Chapter 1

A financing is a financing is a financing...

Dr Georges Affaki[1]

INTRODUCTION

Third-party financing of litigation or arbitration tends to be lauded or vilified depending on which party to the dispute is asked for its opinion. It has allowed victims of obvious wrongdoings to bring their cases to justice notwithstanding the resistance of much more powerful respondents or the cost of international proceedings. In some instances, external financing of its claim has been the only way for a party with limited financial means to obtain vindication and avoid a denial of justice.[1] At the other end of the spectrum, a number of aggressive financiers have pushed vexatiously to bring cases to the court based not on their merit but rather to create a disruption so as to extract settlement. Reports have emerged of attempts to manipulate the connecting factors of a case with a view to creating a link between the claim and a country signatory of an investment protection treaty, without which the claim would not be admissible under the umbrella clause of the treaty.

Very few of the numerous reports, learned articles or conferences on the subject are exempt from an expression of the strong feelings that the topic conjures. The 32nd Annual Meeting of the ICC Institute of World Business Law, which was dedicated to *Third-Party Funding in International Arbitration*, was no exception. Where the conference organizers innovated was in their decision to schedule a panel on third-party financing of claims as a business, with the task of unveiling the economic fundamentals of investment in claims and the associated risks. I had the privilege of chairing that panel which also featured two pioneers of the claim-financing business: Selvyn Seidel (Fulbrook Management) and Timothy D. Scrantom (Blackrobe Capital Partners). Both are true entrepreneurs in the tradition of Carnegie and Hammer, risking not once but repeatedly their successful careers as litigators in international law firms in order to set up new claim-financing businesses.

From our very first pre-conference meeting, the parallel with asset finance in corporate banking became obvious. In terms of risk taking, financing oil reserves, pre-delivery ships or satellites involves substantially similar rules to those of claim financing. Yet, unlike asset finance, claim financing still carries a halo of mystery. This could be because the industry has (so far) escaped any form of regulation and has carefully cultivated a culture of secrecy, which, in fairness, is not substantially different from the one that characterizes many an arbitral proceeding.

1 Vice-Chair, ICC Banking Commission; Council member, Institute of World Business Law.

With its title parodying Gertrude Stein's famous statement of the law of identity,[2] this article presents the third-party financing of claims for what it really is: a financing business, with its own rules, risks and limits.

1 THIRD-PARTY FINANCING OF CLAIMS IS A … FINANCING

Funds operating in the claim-financing business do not follow a unique business model. Some funds invest their own capital in financing the claim, seeking in return a negotiated share in any recovery. Their investment might also take the form of an equity stake in a special purpose vehicle (SPV) that will bring the claim before the court. Alternatively, a fund could lend the necessary finance to the claimant on a non-recourse basis,[3] possibly against collateral.[4] Other funds offer advisory or brokerage services in evaluating the claim and raising finance in the market to fund the proceedings but do not themselves provide finance. In all situations, funds offer much more in terms of bundled claim management services than the mere supply of money and, consequently, are not in direct competition with banks in the lending business.

Setting aside the case of vulture funds, which tend to purchase claims for a fraction of their nominal value, replace the claimants and litigate in their own names,[5] third-party claim finance consists of funding the claimant,[6] with the financier remaining a non-party to the proceeding. That said, the financier will usually be actively involved in strategic decisions concerning the claim, such as the selection of counsel, arbitrators and experts and any settlement prospects.

To yield the staggering returns that the claim finance sector has been witnessing recently (an average of 17%, with highs of 25%, compared to traditional bank asset finance returns of up to 4%), the claim selection and management process need to be rigorous. The rare industry statistics available show only a small proportion of bankable claims ultimately finding a third-party financier.

How does a specialist fund transform the probability of a favorable award into a fundable asset? This question has puzzled many observers. Yet it is but a matter of elementary credit risk calculation and, as such, the daily routine of banks engaged in asset finance. Take the case of reserve-based lending, for example. Like claim financing, it requires an extensive probabilistic approach: what is the quantity of future petroleum production that could possibly be extracted over the next three to seven years from hydrocarbon reserves? When calculating the lending ratio, each category of reserves (already produced, proven, likely or possible) is ascribed a different coefficient according to the probability of recovery. Reserve-based lending leverages the competencies of energy bankers, petroleum engineers and trade finance specialists with experience of the political environment of the countries where the assets are situated. Before any loan commitment is made, a detailed due diligence analysis is performed, which combines:

- a technical evaluation covering geology, petrophysics, an independent reservoir audit and the production history of the particular reservoir;
- a legal evaluation covering the licence, ownership, tax and the contractual framework for supply and offtake;

- a financial evaluation covering the production and operation costs, tax and cash-flow profiling; and
- a managerial evaluation assessing the competencies and strategy of the borrower or sponsor.

