Third Party Funding : the challenge of ethical reliability

Memo based on the presentation made by Alain Grec, Director of La Française IC Fund, on 12th February 2014 at Queen Mary College for the workshop about Third Party Funding under the sponsoring of ICCA

Introduction :

As a first step it is important to understand the two following key questions:

1. What does Third Party Funding consist of? and
2. What are the true drivers of this activity?

The common factor among all types of TPF is:

> "to have a third party who has no pre-existing interest in the arbitration providing a party to an arbitration with part or all of the necessary financing".

However, this activity encompasses a variety of different practices, scopes, joint services and forms, such as:

- from a single person initiative to structured, dedicated and regulated funds,
- from third party judicial litigation funding to focused arbitration funding,
- from a pure financial concept up to an extended servicing approach (for example, specialized knowledge in enforcement of arbitration awards and asset location identification etc…)
- From an indirect insurance-driven consequence to a dedicated Third party funding concept (similar to private equity investment funds).

The emergence of this activity is recent and has been answering a growing need. To make it short, this need is mainly due to:

1. the increasing use of arbitration clauses in international agreements and the accelerating globalization, which together have triggered a multiplication of arbitration proceedings and a multiplication of arbitration institutions (specialized or not). This is –to a certain extent- thanks to the existence of the New York Convention of the Recognition and Enforcement of Foreign Arbitral Awards 1958 which does not have its equivalent in court judgments (excepting intra UE).

2. the expensiveness of arbitration, not only because of the costs of the tribunal and the arbitrators but also because of the partners providing their services to the parties to the arbitration (legal and experts' fees and expenses).

3. The technical requirements of arbitration, a practice that has professionalized (meaning specialized lawyers, forensic departments of audit companies, arbitrators …). Simultaneously, the rules and the case law of the arbitration courts have been fine-tuned, so that going for arbitration often requires from a claimant (having suffered a prejudice) to be knowledgeable in the arbitration specificities and technics, and to dedicate proportionally long working time as well as financial means.

4. Last but not least companies having to face arbitration become aware that the arbitration awards **are not directly enforceable**, and that if the other party is not willing to honor its debt, it may need some advice from a third party who is specialized in recovery when having to transform the award into tangible cash inflow.

<u>In our opinion the Third Party arbitration Funding is primarily meeting a need of an increasing number of companies to:</u>

- Fund a process, which otherwise deprives the claimant from financial means for its core activity or even jeopardizes its solvency; with unclear parameters in terms of budget, internal workload involved, duration. It can be a question of need for finance, or capital cost and allocation.

- Rationally allocate their energy and equity capital: with the increasing recognitions within corporate entities that there are risks inherent in their activities which can better be hived off to third party professionals on terms that result in reduced overhead budgets and funding costs. This is particularly so in the case of disputes wherein the amount claimed has been fully written off .

- Get assistance or back up in their choices and options during the whole story (arbitration and subsequent eventual enforcement).

- Cross-check their own strategy with a rather cautious third party (a third party who is also exposed to the outcome of the arbitration).

- Find a partner able to provide a risk off load based on a qualified risk/reward assessment: the funding is non-recourse and adds no extra costs. The remuneration of the TPF is proportionate to the effective cash inflow.

- Find a partner in line with its own interest to reach a fair compensation of a prejudice suffered in the shortest period of time.

- Eventually find a value adding partner for surrounding issues such as logistics (organize large scale translations, managing payments and invoices, organizing information surveys), and enforcement of the award (elaborating and implementing enforcement strategies).

Focus of the presentation:

The following presentation takes only in its scope registered and **established investment funds specialized in Third party arbitration funding** (as compared to other types of players such as the so called “pledge funds”, wealthy individuals, jumbo investment funds investing in junk assets) : so to say the “Institutional TPF”.

SUMMARY

I) Some key drivers of an Institutional TPF

At this point it is interesting to understand who are the main drivers of a TPF:

A team ("the Team") who has decided to develop a TPF activity needs substantial external financial means. The team itself can only marginally contribute to the equity needed to fund the cases (the Team is an active intermediate/interface between available equity capital and the effective international business disputes leading to alternative dispute resolution such as arbitration).

Therefore the TPF has two clients' types: the investors and the funded arbitration parties.

The 1st clients are indirectly rewarded for their means and the risks they take to support the 2nd clients, with a portion of the final proceeds : indirectly means that most of the time (except for the pledge funds) they are not aware of which case precisely they are funding (dark window pane thanks to the interface of the professional TPF team, and to the observance of confidentiality rules).

