CHAPTER 2

Mechanics of Third-Party Funding Agreements: A Funder's Perspective[1]

§2.01 INTRODUCTION

This chapter is designed to provide an overview of the issues associated with a litigation funding agreement (LFA) governing the non-recourse financing of an arbitration case. The authors of this book have invited a representative of a litigation funding company to contribute this chapter to provide a general framework for litigation funding agreements worldwide, in contrast to the jurisdiction-specific themes covered in the rest of the book.

This chapter answers the following question: What do third-party funders, claimants, lawyers, and other stakeholders actually do when everyone has money at stake?

This overview is by no means meant as exhaustive and focuses on what this author and his learned colleagues and partners have found to be the main issues germane to most cases. Dispute resolution funding is a nascent industry, and every new case raises unique issues that have never before been considered.

The key items covered in this chapter are:

(1) LFA negotiation, including financial terms and ancillary agreements; and
(2) Case due diligence prior to concluding the LFA.

§2.02 NEGOTIATING THE LFA (AND ANCILLARY AGREEMENTS)

We begin with a note on the background themes that drive the LFA negotiation process.

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1. Authors' Note: This chapter was written by Mick Smith, Partner & Co-Founder, Calunius Capital LLP, a funder based in the United Kingdom. We would like to thank Mick for his generous and useful contribution to our book.

One direct consequence of litigation funding's relatively recent emergence into the mainstream is the unfamiliarity of many litigation lawyers with the various structures that LFAs might take on. Moreover, because the industry is driven by participants with a shortage of capital, few resources to date have been channeled into producing harmonized contractual terms.

In the United Kingdom, recent progress has been made with the adoption of certain common contractual features set out in the Association of Litigation Funder's "Code of Conduct," but these items focus on England and Wales. Differing, and arguably longer standing, contractual approaches exist in Germany and Australia. The US third-party funding industry has also advanced rapidly in the last five years. More on these jurisdictions is provided in Chapters Four, Six, and Seven.

Another difficulty faced by litigation lawyers is their inexperience negotiating financial contracts, relative to counterparts in banking and finance departments. As litigation lawyers learn financial contracts on the job, they are forced to consider subtle legal issues such as the priority of payment of returns and security interests in the litigation proceeds.

The interplay between public policy issues, particularly those from the common law doctrine of champerty and in relation to abuse of process on the one hand, and banking law issues driven by insolvency law (often cross-border) on the other hand, requires careful consideration in virtually every large, funded dispute. This interplay also generates significant legal fees and gives lawyers from different practice groups an opportunity to interact and generate further business.

In summary, all of the above requires flexibility among dispute resolution lawyers tasked, by their clients, with finding funding for a substantive commercial or treaty arbitration case. Large and reputable funders of these cases exist in various jurisdictions, but comparing the implications of their offers of funding remains difficult due to considerable differences in funding structures across cases in various jurisdictions. In reality, arbitration lawyers are equipped with multi-jurisdictional and multilingual flexibility, and they are well-equipped to overcome these challenges during LFA negotiations.

[A] Non-financial Terms in the LFA

[1] Due Diligence and Exclusivity Period

The LFA will typically be preceded by or provide for a due diligence and exclusivity period such that only if the third-party funder concludes its due diligence within a satisfactory period will the funding of the case proceed. The length of the requisite due diligence period is first and foremost a function of the case's development. A case close to trial may be relatively quick to assess with full visibility of the memorials on merits, witness statements and disclosed documents, all of which may be completed in as little as three weeks. An early stage investment treaty case with limited preparation, however, will most likely take longer and involve more risk.

Surprisingly, claimants and their lawyers usually express greater frustration with the length of the due diligence period requested than the financial terms proposed by the third-party funder. This frustration frequently stems from the tendency for claimants and their lawyers to underestimate the time it takes to produce documents and answer third-party funder questions. However, this is rarely an issue if stakeholders are reasonable, as extensions are usually granted where it is clear that the third-party funder is spending significant time and energy analyzing a case and incurring its own legal costs on external due diligence.

The purpose and practicalities of due diligence are discussed at much greater length in section 2.03 below.

[2] Proceeds and the Third-Party Funder's Interest in the Proceeds

The legal structure of the third-party funder's interest in the proceeds of the case varies according to the dispute forum and third-party funder's domicile. When the laws of the United Kingdom govern the LFA, third-party funders tend to take an interest in the proceeds which the claimants are to hold in a trust which the lawyers recognize. Other possibilities involve assignments of proceeds, or in the civil law jurisdictions such as Germany, an assignment of the claim itself. This latter approach is also permitted in certain common law jurisdictions where the claimant is in formal liquidation.

