DAWN OF A NEW LEGAL SPECIALISM

FINANCIAL INVESTMENT IN ARBITRATION

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As parties become increasingly reliant on third-party funders and other investors to finance their arbitrations, **Peter Griffin**, **Pierre Pic**, **Raphaël Kaminsky** and **Aurélie Huet** say practitioners will have to get used to seeing themselves as participants in a financial industry, which in turn requires a specialist legal community

Thirty years ago, the notion of international arbitration as a darling of Wall Street would have been met with derision. Times have changed, however, and investors are lining up to make financial bets on arbitration proceedings. These investors have discovered that arbitration can offer the elixir of "uncorrelated returns" – big cash returns that are not dependent upon the state of the financial markets.

While collecting on a big arbitral award makes investors look good in any market, the current state of the financial markets makes it particularly attractive. This is in part because the traditional bond markets offer historically low returns and because the stock markets are seen to be close to a cyclical peak. Whatever the reason, market participants have consistently expressed the view that the level of financial investment in international arbitration has never been higher than over the past 12-18 months.

One of the consequences of this growth is that the contracts pursuant to which these investments are made have become increasingly complicated.

There are many reasons for this. As investors become more sophisticated and mature, the contractual arrangements they insist upon become more complex. The amounts invested are also growing, giving rise to more comprehensive contracts. Many investors are clubbing together to invest, which raises its own difficulties. Finally, we are beginning to see cases with different kinds of overlapping financial investments, which requires even more elaborate contractual arrangements.

Here, however, is where we are confronted by a paradox. Although transactions are growing in complexity, few law firms offer specialist advice on this growing area. You will not find any firm that has a department that is dedicated to investments in litigation or arbitration.

There are probably several reasons why this has not yet emerged as a discrete practice area. Litigation funds (who are very active in this area) have little incentive to see law firms appear opposite them as they negotiate their deals. Up until now, funders have been able to dictate their terms, with the party seeking funding unlikely to push back hard for fear of losing its investor.

To compound matters, many parties seek investors in their litigation or arbitration because they cannot afford their own lawyers. It is therefore unlikely that they can afford lawyers to negotiate their deals with third-party funders.

It may, however, be time for all this to change. There is a strong and growing demand for the legal expertise to put these deals together. Indeed, the more professionally a deal is documented, the better it is for the funder and claimant alike. We therefore suggest that there is a new legal specialism – the law of financial investment in international arbitration – that must emerge to satisfy this demand.

A who's who guide to investors

One of the peculiarities of the increase in financial investment in international arbitration is that the investors are drawn from several different categories. As a result, the way these investors make their bets on arbitration varies a great deal. This is relevant because it will indicate what kind of skill sets may be required in this new area of the law.

So who are these investors?

First, there are the litigation funds, almost all of whom have invested extensively in international arbitrations. The classic litigation fund investment takes the form of the fund paying all fees associated with the arbitration in return for a favourable return on their investment. As these litigation funds have grown and raised additional capital, the kinds of investments they target have multiplied and now includes more substantial investments than previously was the case. One example is the complicated "equity release" deal where the funds will advance money for general corporate purposes that is secured by an interest in the company's arbitration claim. Some litigation funders will even consider purchasing all or part of an arbitral award – something that was anathema a few short years ago.

Second, there are larger funds that do not invest directly in litigation but in litigation funds. While they are removed from the underlying litigations, these funds are very close to the litigation funders and always available to look at co-investment opportunities with them. It is therefore no longer possible to look at a litigation fund's committed capital and extrapolate from that how many investments it can make and how large those investments can be. If a litigation fund has one of these enormous funds among its investor base, there is probably no limit to the size or complexity of investment it can look at. We believe that the availability of this amount of capital will have a profound effect on the arbitration sector over time.

There are, however, even more players in this game. Chief among them are the hedge funds – often very discreet – who have the ability to invest very large amounts of money very quickly in the right kind of arbitration play. Their investments range from investing in companies who are party to international arbitrations and whose share price depends on the outcome of such arbitrations to investing in the debt of such companies. Hedge funds may also purchase arbitration awards outright or even invest in legal assets lying in law firm activity. While known for their discretion, there is growing anecdotal evidence that these investors are very present in the international arbitration space. Many have applied their complex modelling and quantitative skills to assess the value of arbitration claims and predict outcomes, and they tailor their investments accordingly.