Mass financing is also a factor to be weighed. A bank may finance a portfolio of oil reserves where probability spreads from 50% to 90%, whereas, in the case of single reserve financing, a reserve with less than 90% probability is unlikely to be considered as bankable.

Almost all the above-mentioned criteria are mirrored in the methodology followed in claim financing. Each claim is carefully vetted by specialist litigators, financiers and corporate management consultants and allocated a coefficient as to its probability of yielding a favourable award at each stage of the proceedings. The coefficient will determine the amount that a fund is willing to invest in the claim and the terms of that investment as regards pricing and duration.[7] Chances of success need to be at least 60%. No standard litigation funding fee is reported across the market, and funders indicated that each agreement has different terms.[8] This contrasts with the more standardized – arguably because it is more mature – bank asset lending market.

Similar to asset finance, third-party financing of claims often involves taking security over collateral[9] and one or more forms of hedging, such as purchasing commodity price collars, forex or interest swaps. Special insurances can also be purchased. Risks may then be spread among several investors by selling participations in the financing to investors in a very similar way to loan syndication by banks. Larger funds with significant portfolios could potentially also consider bond issuances and securitizations.

2 RULES OF GOVERNANCE FOR THIRD-PARTY FINANCING

The second part of this paper will steer clear of the debate on the legitimacy or morality of third-party financing of claims, as many writers have already expressed their particular views on these issues. Instead, it will discuss the potential responsibility of third-party financiers in situations where they have failed to comply with applicable rules and crossed a red line, triggering legal liability. Such situations could arise out of funding claims that relate to a regulated activity or involve parties that are public companies with listed shares but fail to comply with public disclosure duties. The flouting of such rules could trigger a regulatory backlash and the demise of the whole industry as it is today. Indeed, it is difficult to imagine the industry surviving an investment bank-like statutory regulation of the magnitude and severity that we have seen in the wake of the financial crisis of 2008, that would impose capital adequacy, governance rules, mandatory registration with market authorities, data protection and disclosure requirements on claim funders.

The case of *Oxus Gold* illustrates this point.[10] It involved a public company, Oxus Gold, a gold mining enterprise in the Amantaytau Goldfields in Uzbekistan. Towards the end of 2011, the company's Uzbek state-owned partners indicated their intention to purchase Oxus's stake in the business. In the absence of agreement on the sale price, they

proceeded to audit its value. A number of disagreements during the valuation process led Oxus Gold to suspend the negotiations and file an arbitration claim against Uzbekistan for expropriation.

In March 2012, Calunius Capital funded $400m of Oxus's claim. The funding became known and the media reported that "the funding gave Oxus enough financial backing to pursue its case with increased optimism". In the few months that followed this report, Oxus's share price jumped 200% and became the London Stock Exchange International Market's top-performing stock.

Situations like that inevitably give rise to disturbing questions. Whether they are bondholders, shareholders or otherwise, did all the investors get fair, transparent and equal access to all relevant data at the same time? Could Calunius Capital and the management of Oxus Gold be accused of manipulation of pricing, market abuse or securities fraud? Did all the investors in Calunius Capital realize that their investment carried with it this type of risk?

The recommendations in the Jackson Review[11] are far from the stringent regulation that applies to other finance providers such as conventional banks. Until any meaningful regulation of third-party finance of claims is implemented, if ever, the industry would be well advised to abide by strict governance rules. Avoiding conflicts of interest is key: the party making the decision as to the litigation of the claim should not be the third-party financier. Counsel should likewise be different from the financier and owe its fiduciary duties to the claimant or the defendant to the proceedings, even if counsel has been selected and paid by the financier. This is not to say that claimant's counsel is not entitled to act on a contingent fee basis, thus aligning its interest with that of the claim financier. Of course, this leaves open the question whether communications between counsel and the financier are protected by the legal privilege that attaches to attorney-client correspondence. Questions of this type are likely to be resolved on a case-by-case basis according to the tribunal's interpretation of the applicable procedural law.