A key consideration for the third-party funder is to ensure that the structure of its interest (including the actual financial bargain and control provisions), when read in conjunction with the governing law clause of the LFA, will be enforceable against the claimant's litigation proceeds in the claimant's country of domicile, and potentially, the lawyers' domicile if they are located elsewhere.

A further subtlety lies in the definition of proceeds and the related definition of success in the proceedings. A properly drafted LFA should emphasize that the third-party funder's interest does not attach until proceeds are actually recovered or paid to the claimant's lawyers. Equally importantly, claimant's lawyers should ensure that the funding provided will include the reasonable costs of recovery and, where the likely amount of recovery is uncertain, provide for some consensus on the definition of satisfactory recovery. Claimants need to be especially attuned to these points where there are other stakeholders, third-party funder included, to be paid in priority.

[3] Termination for Fault

Funding agreements must handle the concept of termination for fault, whether by the third-party funder or the claimant. In the third-party funder's case, this usually manifests itself in provisions governing the situation where the third-party funder unilaterally stops paying the bills, or declares the contract null and void, contrary to the independent assessor's opinion (*see* below). These situations should attract the usual remedies for breach of contract.

In the claimant's case, there are a variety of provisions in funding agreements which will include requiring the claimant to behave in a commercially rational manner, to follow the reasonable advice of its own lawyers (such as in relation to settlement offers) and to disclose all material information at all times. Material breach of these provisions will give the third-party funder the right to terminate. In general, however, the opportunity to pursue the claimant for damages is of limited value given the insolvency of many claimants.[2]

In these circumstances, the third-party funder's interest in the proceeds under the contract may survive and eventually pay off, in the unlikely event that the claimant continues to bring the claim and then succeeds. Such survivorship is also important in circumstances where a claimant fraudulently engineers a termination of an LFA and then settles a claim with the respondent through alternative channels.[3]

[4] Funder Termination and Independent Assessment

In LFA negotiations where the third-party funder's view of the circumstances differs from that of the claimant and its lawyers, the clauses governing the third-party funder's right to terminate prove to be among the most contentious. Claimants are generally concerned that they are committing themselves to litigation based on the provision of funding and understandably want the claim to proceed.

The claimant's principal protection is provided through the insertion of a "QC Clause" or its equivalent. This clause provides for the joint appointment of an independent assessor to resolve disagreements between the claimant and the third-party funder. This independent assessor will be mandated to determine the appropriate course of action, which is binding on all parties. This resolution is usually sought for matters pertaining to material adverse change and settlement.

In the heat of a litigious battle, however, events often depart from this norm. In the event of a material adverse change in the case in the view of the third-party funder, it is virtually unheard of for the third-party funder to exercise this right to terminate (with or without independent approval). Because one-sided termination is seen as a bad business practice, most stakeholders simply agree upon a negotiated exit route.

To understand why such a dispute is unlikely, it helps to look at a third-party funder's motivations. At any point in time, the third-party funder will be determining on which one of three paths the litigation sits:

(1) is the third-party funder still likely to make a significant profit;
(2) if not, does the third-party funder have a decent chance of emerging with some or all of its original investment intact (and possibly a modest profit) if it continues to fund; or
(3) is it likely that any new money invested will be wasted?

2. Though, nonetheless, such cases are brought—see for example the Juridica/S&T arbitration under LCIA rules and related litigation in the US (*S&T Oil Equipment v. Juridica Investments Limited 2012* WL 28242 (C.A.5 (Tex.))).
3. See, for example, the follow on litigation after the conclusion of *Siag v. Egypt* (ICSID Case No. ARB/05/15), where the claimant's lawyers pursued Siag for unpaid contingency fees following a settlement agreement directly between the State and the claimant (cf. *Siag v. King & Spalding LLP 2010* WL 2671580 and related LCIA proceedings).

Only in the latter case (path 3) is it likely that the third-party funder will want to terminate. Furthermore, if this is the third-party funder's view, then it is extremely unlikely that claimant's lawyers and the independent assessor will both still view the case as being on path 1 to significant damages. Assuming not, path 2 will not offer the claimant any real upside to proceeding with the case because of the priority structure in the LFA and ancillary agreements (*see* below).

