DOSSIERS
ICC Institute of World Business Law

Third-party Funding in International Arbitration

ICC INTERNATIONAL CHAMBER OF COMMERCE

Edited by
Bernardo M. Cremades,
Antonias Dimolitsa

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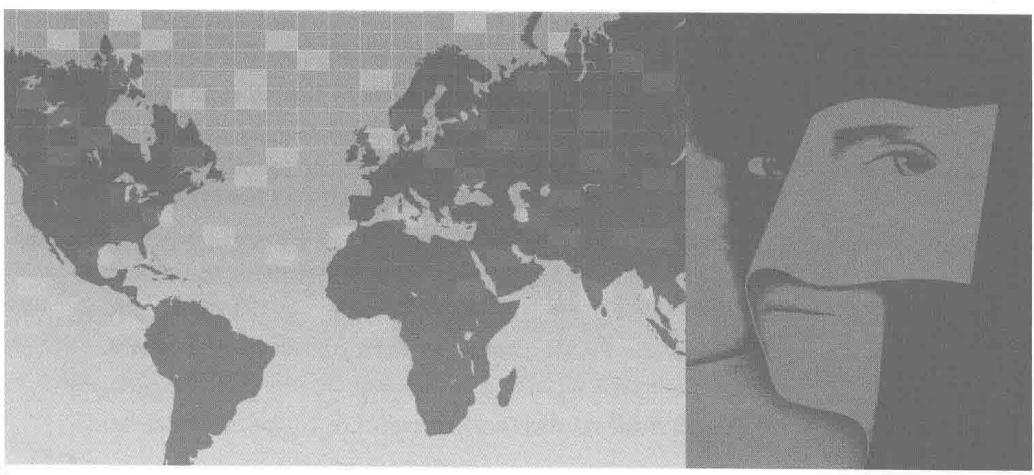

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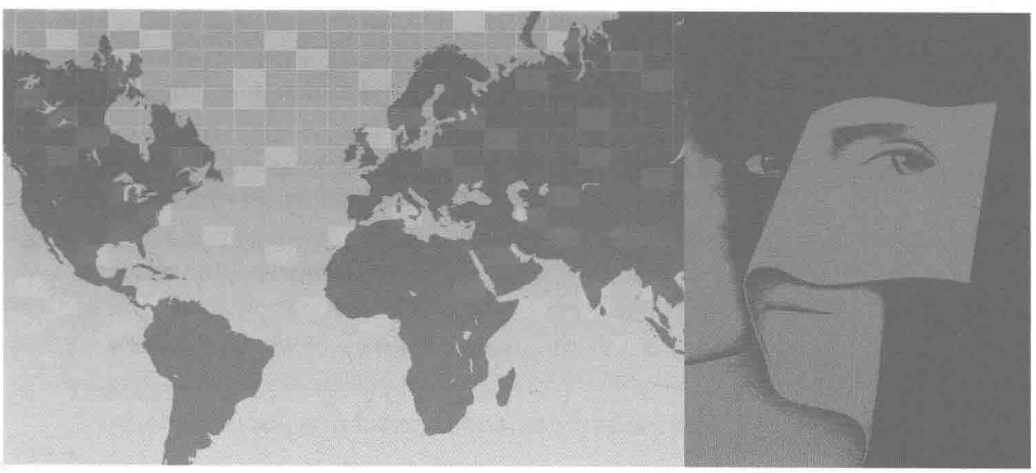