Keeping the person and role of the claim financier separate from that of the claimant was noted in the majority decision in *Teinver*.[12] In that case, Argentina argued that, rather than the claimants, the third-party financier was in fact the real claimant because it was the only party to benefit from a favourable award. As such, it should not be considered as satisfying the jurisdictional requirement of the Spain-Argentina investment treaty. The majority decision dismissed this argument on the basis that the funding agreement was entered into after the date of filing of the claim.

CONCLUSION

Substantial time and effort have been spent, including by this author, in bringing together arbitration and finance. After many years of reciprocal wariness, the two worlds are starting to communicate and interact both through setting up bipartisan working groups and by gradually opening up to each other. This paper argues that the arbitration-finance relationship can also be viewed from a different angle. This time, it is about how finance can serve arbitration. Open dialogue without pre-conception is important, and self-imposed safeguards are key.

Ten years ago, hedge funds were the subject of a heated debate about the unfair competition that they pose to conventional banking. They still do. Five years ago, similar criticism was voiced against sovereign wealth funds, which were considered to be a rampant invasion of our national economies. However, when the 2008 financial crisis brought about a credit crunch, everyone turned to those funds for much-needed liquidity to keep the market afloat. Could third-party financing of claims likewise be a solution that better serves justice?

ENDNOTES

1 *Bernardus Henricus Funnekotter et al. v. Republic of Zimbabwe*, ICSID case no. ARB/05/6 (allegedly expropriated farmers funded by a charity) and *Philip Morris et al. v. Uruguay*, ICSID case no. ARB/10/7 (a US charity combating teenage smoking financing Uruguay in its defence against an alleged expropriation claim filed by Philip Morris).

2 The sentence "Rose is a rose is a rose is a rose." was written by Gertrude Stein as part of the 1913 poem *Sacred Emily*, which appeared in her book *Geography and Plays* (1922).

3 Like in the banking business, non-recourse could turn into full recourse if the borrower breaches any of its representations and warranties. This is usually carefully drafted in the financing agreement. For an example, see *S&T Oil Equipment and Machinery Ltd et al. v. Juridica Investments Ltd et al.*, Civil Action No. H-11-0542, cited by B. Cremades, Jr., 'Third-Party Litigation Funding: Investing in Arbitration', paper presented at the 2012 ICC conference on Third-Party Funding in International Arbitration, conference folder, p. 28.

4 In *S&T Oil Equipment and Machinery Ltd v. Romania*, ICSID case no. ARB/07/13, Juridica, a claim funder, obtained a security interest over the funded claimant's assets, including its rights in a Romanian joint stock company and an assignment of a percentage of any recoveries from claims filed by the claimant against the defendant before jurisdictions other than the one where the funded claim was filed. See Cremades, *supra* note 3, at p. 27, note 103.

5 G. Affaki, 'The *pari passu* Redux', in R. Lastra, ed., *Sovereign Debt Management* (Oxford University Press, 2013).

6 Cases involving third-party financing of respondents are more rare but still conceivable and bankable. For instance, in a case involving a patent litigation, the third-party financier could conceivably agree with the respondent to fund the defence in return for a percentage of the cash flow that the product will yield if the defence succeeds and the defendant is able to market the product. A rare case of third-party financing of a defendant state is Philip Morris v. Uruguay, ICSID case no. ARB/10/7.

7 There can be situations where protracted proceedings require more funding than was originally planned without enhancing the probability of recovery. In such situations, rigorously-managed funds could be prompted either to accept a less favourable settlement or to write off their investment.

8 C. Hodges et al., 'Litigation Funding: Status and Issues', CSIS and University of Lincoln (January 2012), p. 68.

9 See *supra* note 4 for an example.

10 S. Seidel, 'The right to know', *Intercontinental Finance* 109(12) (April 2012), p. 18.

11 R. Jackson, *Review of Civil Litigation Costs: Final Report* (The Stationery Office, 2010).

12 *Teinver S.A. and Others v. Argentine Republic*, ICSID case no. ARB/09/1.