The TPF itself manages the wealth or equity capital of third parties (investors): it is not their own means and they must act according to the "stewardship principle".

Therefore the Team must do its own due diligence about the source of the funds coming from the investors (compliance ethical criteria set by the Team, or mixed with the regulatory ones if the TPF is regulated).

1) The investors and the fund raising:

- Investors are looked for and met at the occasion of the fund raising of the TPF Fund: without their commitment to provide non-recourse equity capital to the funding entity nothing can work, nor even begin.
- Investors are asked to entrust their money on a long-term basis (often between 6 and 10 years) without [guaranteed] liquidity (most of the time there is no possibility to sell back the shares of the Fund in a vivid secondary market like for equity or fixed income funds).
- Investors are asked to trust the investment policy, the expertise (assessment of the judicial merits, quantification, enforcement …), the management rigor etc… of the team throughout the years where their equity capital will be blocked.

- Investors are provided with a story and with ethical, business, investment etc … rules that the Team commits to comply with.

If the Team and the framework are trustworthy for the investors and match their mindset (= investment policy) , the Fund will be able to have them subscribe shares of the Fund and then raise the financial resources needed.

Whoever the investors are, they are all extremely sensitive about the risks associated with their possible investment, all the more so as their invested equity is blocked for many years and the cases funded by the TPF will not be known by them (in Europe, risk concerns of such investors are mostly reputational risks, fraud, conflict of interests within the team, key persons risks, ability to identify adequate cases to fund, compliance with the ethical mindset of the investing entity and the client, and of course last but far from least profitability and reliability of the outlook for profitability); it being reminded that the investor has no guarantee for the risk/reward level (it is impossible to foresee the result of an arbitration and the final cash inflow).

Consequence: to build up and to keep the trust of the investors is vital for the TPF.

Would a Team bet on unmeritorious or frivolous cases? The answer is no, it would be too dangerous to shoot down the profitability for the investor (most single funds invest in a limited number of cases, from 10 to 40 each, so that their global profitability is sensitive to the result of each one).

Would a Team try to influence the arbitrators (being otherwise lawyer counsels in funded cases)? The answer is no, too dangerous because of reputational risk (image definitely damaged for further funds to raise). Apart from that it would at the same time prove unethical and possibly incurring penal liability.

Would a team overfinance cases to strangulate artificially the other party? The answer is no, this uncertain game bears a too heavy financial risk (TPF have limited financial means and a race against the respondent based on financial power may go out of control and beyond budget limits for the TPF). Such behavior could seriously jeopardize the profitability for the Investors (the key for the TPF is to secure best quality partners for each case to the most reasonable price so as to stay within defined budget brackets).

However the difficulty is to define a threshold beyond which a case would be considered as “overfinanced”.

It shouldn’t be forgotten that TPFs often experience the opposite (overfinancing by the respondent in order to exhaust the claimant).

Conclusion: one of the most efficient self-imposed pressures for the TPF to stick to best practices is the pressure of the investors, who are vital to the TPF. Our own experience as a TPF docked within a major regulated asset management group is that we naturally tend

- To adopt a prudential approach similar to the regulatory environment within which our Group operates
- To define and implement operational and best practice procedures that are submitted to the regular controls of auditing departments
- To work with investors having high ethical standards and reputational requirements which constitute a permanent best practice benchmark.

This makes our experience at La Française IC Fund somewhat specific but at the same time of use inspire broader guidelines.

2) The basic philosophy of TPF activity:

TPF is no quick win activity: it requires deep knowledge about international arbitration and its “players”, about trade or industrial business, geopolitics, comparative enforcement schemes, etc…

Core philosophy is, or should be:

A TPF core driver is to provide the victim of a prejudice the means to make its rights be recognized and then to get from the guilty party entire compensation / indemnification.

= the third party funder doesn’t create value but helps restoring a damaged value, by means of the funds entrusted by the investors, who expect a reward proportionate to the risk they take.

The profit expectation of the investors is the price for the use of part of their wealth into the resolution of arbitration disputes.

This applies for TPFs who are backing claimants. It is delicate to build a similar basic philosophy for TPFs backing respondents to reduce their condemnation but in such case the philosophy could be: to prevent faults from being disproportionally sanctioned.

TPF is meant as an auxiliary mean to help access to equitable justice and to effective repair of the incidents/accidents in international trade or international investments which are due to deteriorated business moral (= obviously TPFs have no added value in the case when a respondent caused a prejudice because it became insolvent or unable to honor its obligations).