Similarly, the consensual nature of the litigation project from the outset means that there should be no significant divergence of views at the stage of making or receiving settlement offers. The same analysis regarding which of the 3 paths the case is on should apply, save that differing views as to whether a case was on path 1 and path 2 would suggest reasonable settlement offers should be taken very seriously.

Lastly, the negotiations leading to a well-prepared LFA should include a moment where the stakeholders stopped and clearly set out their future expectations on what would or would not constitute a fair net outcome for them, with or without costs included. One technique to ensure a meeting of minds *ab initio* is to distribute a spreadsheet during the due diligence period setting out a scenario analysis of who gets what and at what time depending on certain quantum outcomes. This approach can be particularly beneficial when lawyers and adverse costs insurers are stakeholders in the outcome. Achieving a workable consensus between four or more different stakeholder groups is no easy feat when views on realistic quantum and the "time value" of money diverge.

[5] Confidentiality and Privilege

By the time the LFA is signed, the third-party funder and the claimant will normally have already executed some form of Confidentiality Agreement, which ideally will set out the basis to maintaining legal privilege on shared materials, whether via the doctrines of legal privilege and/or common interest privilege. It is a good practice to incorporate these provisions into LFA by reference so that there is no break in the chain of the cloak of privilege, and also to include similar provisions in the LFA.

[B] Ancillary Documents

It is the ancillary documents that will be the most novel to dispute resolution lawyers, with the obvious exception of the lawyers' own retainer. The most critical of these are the retainer and the Priorities Agreement, as well as adverse costs insurance, if it is being utilized. Ideally all these agreements should be concluded at the same time as the LFA.

[1] Lawyer Retainer

When the third-party funder is considering the lawyers' retainer, negotiations usually focus on analyzing:

(1) the risk-sharing provisions;
(2) the termination provisions; and
(3) the budget.

The question of budget is dealt with in the discussion in section 2.02[C][1] below. Termination provisions, governed by local bar association rules, are rarely contentious, save in certain large contingent fee deals.

This leaves us with a consideration of risk-sharing provisions. Third-party funders vary in their desire to see claimant's lawyers taking some risk in relation to the litigation. Some feel more comfortable with lawyers taking a partial conditional or contingent interest in the claim in return for a discount on fees. Others find capped arrangements more useful. This places the onus on claimant's lawyers to budget properly and fully, and sees their full hourly rate paid along the way. The risk they run, however, is not that of anticipating the tribunal ruling on liability, but that of failing to manage the time of their team to deliver the case on budget.

[2] Adverse Cost / Own Costs Insurance Policy

Insurance policies that pay out in the event that a losing litigant has to pay the other side's costs are now commonplace in domestic litigation in the United Kingdom and emergent in other common law jurisdictions such as Australia, Canada or the Cayman Islands. In some cases, these policies may extend to reimburse part of the litigant's own costs paid to date. The providers of these policies include some of the largest rated insurers in the global market.

The typical structure and premium payable varies among insurers. Though some request that the premium be paid up front, it is more common for a portion of the premium to be paid at the conclusion of the litigation, and only upon a successful outcome. In these circumstances (at least for now in the United Kingdom) this contingent premium may be recoverable from the losing litigant.

The impact of these policies for the funding arrangements is that any future premium payable needs to be dealt with in the Priorities Agreement. Equally important, the provisions in relation to dealing with material events and settlement offers need to be harmonized across the LFA and the insurance policy to ensure that a common approach is taken by the stakeholders. In particular, if there is a dispute among the stakeholders then there needs to be a common basis to resolve any such disagreement.

[3] Priorities Agreement

The Priorities Agreement will regulate the distribution of proceeds (damages and costs) to stakeholders once the litigation is settled or won. The usual approach is for the claimant's lawyers to be a party to this agreement and to agree to administer the payments to the relevant parties. This will be the case even if the lawyers have no deferred or success fee interest in the proceeds.

A typical priority of payments structure would work as follows, being *pari passu* within each tier:

(1) repayment to the third-party funder of its investment to date;
(2) payment to the third-party funder of its return and to the insurer of any contingent or deferred premium;
(3) to lawyers in respect of any deferred or contingent or conditional success fees; and
(4) the balance to the claimant.

This order of payment reflects principles from the world of corporate restructuring and insolvency, where new money, and the return thereon, is repaid first. Occasionally, some modification might be admitted to this principle to include some historic items funded by the claimant.

