costs

The first condition for a successful application of security for costs is the **authority of the arbitral tribunal to actually order security for costs**. Three layers of rules determine if the arbitral tribunal has such powers: firstly, the law of the seat of the arbitration, secondly, the arbitration rules applicable to the specific arbitration and thirdly, the parties' explicit agreement on the matter, if any. While it is certainly possible to include provisions on security for costs (or interim measures in more general terms) in the arbitration agreement, it is rather unusual that parties actually do so.

The treatment of security for costs by national laws and arbitration rules can be summarized as follows. Certain laws and rules specifically address the issue of security for costs, giving the arbitrators explicit powers to order them.[2] Many rules/laws give arbitrators the general power to order interim measures[3], which is considered sufficient to also give the arbitral tribunal the power to order security for costs. It has even been argued that the tribunal can also draw its power to order security for costs from its inherent authority in connection with the conduct of the arbitration proceedings. There are, however, jurisdictions that restrict the arbitrators' power to order interim measures and, therefore, also to order security for costs.[4] In the latter case, the party seeking security for costs has no other choice than to try obtaining such protection from a state court – if this is not precluded by the arbitration agreement.

It is our experience that at least in international commercial arbitration practice there is a clear trend recognizing the arbitral tribunal's right to order security for costs.

2.2 What are the criteria for obtaining security for costs?

There is **no «fit-it-all» uniform test**. The criteria according to which an arbitral tribunal will assess an application of security for costs will depend on the aforementioned array of applicable legal regimes. This means that more often than not there will be no specific written provisions spelling out the conditions to be met for a successful security for cost application.

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2 See for example art. 41 HKIAC Rules.

3 See for example. art. 183 of the Swiss Federal Act on Private International Law, and/or art. 26 of the Swiss Rules of International Arbitration.

4 These jurisdictions include namely Italy and China.

Arbitral practice has developed the following key conditions an arbitral tribunal will likely take into account when deciding on an application of security for costs:

a) **Fumus boni iuris**: While this common condition to be met for ordering interim measures usually refers to the «likelihood of success on the merits of the case», this is not the argument an applicant should make when applying for security for costs. The arbitral tribunal will usually be reluctant to make any indication as to the merits of the dispute brought before it – and rightly so. Hence, for the issue of security for cost, the «likelihood of success» refers to the probability that the applicant will be able to recover its party costs from the unsuccessful party should the latter's claim fail. In international commercial arbitration this is usually the case if the «costs follow the event» rule applies, i.e., the principle that the successful party in the arbitration can recover its costs from the succumbing party. This interpretation of the «fumis boni iuris» condition is widely accepted for security for costs issues, also because it does not require the arbitral tribunal to conduct a «prima facie» assessment of the material outcome of the dispute. In many arbitrations – and as long as the parties have not agreed to another cost-sharing – this condition will be met without problems.

b) **Periculum in mora**: The applicant must further demonstrate the probability of a non-recovery risk of its party costs from the other party in case – and although – it successfully defended itself against the latter's claim. Here again, there is no «one fits it all» test. The risk that the unsuccessful (counter-) claimant will or cannot pay a future cost award may stem from a variety of situations. The circumstances establishing a strong likelihood that the other party will not meet a future adverse cost award are to be assessed on a case-by-case basis. A serious and imminent danger to the applicant's claim for reimbursement of its legal costs may namely exist if one or several of the following situations are given:

- The counterparty has a proven track-record of not honoring decisions unfavorable to it, in particular cost awards;
- The financial situation of the counterparty will likely result in not being able to honor a potential negative cost award;
- A funding agreement exists, which does not include the funder's obligation to cover a negative cost award;
- The counterparty has thus far refused to lodge any kind of advance on the arbitration costs;
- The counterparty has undertaken or is undertaking active endeavors to hide or «ring-fence» its assets;
- The counterparty has initiated the arbitration and/or its claim in bad faith and the specific intention of frustrating a potentially cost award.

c) **Good faith**: The application must be made in good faith. This means, in our experience, particularly two things: Firstly, the substantial impairment of the other party's financials or other above-mentioned situation was unknown to and could not have been discovered without too much effort by the applicant at the time the contract/arbitration agreement was concluded. Indeed, a party that enters into an arbitration agreement and a million dollar contract with, for example, a BVI shell company without substantial assets, later cannot rely on that company's inability to meet a potentially adverse cost award to motivate a request for security for cost: The applicant took the risk with eyes wide shut. Secondly, the arbitral tribunal may not look favorably at an application for security for cost, coming from a party which «does not come to the table with clean hands». This means in particular that the applicant cannot be the very reason for the other party's inability and/or has undertaken any kind of bad faith dealings vis-à-vis the other party itself. The applicant must also have honored all of its cost-related obligations.