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Foreword

Yves Derains

That there is no such thing as a free lunch remains a debatable statement. But that there is no such thing as a free arbitration is not. The issue is not whether or not arbitration is more expensive that litigation, in particular in the light of the success of the Report on Techniques for Controlling Time and Costs in ICC Arbitration.* The respective costs of litigation and arbitration depend mainly on the characteristics of the legal system of each country, on the complexity of each case as well as the possibilities of recourses existing in each jurisdiction. The issue is that, as a form of private justice, arbitration is meant to be exclusively financed by the parties. This does not apply to litigation. As access to justice is a constitutional right throughout the world, ways and means have been devised in order that this right might be exercised in national courts. They are not always very efficient but at least the concern is universally shared. On the contrary, an impecunious party to an arbitration agreement may be *de facto* deprived of the right of access to justice when it is unable to sustain the costs of the arbitration procedure. In the *Pirelli* case, for example, the Paris Court of Appeals in November 2011 set aside an ICC award because of the arbitral tribunal's refusal to deal with counterclaims due to the respondent's failure to pay the special deposit applicable to them, on the grounds that this was at odds with the right of access to justice and the principle of equality among the parties. The French Cour de Cassation annulled this decision in March 2013,† but only because the Court of Appeals had not checked whether the counterclaims were really intertwined with the claimants' claims, admitting that – if such had been the case – the right of access to justice and the principle of equality would actually have been breached. Thus, the tension between the need to finance arbitral proceedings and access to justice is not an abstract issue.

Third-party funding of arbitration offers a solution to this irritating problem. It is a scheme where a party unconnected to a claim finances all or part of one of the parties' arbitration costs, in most cases the claimant. The funder is remunerated by an agreed percentage of the proceeds of the award, a success fee, a combination of the two or through more sophisticated devices. In the case of an unfavourable award, the funder's investment is lost. Such arrangements, said to originate from Australia where they appeared in the 1990s, are made with specialized finance corporations that have their biggest markets in the UK and the US. However, since 2010, they are operating worldwide, both in common law and civil law countries.

Situations where a claimant is not personally financing its claim are not unheard of. It happens when an insurer has already compensated a party for its damages (or a substantial part thereof) on the condition that the party files an arbitration claim against the author of the damage. Likewise, a claimant is not financing its case when its counsel is working on a contingency fee basis. However, beyond the fact that the claimant is not personally financing its claim, such situations have very little in common with third-party funding. The insurer is financing a claim in order to recover the money it has paid out. The attorney working on a contingency fee basis is primarily financing his or her representation activities, before receiving a success fee. Third-party funding is an investment per se in arbitration by a corporation specialized in this business. It should come as no surprise that, as any new novelty, third-party funding has been and remains controversial. In common law countries, medieval concepts such as maintenance and champerty were even referred to, although, in modern times, their only function is to protect uneducated persons ignorant of the availability

* ICC publication no. 861E.

† Cass. Civ. 1er, March 28, 2013, n° 392 (11-27.770).

of legal aid, which, as mentioned above, does not exist in arbitration! In civil law countries, the old principle *nul ne plaide par procureur*, which requires anyone acting as a plaintiff or defendant in a lawsuit to make his identity known individually in the legal proceedings, was opposed to third-party funding, although it hardly seems applicable in the circumstances, as the funder is not acting in the arbitration. It does not buy the claim, it finances it. The suggestion that third-party funding might encourage frivolous claims was also made, without considering that no serious corporation would finance a claim without being convinced through due diligence that it has a good chance of success.

All this merits little concern given that there is no doubt that third-party funding allows easier access to arbitration for impecunious claimants with meritorious claims, and, as such, represents progress. Yet, one must not ignore the difficulties generated by the involvement of a funder in arbitration, due to the specificity of arbitration proceedings. Third-party funding raises ethical issues relating to the level of independence of counsel in the control of the proceedings and in particular in the choice of the arbitrator. Can an arbitrator act in a case where the claimant is financed by the same third-party funder who is also financing a different claimant in another case in which a partner of the law firm of the arbitrator is acting as that claimant's counsel? As long as the intervention of the third-part funder is not disclosed, the matter may raise serious concerns.

This is only one of the many sensitive issues that were discussed by advocates, arbitrators, experts, scholars and, above all, representatives from some major third-party funding corporations at the 32nd Annual Meeting of the ICC Institute of World Business Law on November 26, 2012. The programme, prepared with efficiency, diplomacy and great intelligence by Antonias Dimolitsa, Vice-Chair of the Institute, and Bernardo Cremades, one of the very active members of its Council, is at the origin of this Xth Dossier of the Institute. There is no doubt that it will be a masterpiece in the collection.