Once the financial means are secured and the basic philosophy is clear (= this is the story which is explained to the investors): the Team must thoroughly examine cases that are submitted to them (opportunities).

3) Claimant clients:

When the TPF is funding a new case it is fully at risk on a non-recourse basis. It commits itself for the case of its client which will be managed and defended by the lawyer counsel. Most of the times agreements consider the case where the client may seek to impose a strategy which is different to the one agreed with the Fund, and to the one recommended by the counsel (which usually prevails): in such a case, the TPF is usually entitled, under certain conditions, to cease financing the dispute and is entitled to a compensation for the funds it has already expended.

Apart from the "opt out" reserve above and the breach of the agreement by the other party, the TPF is basically committed to the case and its claimant client (the funding agreement is signed with the claimant client, not with the lawyer counsel).

The TPF is single case driven (it is not a logic of mutualisation of numerous cases with a statistical default threshold like in the insurances): each single case involves a significant enough budget that it may influence the economical balance of the Fund. Losses in a handful funded cases may deter the track record of the Fund and then make it impossible for the team to raise further capital means for future operations. The due diligence phase prior to decision is essential to build up a conviction about the undisputable strength of the case, but 100% certitude is obviously impossible (= TPF is not a betting game).

II) Due diligence process prior to the decision to fund a case:

1) Merits of the case: is there a clear prejudice suffered by the claimant? is there the legal background to support the case (supporting documentation, time bar issue, jurisdiction, etc …)?

   The analysis of the merits is extremely important for the TPF, since all the funds invested are at stake.

2) Ethical due diligence:

   The ethical environment of the underlying litigation, and of the claimant itself: is the underlying conflicting situation compliant with the commonly accepted rules of international trade ? Is the claimant compliant with the same rules and ethically "clean"?

   Enforcement outlook : may the enforcement of the final award or of any amicable settlement induce ethical damage (to vulnerable population, to the environment etc …)?

   This aspect is essential for many TPF, at least for ours, to prevent reputational risks and to comply with its own commitments towards its investors.

3) Quantum: what is the quantification of the core undisputable prejudice (= what is the minimum level at which the claimant can expect the award amount= reasonable worst case scenario)?

4) Budget: assessment of the necessary budgets (tribunal costs, lawyer fees, expert fees, enforcement costs, expenses, miscellaneous).

   In order to prevent relationship difficulties and possible mismanagement of a case , budgets should be considered on a worst case scenario, i.e. the arbitration in full + the situation where the debtor doesn't pay voluntarily (to avoid speculative bets on early settlements).

5) Claimant client sustainability and good faith: the claimant to the arbitration must stay alive and solvent during the whole proceeding (condition for the invested TPF funds not to be lost for reasons external to the case); and the TPF must make sure that its decision is based on a transparent and comprehensive understanding of the case. The good faith principle may

sound quite civil law minded but corresponds to a true approach, at least in our experience..

6) Outlook for enforcement: even if enforcement should take place in 2 to 4 years: what are realistic enforcement strategies against the “debtor to be” ; what is the risk that it becomes insolvent or significantly troubled in the meantime?

7) Remuneration expected for the TPF so as to be consistent with investors’ expectations (= the story on which they decided to commit their equity capital to the TPF). The proceeds to be cashed by the claimant client must anyway by far exceed 50% of the total expected proceeds (= the TPF works for a prejudiced entity to help it recover the greatest part of a lost asset value).

The comparative weight of these items in the decision making may differ from TPF to TPF but they are probably always part of the due diligence.

Once a decision is taken, based on the due diligence done by the Team, and if the negotiations run successfully with the claimant client, a funding agreement is signed between the TPF and the claimant client.

The agreement is a comprehensive document , tailor made according to the characteristics of the case and the requirements of the client.

The lawyer counsel shouldn’t be a party to the agreement (a separate fee engagement letter may link TPF, Claimant and Lawyer counsel if needed).

III) TPF management of an ongoing case:

1) Commitment of the TPF

TPF is committed to provide complementary means to contribute to the case management: financial means but also eventually additional services , depending on the TPF and on the requests of the client or of the lawyer counsel (coordination, translations, information collection, enforcement, cross reading of writings …) .It works as an available additional working capacity (depending on the TPF) to back the claimant client in its way to restore its damaged asset value.