It cannot be stressed enough that these criteria are not applied by means of a fixed checklist by arbitral tribunals. In some instances, the arbitrators will also consider further elements characteristic to interim measure proceedings, such as urgency or the balance of the parties' respective interests[5]. The weight attached to the respective criteria will vary from one tribunal to the next, depending, for example, on the arbitrators' background.

2.3 Third party funding in international commercial arbitration and its impact on security for costs

In past years, there has been increased participation of third party funders in international commercial arbitration proceedings. While there are voices in the arbitration community advocating that the mere fact that a third party funder is involved justifies ordering security for costs or reverses the burden of proof, we politely disagree with this view. It ignores the business setting in which commercial parties operate. Third party funding is not only used by parties in financial strait, but also more and more frequently by financially stable parties that seek to share the cost risks associated with arbitration proceedings and/or that simply wish to maintain their cash flow. Hence, we are of the opinion that the involvement of a third party funder does not per se justify ordering security for costs. In specific circumstances, i.e., for example when there exists evidence suggesting that a party is in such big financial difficulties that it could not even honor an adverse cost award and if in addition the funding agreement does not (also) cover an adverse costs award, a tribunal might consider ordering security for costs. We do not see any necessity to reverse the burden of prove in this respect. It is the applicants duty to request the disclosure of the funding agreement (or at least the part dealing with costs). Here again, however, it is not the presence of a third party funder as such which should guide the arbitral tribunal's considerations, but the clear and present danger (to be proven by the applicant) that the defending party might see a favorable cost award frustrated.

[5] It is our view, however, that if the before-mentioned criteria are met there is no room for either urgency or a balancing of interests to play a decisive role in the peculiar setting of a decision on security for costs.

3. Procedural aspects of obtaining security for costs

3.1 **Applicant**: Typically, the respondent may request security for costs against the claimant. The claimant, however, if faced with a counterclaim, may equally have a legitimate interest to obtain security for its legal costs in connection to this counterclaim.

3.2 **Right to be heard**: Usually, issue of security for costs is discussed by the parties early in the proceedings (e.g. during the case management conference), so that the arbitral tribunal and the parties can discuss and agree on how to deal with such application within the framework of the arbitration. It is, however, possible and in some cases even appropriate to file such an application only later in the proceedings, for example if the applicant gets aware of the counterparty's endeavors to hide its money only at a later stage of the arbitration. In general, the other party will be granted the opportunity to comment on the (written) application. It is not unusual that the arbitral tribunal will decide on the application after only one exchange of briefs/arguments, so applicants should not expect a «second shot». If this is more efficient, however, the arbitral tribunal may also decide to hear oral arguments on the issue of security for costs, e.g., during a hearing or a video conference. It is not excluded per se that security for costs can be ordered «ex parte». Two additional conditions need to be met; on one hand, the lex arbitri has to provide for ex parte orders[6]. On the other hand, exceptional circumstances must justify an ex parte order, e.g., extreme urgency or that the very purpose of the security for cost order would be jeopardized by providing advance notice to the other party. It is our opinion that these additional conditions will only be met very rarely.

3.3 **Evidence and burden of proof:** The burden of proof is one of prima facie evidence / likelihood. This gives the arbitral tribunal a very broad discretion when deciding on such applications. The applicant is well advised to anticipate possible arguments, to frontload its application, as there might not be a second exchange of briefs. Similarly, and although the burden of proof is less strict than on the merits, the applicant should provide the tribunal with all and any available evidence supporting its application, be it documents, affidavits, or even documents in the hands of the counterparty[7] etc.

3.4 **Form of security for costs:** While it is in the arbitral tribunal's discretion to determine the form in which the (counter-) claimant shall provide security for costs, the wise applicant spells out his preference in the application as precisely as possible. This might go as far as to attach a draft of the escrow agreement or the exact wording of the bank guarantee to the application. The favorite form to lodge security for costs is by means of a bank guarantee. In practice, the arbitral tribunal have been very reluctant to order the claimant placing the funds into an **escrow account** that is either controlled by the arbitral

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[6] See e.g. art. 26(3) Swiss Rules of International Arbitration.

[7] The applicant will then have to declare already in his application the materiality and pertinence of the requested document for its application as well as why it concludes that the other party is in possession of such documents.

tribunal or jointly by the parties, because (i) they do not want to deal with keeping such escrow and (ii) this often proves to be more complicated.