Yves Derains

Introduction

Antonias Dimolitsa*

The rise of third-party funding in international arbitration is a reality, and has been the subject of many conferences, articles and roundtables over the past four years. Recently, entire books have even been published on this subject. A significant number of parties in international arbitrations, whether or not in financial distress, are today financed by professional funders, and the demand for such funding apparently outstrips the supply. These parties – mostly claimants but also respondents – originate not only from Australia, Canada, the United States and the United Kingdom but also from civil law countries. A lot of issues, however, with tangible hazards regarding both the functioning of this new funding industry and its impact on the arbitral process remain open and are even growing. On the one hand, reluctance and criticism still exist, even in fora like the US Chamber of Commerce; on the other hand, case law is evolving towards acceptance of third-party funding and is beginning to resolve some salient issues in this field. The ICC Institute of World Business Law, with its think-tank role, could obviously not ignore this overwhelming development in business law and international arbitration.

We organized the 32nd Annual Meeting of the Institute with a view, first of all, to achieving a better understanding of the reasons for the expansion of this funding industry by distantiating it from its origins, comparing it to other funding mechanisms and, in particular, examining its special features as an investment process. All these issues were covered during the morning sessions, where the focus was on the funding industry and its specificities and the underlying aim was to reconsider any legitimate doubts that we might have in this respect. Second, during the afternoon sessions, the aim was to explore the status of third-party funders and the possible complications that their presence may bring about in the arbitration process from the point of view of both counsel and the arbitral tribunal. Third-party funder's involvement in the post-arbitral phase was also discussed. In addition, special attention was given to investor-state arbitration, and several much discussed precedents were considered. The focus was the impact of third-party funding on arbitration, and the underlying concern was the preservation of the integrity of the arbitration process.

The present volume of the Dossiers includes the contributions of most of the speakers at the Annual Meeting. On the subject of the third-party funding industry *per se*, **Georges Affaki** explains its characteristics as a financing business, including its rules, risks and limits, and discusses some rules of governance, posing various questions as a consequence of the *Oxus Gold* case. In a comprehensive overview of third-party funding as a financing industry, **Selvyn Seidel**, initially focuses on the distinct features of third-party funding in relation to international arbitration and urges on developing a record of experience, rules, regulations and guidelines. In a proposed way forward, he also identifies several issues that require early attention. Next, he analyzes the particularities of the investment decision based on the asset class (*i.e.* arbitration claims) and highlights the skills that decision-makers must have, or have available, in order to overcome its "daunting" character. In a new additional paper closely pertaining to the subjects dealt with during the morning sessions, **Selvyn Seidel** and **Sandra Sherman**, also bearing in mind the *Oxus Gold* case, stress the necessity of governance rules for the third-party funding industry in reply to concerns at two levels: first, the need to prevent and/or reduce the risk of illegal conduct by funders; and, second, the need of the funder to assure itself that the claimant has taken proper precautions against illegal activity. They conclude by proposing some rules or guidelines for consideration.

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Christopher P. Bogart's aim is to illuminate the advantages that arbitration finance brings to companies and their lawyers by stressing the fact that it allows access to justice, especially in investor-state arbitration, and levels the playing field. He also examines some key issues that preoccupy arbitration practitioners, such as disclosure and the impact of third-party funding on settlement and adverse costs; and he discusses the different forms that third-party funding may take. **Mark Kantor** departs from third-party funding that focuses on claimants and deals with risk-management tools for respondents, specifically two insurance products: "after-the-event" (ATE) insurance for legal costs and "outcome hedging", "caps" or "litigation buyout" insurance (LBI) to create a stop-loss liability (outcomes policies).

Turning to issues that arise as a consequence of the existence of third-party funders in the arbitration process, three contributions deal with such issues in general, while three others deal with them with respect to investment arbitrations.

Charles Kaplan deals with these issues from the counsel's perspective. Counsel may him/herself be a third-party funder, in which case the possibility of the prohibition of contingency fee arrangements in comparative law arises. At the present time, however, the key issues for international arbitration practice concern the relationship counsel/client/professional funder, both during the due diligence process (in view of the conclusion of the funding agreement) and during the arbitration proceedings. The obligation of attorneys to act in the interests of their clients and take instructions only from them certainly applies but may be somewhat nuanced in the presence of a third-party funder. In addition, confidentiality as an obligation towards the client during the due diligence process, as well as professional and ethical obligations towards the arbitral tribunal during the proceedings with regard to disclosure of the presence of a third-party funder may well become problematic.