2) Confidentiality

Confidentiality is key. Strict observance of confidentiality rules is essential (for this purpose, the TPF could use external control bodies).

3) Ethics

Ethical commitments must be practicable and applied on a day to day basis versus self-declarative good intentions (again, for this the TPF could use external control bodies).

4) Cost management

It is part of the financial know how of the TPF. The cost efficiency is measured by regular comparison to the budget, to the expected or existing award , and then more importantly to the expected or existing final proceeds: this means that the TPF must be confident that the partners of the case (lawyers, experts, bailiffs etc …) are the best suited, but at the same time it must make sure that the budgets are reasonable (market price doesn't exist in the universe of arbitration), capped but still motivating.

5) Time management

The quickest the best , but only provided that the amount is suitable. Identical interest as the claimant. Claimant and TPF interests are totally in line. However time pressure may be an "pernicious advisor". TPF should always have room to best manage time issues (otherwise it is a factor of collective vulnerability).

IV) Best practices: stereotypes and real issues:

Starting from these basics we can draw a survey of what can be understood as the best practices for a TPF in order not to jeopardize the genuine process of arbitration, not to enter into conflicts of interests, not to fall into the trap of financial greediness, or misuse of confidential informations.

1) **Stereotypes**:

- Encouraging unmeritorious/frivolous cases ?

The claimant has suffered a clear prejudice: it has been subject to a thorough due diligence. This is vital as the TPF invests on a non-recourse basis and gets eventually its remuneration from the effective proceeds. The TPF must be sure of the merits. The idea that a TPF would deliberately back frivolous cases is just incompatible with its interests.

A clause in the agreement should foresee that if the client has lied or intentionally hidden information which misleads the analysis of the TPF, the TPF has a right to terminate the agreement and to get an indemnity.

- Using dubious or questionable methods?

  The TPF could try to strengthen a case by launching its own investigations or trying to get information or documents which are not in the natural ownership of the claimant client.

  This again would be immediately pointed out by the respondent , and the claimant would be weakened by the issue, which is not in the interest of the TPF. The use of such questionable methods would ruin the reputation of the TPF.

- Overfinancing a case in unfair manner?

  Due to the sensitivity of the TPF business model to misfortune of each single funded case, this is against the very nature of the TPF. TPFs naturally tend to optimize the relation cost/time/reward but, at the same time are highly depending on the claimant client (who intimately knows its case and the respondent) and on the lawyer counsel (who leads the arbitration developments).

- Using dilatory maneuvers?: the answer is the same.

- Generating conflicts of interests with arbitrators?

  A typical situation would be to influence an arbitration by having arbitrators nominated who have a business relationship elsewhere with the TPF: if the arbitrator is not aware that the TPF is funding the case , the issue is irrelevant (see Laurent Levy).

  If the arbitrator is aware of this, he has to declare it in its statement of independence or as soon as he becomes aware of it.

  In principle the TPF has no interest in going this way , at least with the intention of making use of it, because the risk that the respondent becomes aware of it and makes an argument about it during the proceedings is too high: it can delay the whole story by 6 to 12 months (time is money) and jeopardize the image of the claimant in the eyes of the tribunal.

2) **How to trigger sustainable best practice behaviors:**

The main ethical issues:

- <u>To ensure that the ethical environment of the case is satisfactory</u>: the underlying agreement or investment in a host country should comply with the commonly accepted practices in international trade.

  This checking is self-evident if the TPF is sensitive to its reputation and image. Its reputation is vital if it addresses investors which/who are sensitive about their image or their reputation , or if the fund is public, or regulated.

- <u>To ensure that the claimant client complies with the general western standards of business morality</u> : search for focused information to detect any doubt or suspicion, cross check in available data bases. Confidential processing of these due diligence information.

  This can be subject to an external control or an external check at the decision making of the TPF to ensure the reliability of this study.

Code of conduct , ethical guidelines:

A TPF may write down its ethical guidelines and rules (code of conduct of the TPF association in London, our own ethical chart).

This is a nice step if it is subject to external compliance controls and a suited governance that prevents the TPF from doing whatever it wants, while claiming loudly that it observes its self-declared rules.

The TPF seen as a "co claimant" :

TPF, lawyer counsel and client have converging interests to win the case. In practice the triangle relationship leads to a teaming up for the best of the case: TPF manages the funding and costs questions and therefore is entitled to follow up intimately the progress of the works.