3.5 **Determination of the amount of security:** The amount to be secured is determined by estimating the costs the (counter-) respondent will reasonably incur in defending the (counter-) claim. While certain arbitral tribunals will only order security for the costs in the future, i.e., from the filing of the request onwards, other arbitrators include in their order also costs that already incurred by the applicant in the present arbitration before he filed his request. This uncertainty can usually be avoided by filing the request for security for costs early – or, if this is not possible, at least by substantiating why in the case at hand security for costs should also include already incurred costs. The types of costs for which security can be requested depends on the types of costs that are considered «party costs» in the particular arbitration. It is generally accepted that the expenses for legal representation and assistance are recoverable. Beyond that, security may also be requested for lost management time, costs of in-house counsel, out of pocket expenses of the party and its witnesses, expert costs, and also for the arbitration costs which the requesting party has lodged instead of the other party. When requesting security of costs in the form of a bank guarantee, it is recommended to specify the duration and amount of the guarantee with regard to the specific circumstances of the case.

3.6 **When should a request for security for costs be lodged:** Security for costs is usually lodged at the very beginning of the arbitral proceedings. In this respect it does not help the other party to object to the jurisdiction of the arbitral tribunal as to the merits of the case: an arbitral tribunal may, as a rule, award costs even if it ultimately determines that it has no jurisdiction over the subject-matter of the dispute.

3.7 **Enforcement of an order for security for costs:** Arbitral tribunals lack the coercive powers to order compliance with an order for security of costs – same as they lack such powers in general. If the claimant does not voluntarily comply with the order for security for costs, it may be a possibility to request a state court's assistance in the enforcement of the order, subject to the national laws at the place where such enforcement is to take place providing for this possibility. This may, of course, undermine to a certain extent the very reasons the parties chose to arbitrate instead of litigate in the first place. In any event, the party requesting the security is usually better served with the consequences of non-compliance than with enforcement of the order.

3.8 **Consequences of non-compliance:** The effectiveness of an order for security of costs lies in the consequences of non-compliance: If the party against whom the order is directed fails to comply with such order, the arbitral tribunal may order the suspension and ultimately order the termination of the arbitration proceedings in connection with the claim for which security has been ordered. However, the arbitral tribunal in general cannot ren-

der a default award based on the non-compliance unless they have expressly been empowered to do so.[8] Consequently, non-compliance with an order for security for costs, in principle, entails the dismissal of the claim by the arbitral tribunal **without prejudice**. The careful applicant will request that the arbitral tribunal's order shall explicitly contain the warning that non-compliance with the order entails such dismissal.

4. Dos and Don'ts

Based on the above, the following Dos and Don'ts, when considering the potential filing of a request for security for costs, will greatly increase your chances to obtain it:

4.1 Don'ts

- «Surprise» the arbitral tribunal with a request for security for costs;
- Withhold arguments;
- Expect the arbitral tribunal to make the work for you;
- Submit a lengthy request.
- Don't play dirty games during the contractual relationship: If you are the very reason for the financial distress of the other party, this might decrease your chances of getting security for costs;

4.2 Dos

4.2.1 When drafting the contract/arbitration agreement:

- Choose a seat country for the arbitration and arbitral rules which do allow for security for costs or at least interim measures to be ordered by the arbitral tribunal;
- Check the financials of your contractual partner, including a copy of its financial statement. Keep it.

4.2.2 During the contractual relationship:

- Document yourself and gather evidence, as you might not have too much time once you need to file a request for security for costs;

4.2.3 At the start of the arbitral proceedings:

- Include the possibility of a request for security for costs into your case strategy, e.g. with the goal to get the (counter-) claim thrown out;
- Address and prepare the issue early with the arbitral tribunal, so that your request will be treated before you incur too many costs;
- Pay the advance on arbitration costs promptly;

[8] See for example Art. 25(2) LCIA Rules.

4.2.4 In your request for security for costs

- Argue (i) fumus boni iuris, (ii) pericumul in mora and (iii) good faith;
- Fumus boni iuris is not the merits of the case, but of your claim for costs should you successfully defend yourself against the (counter-) claim;
- The burden of proof is on the applicant: don't just simply allege that there is a risk of non-recovery, but prove it to the best of your abilities;
- Ask for the funding agreement or at least an excerpt as to the funder's duty to cover an adverse cost award;
- Frontload and anticipate possible counterarguments: you might only have one shot;
- Be explicit on what you want the tribunal to order (type of security, amount, consequences of non-compliance);
- Attach the bank guarantee you want;
- Ask for security from the very beginning of the arbitration;
- Make it as easy and simple as possible for the arbitral tribunal to order the security for costs you request.

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