Finally, there are the insurers who offer an increasingly sophisticated suite of products tailor-made for arbitration. The arbitration community needs to get used to the presence of different financial players in arbitrations of any significant size. All of them are jostling to get a piece of the international arbitration pie.

The background of the various investors in arbitration is significant because they often require some form of contractual mechanism that is prevalent in their particular industry and that requires a specific legal expertise.

Matching contracts to expertise

With such sophisticated investors hovering around, the nature of the arbitration investments they make have become increasingly complex. Contracts often involve a combination of mechanisms drawn from other contractual specialities that are then adapted to suit the specific requirements of an arbitration-related investment. The most common contractual mechanisms that are used are drawn from models including debt finance; secured lending; M&A; and private equity.

Of no less importance is the specific nature of the investment. In international arbitration-related funding, the investment will mainly lie in the pursuit of a pending claim or the enforcement of an arbitral award, which are subject to different applicable laws and bodies of rules. As a result, specialist arbitration knowledge and careful consideration of the interplay between the rules governing the investment contract and the rules applicable to the underlying procedure and the participants are also needed to negotiate arbitration investment contracts that are effective and that do not undermine the integrity of the underlying procedure on which any recovery is ultimately dependent.

Debt finance

For a variety of reasons, investments in international arbitrations are often structured as loans. This is obviously the case for third-party funding agreements. However, even where an investor is acquiring a part of a claim or a part of an arbitral award, the deal is often structured as a loan to afford maximum protection to the lender. Expertise in negotiating and drafting loan documentation is therefore very helpful when documenting investments in litigation or arbitration.

Secured lending

Often the most challenging part of a deal is to devise a security package that will give the investor sufficient comfort that its investment is secure and that any proceeds will flow back to it. This concern is heightened because many arbitration-related investments are made in companies that are incorporated in the emerging markets which, for one reason or another, are exposed.

For example, some arbitration claimants are at risk of expropriation or other unlawful state action simply by bringing a claim against their host state. The challenge under such circumstances is to ensure that the investor has a secured interest in an asset that will not be expropriated or liquidated, depriving the investor of its expected profit.

There are other risks, such as where the claimant seeks to deprive the investor of some or all of its proceeds once it has procured funding and won the arbitration. For all of these reasons, it is essential that investments into international arbitration be properly secured.

The good news is that the skills already exist to satisfy this demand. Many firms have a banking or secured finance department or an international financial group that can advise on how to secure revenue streams and cash flows coming from "difficult" jurisdictions. It only takes a modest amount of reengineering to adapt these models to suit investment in litigation or arbitration.

Mergers & acquisitions

Strange as it may seem, many arbitration investment agreements also resemble M&A transactions. This is most obvious where the investor is purchasing either a claim or an arbitral award. In these scenarios, the parties will typically follow an M&A-type process, with a due diligence phase, followed by a negotiated term sheet, and then an agreement that will look much like a typical sale and purchase agreement. This is even more marked in investor-state cases where an investor will seek to preserve jurisdiction by not only purchasing the claim or award, but also the company that brought the claim in the first place.

Private equity transactions

Broadly, the term "private equity" refers to the many different (and creative) contractual mechanisms whereby investors inject capital and then share investment returns with the company that they invest in. In a typical private equity deal, for example, there are often complicated mechanisms referred to as "waterfalls" that govern which investor gets how much of what return, as well as when they get it.

Investment in arbitration is no different. Often, for example, if a fund purchases part of a claim, but the original owners remain invested in the claim, the fund will recover an agreed preferred return, and then the two groups will share any remaining returns according to an agreed proportion, which may change according to an agreed formula as the recovery gets higher. Once again, while mechanisms of this kind may be unfamiliar to a litigator, they will be very familiar to a specialist lawyer working in private equity or venture capital.

Insurance

One of the most significant developments in the world of international arbitration against states over the past year or two has been the emergence of sovereign arbitration default insurance, which will pay out if an award rendered against a sovereign is not paid within a brief agreed time period. Here, again, the matter can get complicated very quickly. Such insurance policies are not standard. All of them are negotiated directly with insurance syndicates and they are bespoke. As a result, an understanding of insurance law will be of great assistance in assisting clients to put together the right insurance deal for them.