Disclosure of the existence of a third-party funder is certainly a central and much debated issue. **Laurent Lévy** and **Régis Bonnan** examine the issue from the arbitral tribunal's perspective and show that there is no specific obligation of the funded party to disclose this existence as such; however, other circumstances may sometimes require such disclosure. On the other hand, in the event that the tribunal knows about the existence of a third-party funder, it is improbable that the latter will meet the conditions for being joined to the proceedings as a party. The effect that the third-party funder may have on the admissibility of the claim and the arbitral proceedings triggers a discussion of different legal concepts and procedural mechanisms but does not seem to be of real or specific importance in actual practice. Focusing on disclosure and expressing a somewhat differing opinion, **Maxi Scherer** circumscribes the rationale for a possible obligation to disclose the funding agreement to the assessment of the necessity of ordering security for costs and the avoidance of conflicts of interest. Questions regarding the scope of such an obligation and its modalities do, however, arise, taking into account, *inter alia*, the imprecision of the definition of "third-party funding agreements" and the reluctance of professional funders to disclose the exact terms of funding agreements.

Due to transparency under its different forms, the involvement of third-party funding in investment arbitrations arguably seems most important. Three articles focus on investment arbitration. In their introduction to and overview of the topic, covering issues regarding the implications of third-party funding that are specific to investment arbitration as well as general issues applying to all types of arbitrations, **Carolyn B. Lamm** and **Eckhard R. Hellbeck** also consider potential concerns that a state may have in making use of third-party funding. Contrary, however, to the existing few examples of states making use of third-party funding and notwithstanding such concerns, information exists that the funding industry appears to discern a "clear demand" for respondent funding in investor-state arbitration. **Angelynn Meya** concentrates on the investment arbitration decisions that have assessed the role of a third-party funder from two angles: jurisdictional challenges (questions of standing with regard to the nationality requirement of a BIT or the ICSID Convention and with regard to the real party in interest) and costs and security for costs. Her conclusion is that investment tribunals seem to prefer to ignore the implication of third-party funding. **Antonio Crivellaro** lists and analyzes all publicly known investment arbitrations that involved third-party funding. This paper constitutes an important overview of the subject. He observes that in most cases

such involvement did not give rise to procedural or substantive obstacles and that international tribunals are generally well disposed towards third-party funding in investment arbitration. In his opinion, disclosure should be mandatory in investment arbitration, in view of the protection of the state and the guarantee of due process. Moreover, he claims that third-party funding should be regulated by a soft-law type of instrument that the parties or tribunals might voluntarily adopt as binding in each individual case.

It appears that there is no clear-cut conclusion to be drawn from the contributions to the ICC Institute of World Business Law's 32nd Annual Meeting. The third-party funding industry continues to be very secretive, and funders are reluctant to disclose, if not their very presence behind an arbitration, then at least the funding agreements they have concluded. Conversely, counsel and arbitrators seem to be in favour of disclosure, yet not as a general, absolute rule. In addition, no consensus exists at all on the need for regulation of third-party funding, and those who are in favour of an international regulation, for example through soft-law instruments such as codes of conduct or guidelines, run up against the issue of enforceability.

In any event, the aim of the Annual Meeting was to consolidate the knowledge in this area in order to better deal with the growing phenomenon of third-party funding in our professional activities, without exaggerating the problems and risks it may generate during this period of unregulated yet overwhelming development. We are left with the impression that the general understanding emerging from this meeting of third-party funding pioneers and experienced arbitration practitioners is that our common interest lies in the direction of a serene coexistence that facilitates the rendering of justice and does not affect the integrity of the arbitration process.

Chapter 1

A financing is a financing is a financing...

Dr Georges Affaki*

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 to bring vexatious cases to the courts 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 the fruits of their successful careers as litigators in international law firms in order to set up new ventures in the claim-financing business.

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.

* 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.