[4] Standstill Agreements and Other Arrangements with Creditors and Shareholders

In circumstances where the claimant is insolvent or in financial difficulty (or there is a foreseeable risk of this happening) the third-party funder will want to ensure that its interest in the claim is protected from future challenges from stakeholders. These challenges are likely to present themselves at the beginning of a case, under conditions where a particular creditor takes a different view from the claimant's management as to how to fund the claim, or at the successful conclusion of the case, when the litigation proceeds come in.

A rare public example of this kind of challenge appeared in 2011.[4] Crystallex, a publicly listed Canadian company, had commenced an international treaty arbitration claim against Venezuela, and subsequently tried to raise finance to repay its own creditors ***and*** litigation funding by way of an issue of securities.[5] This issue of securities did not complete and Crystallex then sought and obtained Canadian court protection from its creditors while it attempted to raise alternative financing.[6] Ultimately the company obtained approval for a reorganization plan via the Court appointment of insolvency specialists as the plan monitor. The monitor arranged (via auction) for a new financing plan to meet the company's operating costs and the funding for the arbitration.[7]

4. Crystallex International Corporation < www.crystallex.com > announced on June 1, 2011 that certain of the Crystallex's bondholders were seeking an acceleration of the redemption of their bonds because of a purported "Project Change of Control" event following acts by the State of Venezuela in relation to Crystallex's mining assets.
5. See Press Release dated Oct. 11, 2011—"Crystallex Announces Proposed Private Placement To Raise Up To US$120 Million".
6. Under the Companies' Creditors Arrangement Act. RSC 1985 (as amended).
7. Decision of Mr Justice Newbould in the Ontario Superior Court of Justice (Apr. 16, 2012), Court File No. CV-11-9532-00CL.

In most jurisdictions, a court-sanctioned insolvency practitioner will be able to give the third-party funder all of the protections it seeks in the LFA; where no such safeguards exist, a third-party funder may investigate a variety of methods to protect its position in the future. This requires consensus with key shareholders and creditors and may include registering its interest in the proceeds by way of a security interest against the claimant or its assets. A third-party funder may also seek a Standstill Agreement whereby shareholders or creditors agree not to enforce their rights against the claimant until the litigation is concluded or to do anything which will imperil the litigation along the way. Alongside these agreements, a third-party funder may also expect the claimant's lawyer to provide an opinion as to the due execution and enforceability of the various agreements.

[5] Notifications of Funding Arrangements to Third Parties

At present there are no explicit provisions within the various arbitration rules applying to commercial and treaty arbitration, requiring the disclosure of the existence of third-party funding arrangements. There is, however, much discussion amongst arbitrators and lawyers as to whether such disclosure would be a good thing.

Some argue that it is needed to prevent conflicts, say where there may be an existing financial relationship between a funder and an arbitrator (or his or her law firm). Others suggest that if an arbitrator is unaware of the existence of a third-party funder, then by definition it can have no impact on the arbitrator's decision.

Third-party funders, for their part, would seek to avoid funding cases where they have an on-going material economic relationship with an arbitrator. This in itself will be a function of the size of the arbitrator's law firm. Third-party funders are also generally hesitant to disclose their presence if they think it may lead to distracting satellite litigation or ancillary applications to the tribunal. Nonetheless disclosure is sometimes warranted, and in some cases required by law, such as when the funded claimant is a company listed on a public stock exchange and the LFA represents a material transaction for the claimant. See Chapter 3, Ethical Considerations in Third-Party Funding, for more on this and other ethical concerns.

[C] Financial Terms

The financial terms are usually the first (and among the quickest) points to be agreed upon when negotiating the LFA. Typically they are agreed upon as a first step when the third-party funder has conducted its own prima facie assessment of the case and understands the case sufficiently to be able to offer terms that should satisfy the third-party funder's risk and reward requirements.

The logic behind this approach is that it is not worth the claimant, the third-party funder and the lawyers spending time and energy negotiating contract terms and then conducting due diligence if there is no meeting of minds on the numbers. More often than not, the preliminary budget and third-party funder terms can be agreed within a week.

[1] Budget and Maximum Investment

The budget or costs estimate is a key item. Its structure identifies how cash resources will be spent through the various phases of the case and in what way they will be spent, e.g. on arbitration lawyers, local law experts, tribunal fees, and expert witness fees.