The parties who procure insurance coverage of this kind will also be keen to ensure that the insurable interest is not subject to expropriation or confiscation. This may necessitate an additional degree of complexity in the deal documentation as well.

Litigation and arbitration expertise

Amid this discussion of corporate law, it is essential to bear in mind that the "asset" that investors are investing in is an arbitration claim or award. A specialist understanding of international arbitration is essential to understand the "asset" and how the investment may perform.

This starts with knowledge of the relevant procedure and timing. More importantly, an investor will want to assess the chances of success, which may involve extensive due diligence on the arbitrators, and the various experts (particularly the financial experts) and the nature of the damages claimed. The investors will also need to understand what the likelihood is that any award will be contested, as well as the enforcement opportunities.

This emerging area of the law therefore draws on both corporate and litigation/arbitration skills, almost in equal measure. A simple example illustrates this complexity:

Company A seeks funding for an arbitration against Country B. Company A may approach Funder C who will conduct due diligence and seek the advice of specialists in international treaty arbitration.

If Funder C is happy to invest, it will instruct corporate lawyers to document its investment and secure its interest in the outcome of the arbitration somehow. If they elect to structure the deal as a loan, the loan documentation will probably include some form of security package. That security package may cover Company A and its shareholders, but it may also cover Company A's local subsidiary in Country B, and any intermediate holding companies.

This will, in turn, raise issues about secured lending under Country B's law as well as the laws of each country where the intermediate holding companies are incorporated. There will also probably be taxation issues to address.

A further layer of complexity may be added if Hedge Fund D purchases Company A's shares or debt securities to gain an interest in the outcome of the arbitration. The competing interests of Company A, Funder C, Hedge Fund D, any lawyer representing Company A in the arbitration under some form of contingency agreement, and any existing creditors of Company A may have to be addressed in a contract to ensure that there is clarity about who is entitled to receive what and when.

Yet another layer of complication may be added if Company A procures sovereign arbitration default insurance, because the various interested parties will want to ensure that they participate appropriately in the proceeds of any insurance pay-out. Thus, it is readily apparent that the contractual architecture around these interconnected deals can become very complicated indeed.

The question that naturally arises is whether there is a need for an external, specialist counsel to advise on litigation funding agreements or whether firms can draw upon all of the expertise they already have in house when required.

Of course, there is nothing stopping firms from drawing together the requisite skills from their internal resources. However, this may not be the most efficient approach. As in many other areas of the law, there are certain efficiencies that can be gained from specialisation. There are many examples that suggest that litigation finance law will, over time, be either carved out as an independent practice group in the larger firms (similar to the development of environmental law), or become a niche area for specialist external firms (such as those that specialise in loan trading).

There are certain efficiencies that can be gained from specialisation

Types of challenges in arbitration investments

While no two investments are the same, there are some recurring issues that come up in many investments, some of which are identified below.

Is the investment lawful?

Notwithstanding the global wave of liberalism that has engulfed the world of investment generally, there is still some residual discomfort about investments in litigation and arbitration. Last month, in the 2017 case of *Persona Digital Telephony Ltd and another v The Minister for Public Enterprise and others*, the Irish Supreme Court held that a litigation funder could not fund a case in Ireland because it was contrary to the law on maintenance and champerty. This is the most recent in a line of cases in various courts throughout the world that have called into question the legitimacy of investing in litigation and arbitration plays. Back in the 1990s, this same issue preoccupied the New York courts for several years in connection with investors who were alleged to have bought claims against various Latin American states.

Maintenance and champerty and their potential interference on third-party funding mechanisms are uniquely common law issues. By contrast, "no provision in French law prohibits a party from resorting to a third party to finance international arbitration proceedings", as the Paris Bar Council recalled in its resolution on third-party funding in international arbitration, adopted on 21 February 2017. However, the civil law system also throws up comparable issues from time to time. One civil law example is the "*retrait litigieux*" as demonstrated by. article 1699 in the French Civil Code), which can limit the amount a purchaser can recover if it purchases a litigation claim.

