Hughes Hubbard & Reed

What is Third Party Funding? How Is It Used in International Arbitration?

March 6, 2024 - In Dispute
Client Advisories

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What Is Third Party Funding?

International arbitration can be a costly endeavor. Third Party Funding (TPF) – also known as litigation funding or litigation finance – is a way for a claim holder or claimant in an international arbitration to finance the costs associated with pursuing that arbitration. In exchange for providing capital to cover arbitration costs, the funder will stand to receive a portion of the final arbitral award if the dispute is decided in the claimant's favor.

TPF is typically provided on a non-recourse basis: if the claim is unsuccessful, the claimant is not liable to pay back the funder's investment. As a part of TPF, claimants can often insulate themselves further by acquiring after the event (ATE) insurance, which insures against the risk that a claimant will be ordered to pay an opposing party's costs by an arbitral tribunal.

Who Are Third Party Funders?

Third party funders can be defined as "any person or entity that is contributing funds [to the defense] of [a] case and that has a direct economic interest in, or a duty to indemnify a party for, the award to be rendered in the arbitration."

As participants in a relatively young industry, third party funders come in many different shapes and sizes. While some funders specialize in funding personal injury, medical malpractice or consumer-based disputes, a large number of funders focus on commercial-based, business-to-business disputes. This article primarily focuses on those commercial funders, in particular those that seek to invest in cases, where the expected damages are in the tens and hundreds of millions of dollars range.

Why Is TPF Advantageous?

TPF can be an attractive option for claimants for a variety of reasons. First, TPF offers claimants with limited liquidity an opportunity to prosecute meritorious claims they might otherwise not have sufficient means to pursue.

TPF can also benefit claimants, who have the cash to fund a legal dispute. By availing itself of TPF, a claimant can keep the expense of an arbitration off the claimant's books and use its capital to grow its business rather than to finance an arbitration. This has the effect of transforming the legal department from a cost center to a revenue generator.

When claimants make use of TPF, they potentially increase their leverage in settlement negotiations because a funder's willingness to finance the claim may signal to the opposing party that an impartial third party (i.e. the funder) performed its own evaluation of the case and found it sufficiently probable to succeed such that financing the case was likely to offer an attractive return on investment.

How Are TPF Arrangements Established?

While every funder has its own specific process (and risk tolerance) when deciding whether or not to invest in a claim, most funders appear to be highly selective: anecdotal evidence suggests that 90-95% of claims presented to funders are rejected.

Securing TPF is time consuming. It typically entails three core phases: (1) packaging the claim and approaching potential funders; (2) concluding a term sheet and participating in a funder's due diligence process; and (3) deciding to invest and reaching agreement on the terms of the funding agreement.

1. Packaging the Claim and Approaching Potential Funders

Claimants who wish to secure TPF must gather material and prepare a detailed analysis of the case to explain to funders why their case is worth investing in. This process can be referred to as "packaging a claim." Once the baseline materials are gathered, a claimant will typically approach a handful of potential funders.

Experienced counsel can help claimants package the claim and provide the claimant with industry insights relating to the funder search, including advising on how many funders to contact and which particular class of funders to reach out to. For example, certain funders do not invest in intellectual property claims, others do not invest in claims against a specific sovereign state and many will not fund claims the value of which does not exceed a certain minimum threshold. Presenting the claim to a funder who seems most likely to invest can save significant time, effort and money.

Claimants may also seek guidance with respect to matters that the targeted funders want to see addressed in the claim package and how best to address these matters. While each funder's method for carrying out their initial case assessment varies, key criteria considered by most funders include the following:

- **Damages:** Third party funders will want to conduct an assessment of reasonably-to-be-expected damages. Funders make use of these findings to reach a determination on whether the plausible damages value offers a sufficient rate of return to compensate the funder for the risk it is taking, often using a benchmark ratio of 10:1 for provable damages against expected investment.
- **Budget and Timeline:** A detailed prospective budget may contain, inter alia, the anticipated attorneys' fees, the fees of any expert(s), translation costs, fees and expenses of arbitrators and the arbitral institution administering the case, etc. Alongside the budget, claimants are generally expected to provide an associated timeline that lays out the anticipated steps in the process up to the final award.
- **Recoverability:** This typically includes any data that the claimant has compiled on the respondent's financial position, with particular focus on their current and anticipated financial strength, asset location, and their historical attitude towards arbitration. Each of these insights aids the funder in determining how confident they are that recovery will be possible if the claimant's case is successful. Having a concrete plan for the end game of collecting an award significantly increases the likelihood of obtaining funding.
- **Strength of Legal Claims**: This may include documentation collected by the claimant's counsel that provides a thorough summary of the case's facts, affirmative arguments, anticipated counterpoints, and relevant case law both for and against the claimant's position.