It needs to be stress-tested for plausibility and should not be a "marketing" budget. In fact, unrealistic budgets tend to set-off third-party funder alarm bells. A well-thought-out budget may well include unallocated contingencies and ranges for different phases.

The budget may be used to produce a cap on the lawyers' fees, and in return for this risk, the claimant might grant the lawyer an upside interest in the case. In any event, the budget will be a pivotal document in defining the Funder's maximum investment in the case. Without this, neither the claimant nor the third-party funder can explicitly identify the extent of the third-party funder's investment and agree upon the financial deal.

The maximum investment will also need to incorporate planned expenses in relation to any upfront premium for an adverse costs insurance policy or cash advance required as security for costs (*see* below).

Notwithstanding the above, the budget is not the end of the story on billing as the case progresses. Inevitably all parties will need to deal with deviations from the budget, as some facets of the case become more important than others. All commercial funders are sensible enough to know when an additional unplanned expense is necessary; they are also uniformly resistant to overspend on foreseeable items. Ultimately, the process amounts to a three-way, on-going negotiation between the claimant, the lawyer, and the third-party funder to ensure that the right amount of money is being spent on the case given the prospects of successful recovery at that time.

[2] Adverse Costs and Security for Costs

In the context of international arbitration, particularly treaty cases, tribunals have historically been reluctant to award costs against a losing party. They have often found a basis for each side to bear its own costs. However, this is no longer always the case. In the context of commercial arbitration in particular, it is very common for tribunals to apply an English-style "loser pays" rule.

More recently, respondents have petitioned arbitration tribunals to make orders requiring the claimants to provide security for adverse costs. To our knowledge to date, these petitions have not found favor in treaty cases, though they have been considered in some commercial cases.[8]

8. In particular, some respondents have argued that since the claimant is only able to bring a claim because it has the backing of a third-party funder, it is only equitable that the respondent should have security for its costs in case the claim is dismissed. This argument seems contrary to essence of an arbitration agreement where the possibility of a third-party funder of either side's legal costs is not contemplated at the moment of consent to the arbitration, at which

To the extent that finance for security for costs orders or a future adverse costs award is required, the funded claimant will likely need the third-party funder to also pay these sums or enter into an arrangement with an insurer to cover these risks.

[3] Typical Funding Terms in the Market

The price for litigation funding varies from third-party funder to third-party funder, as does the structure of the third-party funder's terms. Some are more expensive than others in general; others price different risks at different rates. Regardless of variation in approach, the cost of litigation funding is often referred to as "three times." The term "three times" means that a third-party funder (if a case is successful) hopes to achieve a return of at least three times its investment to date, i.e. for every dollar invested, it hopes to receive that dollar back plus two more. The third-party funder will hope to achieve this return whether the case settles relatively early, or is only resolved following enforcement of an award. However, this is usually on an expectation basis, so that if the damages outcome is more modest than expected then the third-party funder may well undershoot three times and likewise, where damages are greater, the third-party funder may exceed expectations.

For many newcomers to dispute resolution funding, the cost of the money can seem high, if they come with expectations built on bank interest rates. But the key difference is that this is non-recourse money used to finance a project, i.e. the arbitration. If the project fails, the third-party funder loses its entire investment. In other words, dispute resolution funding is an equity investment in the claim, not a full recourse loan provided to the claimant.

The best comparable price data can be drawn from the worlds of venture capital, private equity and project finance. Their equity investors look to achieve three times multiples on their equity investments when they are successful over similar three to five-year time horizons and run similar risks of total loss.

In all of these investment strategies, if third-party funders manage business well and achieve three times on their winners over a six-year fund cycle, allowing for the occasional "home-run," then once the cost of the losers and the running costs of the investment business are deducted, the total net return on the portfolio of cases or projects will look more like two times, i.e. a return of every dollar invested plus one more, or in other words, a profit of 100%. In simple interest terms, this 100% profit would in turn equate roughly to an investment return on the portfolio of 15% to 20% over five to six years.

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point each side accepts the risks around the other party being able to pay the costs or damages, or provide security for costs, associated with any future arbitration under the relevant contractual jurisdiction clause.

To look at the position further, if the credit standing of a respondent or claimant should improve (post consent to arbitration) via the presence of a third party, for example, where a litigant is purchased by another entity, or at least funded by a parent within a group structure, this would not give the other party grounds to seek security for costs. This is not a term that any tribunal would import to arbitration rules. But if this is right, then it must also be right that the funded claimant should not be treated differently.