Therefore, one of the first issues that any specialist counsel will have to determine is whether the contemplated investment is permitted under the governing law, as well as under the laws of the likely enforcement jurisdictions.

Are the parties' financial interests fully aligned?

Assuming that an investment can lawfully be made, investors are often keen to ensure that the financial interests of all parties are aligned all the way through to enforcement and collection. If the interests diverge at any point along the line, there is risk that the parties will fall into dispute and that the recovery of any returns will be disrupted. This guiding principle expresses itself in many ways throughout the investment process.

At the outset, investors are keen for the original owners of a claim to remain involved in the case so that they will be available to provide evidence, or testimony or other assistance. The best way to do this is often to ensure that the original owners of the claim have some financial interest in the outcome of the case, notwithstanding the investment made by the investor.

One key area of potential discord relates to the control of litigation strategy and settlement authority. At first blush, it appears obvious that an investor will expect to be able to control certain aspects of the litigation, given that it is paying the costs needed to pursue the case in the first place. But things are not always that simple. Rules of champerty and maintenance may well require an investor to relinquish control over the litigation. Even if not required, the original claimant may demand that its views be considered given that it is its case in the first place.

A second common area of friction regards the authority to settle. On the one hand, an investor will want to ensure that an opportunity to settle a case on attractive terms is not lost because a claimant suddenly gets greedy and wants more money. On the other hand, a claimant will want to ensure that a funder cannot force it to settle a case at a level where the funder makes its return but the claimant loses out.

There are contractual mechanisms that can be employed to reconcile these two divergent imperatives. Many of these mechanisms are borrowed from other areas of the law. For example, in the settlement scenario, the claimant can be given the power to veto settlements below a certain level or a put option requiring the investor to buy out its interest if the investor wishes to settle at certain specified levels. Also, the recourse to an independent assessor jointly appointed by the claimant and the investor and whose decision will be binding on the parties may be an additional contractual mechanism to resolve specific disagreements between the parties over matters pertaining to settlement decisions.

Is there a fair allocation of risk and recovery?

At the end of the day, the key issue in any arbitration investment will be one of risk allocation. This can manifest itself in many ways. When an investor invests in a claim, it is making a series of binary bets, any one of which can go against it and cause it to lose all of its investment – for example, a finding of no jurisdiction, failure on the merits, no damages or annulment.

An investor will expect to be richly rewarded for making those bets. But at some point, if the investment is successful, that risk will have been fully rewarded and a different distribution of the profits may be called for.

The contractual mechanism used to accomplish this is the concept of the preferred return, which is special, usually very generous, return that an investor makes on its at-risk capital (usually an agreed multiple of the money invested).

Once that preferred return is achieved, then the parties typically agree on a different distribution ratio that rewards the original claimant. Depending on the case, it is even possible to tailor that distribution ratio so that it changes as and when certain damages thresholds are met. In this case, either the original claimant or the financial investor could reap the lion's share of the damages at differing levels. The bottom line is to design a distribution waterfall that is properly negotiated and fair to all parties.

A new dawn

We are at the dawn of a new world in international arbitration, one where we will encounter many different kinds of financial investors. Arbitration practitioners will have to get used to seeing themselves as participants in a financial industry. We must get used to the fact that our clients may want advice on how to buy or sell claims or how to bring in investors, just as much as they require advice on arbitral jurisdiction or procedure. We should not be afraid of this change but rather embrace the opportunities that this offers. At the end of the day, the trend will be towards granting parties greater access to justice and, if properly managed, should result in a fairer allocation of risk.

Arbitration practitioners will have to get used to seeing themselves as participants in a financial industry

This can only happen with the development of a specialist legal community that can guide its clients through the various investment models and tailor them to their clients' specific needs. That can happen either by the creation of dedicated practice groups that can handle litigation finance law in house in the larger firms, or by the establishment of niche firms that can handle this work independently.

Our preference, in the initial stages at least, would be to see niche firms develop for this activity for several reasons. They are likely to see more litigation financing deals and can serve many more firms than their own in-house colleagues. This should lead to the development of the specialism quickly. Niche firms also have a greater degree of flexibility on their fee structures. Finally, their independence can allow them to take a more robust negotiation approach on behalf of their clients, which can be difficult for the larger firms who may be conflicted by their desire to secure funding for their case.