It may also be a peripheral service provider: logistics, translations, information collection, monitoring of the enforcement etc… for the benefit of the case : it must be at all times clear that the client is the claimant, and that if a disagreement appears, the lawyer counsel will prevail (should be clearly stated in the Funding agreement).

May the TPF be regarded as a co-claimant because of its intrusive or directive behavior? Could the TPF tend to give instructions to its client about what to do during the proceedings, and the preparation of hearings or give instructions to the lawyer counsel?

Here the interest of the TPF is naturally converging with the one of the lawyer counsel. My feeling is that any instructions given by a TPF to its client which would drift from the advice of the lawyer counsel would be dangerously contra-productive for the fate of the case, especially with view of discordances during the hearing and weakening of the strategy developed by the lawyer counsel.

The funding agreement must contain clauses that clearly state that in case of diverging opinions, the opinion of the lawyer counsel shall prevail, + clauses that leave the right to the claimant client to terminate the agreement under clear conditions.

To underfinance a case :

This is a real danger and can be seen from time to time. This reminds of the" long-short" speculative management in the trade markets. Within a long lasting proceeding one may identify a probable event on a shorter term that one could bet on.

If the risk assessment is favorable enough, the TPF may make the bet and allocate a reduced budget to the case , just sufficient to reach the expected event. If the event doesn't happen , then the TPF would reopen the negotiation with the client, who may become then highly dependent on the wishes/requirements of the TPF.

A governance requirement to avoid these conflicting relationships at different crucial stages of the proceeding is to follow **systematically a worst case scenario** when defining the budget, which is to be disclosed to the client, and the estimated duration of the case at the decision making point. This "worst case scenario approach" can eventually be checked and/challenged in the external controls of an educated auditor (for example) .

A follow up of the budget consumption by regularly reporting to the claimant client is also sound and prophylactic.

Financial greediness:

Especially when backing a claimant who is financially too weak to fund its case , the TPF could be seen as a bird of prey which robs its armless client.

1stit is of essence for a TPF to contract with a sustainably solvent client (liable for its own expenses and operating costs). Otherwise, funding the working capital of the claimant client would inevitably lead to conflicts of interest.

2nd the TPF should steer its activity towards the target profitability it is to bring to its investors , and not towards getting the most of any case at the edge of the pain limit of its client (governance of the TPF).

3rd The largest portion of the expected proceeds of the case must go to the claimant , because after all both the TPF and the lawyer counsel are backing a prejudiced entity with the aim that it obtains a fair indemnification for its prejudice.

4th A Third party arbitration funding contract is an agreement : this means that all parties have signed together on a "arm's length", mutually agreed, basis. **Nobody has compelled the other one to sign**.

To ensure the fair conditions of its potential funding partner, the claimant should compare competing TPF proposals.

Confidentiality:

A tricky question. As the TPF takes alone the full non-recourse risk, it is the least that he accesses the documentation necessary for its decision making but also to follow the proceedings in order to eventually contribute with its own inputs.

It is then a matter of the TPF having signed with the claimant or the lawyer counsel , as the case may be, state of the art confidentiality agreements and having implemented strict procedural framework and discipline for itself. This key issue of confidentiality can be put under external controls (in order to avoid hypocritical self-declarative commitments).

Obviously the issue of 'confidentiality is still more complex: should the arbitrators be made aware of the existence of the TPF ? If so, to what degree should that awareness go ? Shouldn't the potential duty to disclose cover equally all various types of third party funding (endowments, shadow interests of third parties, insurers etc…) applying to all parties to the arbitration ?

The essential point may be that as long as the TPF doesn't obtain 'executive control' of the arbitration, then there should be no reason for the existence of the TPF to be disclosed to the arbitrators.

Conclusion :

The experience of La Française IC Fund

Most of the best practices can be ensured and triggered on a sustainable basis with the following elements:

- Governance of the TPF: implementation of external control bodies (observance of internal procedures, traceability, respect of ethical commitments, observance of confidentiality rules , mapping and checking of conflict of interests).
- Intelligent use of the auditors (checking of the worst case scenario assumptions taken for each case in the portfolio, …).
- Introduction of independent reliable gate-keepers in the governance (decision making, advisory …).
- Emphasizing the role of corner stone investors for their virtuous role (to avoid reputational risks, to comply with ethical guidelines of their investment policies etc…).
- Going for regulated structures/vehicles provided that such structures are adequate to the specificities of the Third Party Funding: the regulation authorities ensure a set of constraints and external controls that provide sound management behavior (like it is the case in the private equity funds).

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La Française AM International Claims Collection