- **Factual Evidence Supporting the Claim:** Examples of such evidence include but are not limited to financial statements, transcripts, contracts, lawful recordings, and affidavits. Once received, this information can be used by the funder's in-house or external counsel to confirm or refute the substance of the claim(s).

Before any of the information listed above is shared, funders and claimants will typically sign a non-disclosure agreement to protect the confidentiality and legal privilege (in select jurisdictions) of their communications.

2. Conclusion of Term Sheet & Funder Due Diligence

Claimants will typically approach several well-suited funders with their packaged claim. These funders will then complete a prima facie review of the viability of the claim and, if the case is compelling, one or more funders will respond by submitting a term sheet to the claimant. The claimant will then pick a funder and agree to the submitted term sheet. As with any supply/demand dynamics, if funders are slow- or fail to respond, a claim may increasingly lose its appeal within the funder community. Attractive packaging of the claim and insightful targeting of funders is therefore crucial.

The term sheet serves several important functions. First, the term sheet constitutes the negotiating foundation for the eventual arbitration funding agreement outlining all of the commercial and economic terms intended to govern the funding relationship, including the cash outlay, the return, the funding termination events, etc.

Second, term sheets will often grant the funder exclusivity for a defined period while the funder conducts a comprehensive due diligence of the claim and negotiations are conducted with the claimant to finalize commercial terms of the funding agreement. Such exclusivity is required by many funders before they incur any costs conducting due diligence. Other funders may decline to require exclusivity, and instead use break-up fee clauses where the claimant will pay the funder for their time and resources spent on the prospective deal if the claimant ultimately goes elsewhere for funding.

Following the signing of the term sheet, the funder proceeds to undertake a comprehensive due diligence of the claim by independently confirming the information provided and performing a targeted review of the claimants themselves, their arbitration history and their lawyers, as well as their reasons for seeking outside financing. In conducting this review, each funder has its own process. Some funders employ a large team of seasoned litigators, arbitrators, and financial analysts to carry out the due diligence of claims in-house, while others opt to outsource such a review to trusted external counsel and financial firms.

With respect to the claimant's lawyers, the funder examines the reputation and level of expertise of the claimant's selected counsel generally and specifically in matters related to the underlying claim type. Moreover, third party funders will review the terms of the engagement letter between counsel and the claimant to further ensure compatibility with the proposed funding documents. The funder seeks to gauge if the interests of the claimant and the law firm are aligned, and if that arrangement aligns with the risk tolerance of the third party funder. Claimants typically retain the right to choose counsel, particularly in those jurisdictions where the common law doctrine of champerty (discussed further below) may apply.

3. Decision to Invest & Funding Agreement

If, at the conclusion of a satisfactory due diligence review, the funder wishes to take on the case, the relevant funder team must bring the claim up to the funder's investment committee. The funder's investment committee will then decide whether to invest in the case. If the investment committee grants approval, the funder will present an offer with proposed terms and negotiations over those terms ensue. Only after negotiations between the claimant and the third party funder have produced mutually agreeable terms, will both parties sign a binding arbitration funding agreement.

Although each agreement will be tailored to the specifics of a particular case, well-devised funding agreements are likely to have provisions specifically addressing the funding structure both during and after the dispute (i.e. recovery of the proceeds).

One of the most consequential terms of a funding agreement is the selected method by which the funder will release funds to the claimant's counsel during the dispute. As is the case generally for TPF, no two structures will be exactly alike. In one, so-called "traditional" model, the claimant submits invoices via counsel to the funder as their expenses accrue and the funder pays out disbursements to the claimant accordingly. In another model, known as the "monetization model", the funder deposits the contracted monetary sum either in one lump sum or in scheduled intervals into an escrow account held by the claimant or their counsel, where they then deduct expenses of the proceedings from the provided funds.

To address what happens if an award is granted in the claimant's favor, funding agreements will typically have a section concerning the recovery distribution plan, including mechanics for valuation of non-cash proceeds. A recovery distribution plan specifies how the claim proceeds will be allocated between the claimant, third party funder, and where applicable the claimant's lawyer(s) and/or the adverse costs insurer(s). Ordinarily, proceeds payments are modeled after a "cascading waterfall", where funders are first paid in an amount equal to their initial investment. Payments flow to the funding party, claimant and the claimant's legal team according to an agreed upon formula. While the formula is negotiated with respect to the unique claims of each specific case, there are two methods that are frequently used (sometimes in combination with one another) to establish the amount that third party funders are entitled to in recovery. One is a fixed percentage share, where funders receive a pre-negotiated percentage of the proceeds recovered from the defendant. The other is a multiple of the funding amount originally used as an investment to push forward the claim. Accordingly, after the funder has been completely paid out, the remaining proceeds are divided up between the claimant and their counsel pursuant to their engagement agreement (which typically foresees, in addition to a share of the proceeds, regular payment of the firm on an hourly basis).

Finally, a well-crafted funding agreement will establish provisions to preemptively mitigate the potential risks associated with TPF. For example, funders may wish to reserve their right to terminate the funding agreement following a material change in the case. Another risk that claimants have faced when employing TPF is that the funder runs out of funds to support the claimant's case. This fateful scenario can be abated by negotiating the inclusion of a section on warranties and representations made by the funder and a right of first refusal with respect to additional funding requirements. In that section, the language could require that the funder guarantee with assurances at multiple points during the life of the agreement that they are maintaining adequate capital to fund the arbitration proceedings.

TPF – An Evolving Industry

Over the better part of the last two decades, third party funding in arbitration has become increasingly common. During this time, TPF has made its way around the world and evolved into a multi-billion-dollar industry. Yet, while now a financing source used globally, TPF has not been applied equally across all jurisdictions.

For example, in certain common law jurisdictions, third party funding has historically been illegal due to its perceived violation of the ancient common law doctrine of "champerty". An agreement is considered "champertous" (and thus presumably unlawful) when "third parties unrelated to a litigation provide material support to litigants in exchange for consideration contingent on the outcome of the litigation."

Most common law jurisdictions have evolved to recognize TPF as a valuable means of ensuring that access to justice is not a function of wealth. The concerns that these champerty doctrines sought to address in medieval England are much less relevant today. Evolving attitudes in Australia, the UK, and Canada have led champerty restrictions to become narrowly tailored if not completely abolished. Hong Kong and Singapore have opted to do so through legislation that expressly permits third party funding specifically for arbitration proceedings. In the U.S., the legal applicability of champerty is more unsettled. For example, in New York, whether TPF is champertous is governed by a statute and the nuanced interpretations of that statute by the New York courts. Some New York court decisions will find an agreement champertous and void based on whether the sole purpose of the funding agreement was to bring litigation.

Civil law jurisdictions have generally not faced a similar legal doctrinal hurdle in addressing the legality of third party funding arrangements. Instead, in advanced arbitration markets such as France and Switzerland, the approach towards TPF has been to leave it largely unregulated, with the general understanding that such funding contracts are available for use in arbitration proceedings, both domestic and international.

Conclusion

TPF can even the playing field between David and Goliath by providing the less pecunious Davids with the financial means to pursue meritorious claims against well financed Goliaths. However, as a more recent tool in the field of arbitration, the task of obtaining TPF can feel overwhelming if not downright impossible. Claimants may wish take guidance from sophisticated arbitration counsel, who can help find the right funder for a particular claim.

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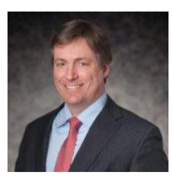

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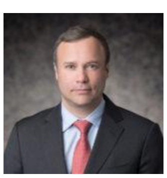

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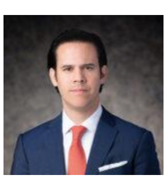

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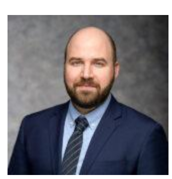

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