It is this portfolio return[9] over a lengthy period that is attractive to long-term investors such as pension funds who need to generate capital growth of this magnitude to provide for retirees who are remaining healthy and living longer and longer.

[4] An Approach to Valuing A Claim and Offering Terms

This section 2.02 [C][4] is included for the reader who would like some further insight into how a third-party funder attempts to fit a quantitative framework around the qualitative asset that is a legal claim. This framework is an essential part of determining that, following prima facie assessment, a case offers the necessary potential. However, as described below, it is not the only benchmark for assessment.

[a] What Determines the Value of A Claim?

Below are the key variables that determine a third-party funder's assessment of the value of an arbitration claim. They are:

(1) Jurisdiction—what is the strength of the legal arguments raised by the respondent? Why might the tribunal resist seizing jurisdiction?
(2) Merits—how strong is the factual matrix supporting the theory of liability? Will the case involve considering open points of law?
(3) Quantum—how much of the loss flows from the respondent's conduct? Did the claimant have an operational track record to support a lost profits claim? Alternatively, were there proven valuable assets held by the claimant that have been confiscated or impaired by the respondent's conduct?
(4) Recovery—what is the credit standing of the respondent? Do they have a presence in the OECD world which can be attached? Are they a sovereign state adopting a "won't pay" policy? What is the size of the claim relative to the size of the respondent?
(5) Duration—how long will it take to get an award? What is the likelihood of a bifurcation of proceedings to hear jurisdiction separately from merits? Might the damages assessment be heard separately? Is there much scope for an appeal, annulment or revision hearing?
(6) Cost—what is the likely cost of bringing the arbitration claim, including any ancillary expenses legal costs?

9. Note that there are additional subtleties here in relation to committed capital versus invested capital, i.e. pension fund investors will view an investment principally in terms of the capital they allocate to the Funder, but the Funder itself will manage its cash day-to-day in terms of capital drawn to fund cases. Nonetheless any funded case will need to offer an attractive return in relation to the amount committed to the case not just the amounts drawn by the date of an early settlement. This applies whether the Funder is a permanent capital company or utilizes a private equity fund model, drawing money for investments as required.

[b] Quantitative Assessment

Now that we have laid out our key variables, how do we turn these into numbers? Cost, duration, and quantum are the most straightforward, yet all may well be subject to significant deviation from expectation as the arbitration progresses. A conservative day one valuation approach would be to assume expense and duration at the upper end of the forecast and quantum at the lower end, focusing purely on the claimant's wasted investment costs.

Assessing recovery prospects, too, can be relatively straightforward, depending on the nature of the respondent. Large corporate and sovereign state respondents will have credit ratings and debt instruments that they have issued from which a probability of their future ability to pay can be extracted. In fact, it is reasonably straightforward to assess the probability of a large respondent defaulting on its financial obligations. However, such assessments only yield the "can't pay" risks, not the "won't pay" risks. This is a subjective judgment about the international footprint of the respondent, the size of the likely award relative to the asset position of the respondent, the possibility of similar claims emerging, and in the case of states, the likelihood of political change for better or worse. Third-party funders tend to divide respondents into two camps: respondents worth pursuing (either because they have a history of paying or because they can be compelled to pay through enforcement), and the rest. The third-party funder then assesses the "won't pay" risk as close to zero, and relies purely on the "can't pay" assessment.

This leaves assessing the key legal variables, namely the strength of the legal arguments on jurisdiction, liability and the theory of damages. In the UK litigation circles, barristers are regularly asked to give their views on the prospects of success in percentage terms. However, such assessments of success fail to disaggregate prospects of settlement from those of winning at trial. In many domestic court systems, the percentage of cases that settle exceeds 70% or even 80%; limited empirical data would suggest that a smaller percentage of arbitrations settle, and that the prospects of success of cases that go to trial may be nearer 50% to 60%.

Payments flowing to the claimant will be radically different in each of these outcomes. A settlement will usually result in a claimant with the upper hand still taking a significant discount, or if a case has worsened, discontinuing on a "drop hands" basis. At trial, outcomes are polarized between losing and paying adverse costs, or winning and recovering costs, although settlements on the court steps or in the face of a possible appeal are commonplace.

A similar type of analysis can be applied to bifurcated arbitral hearings, in that a claimant might lose on a technical point when the amount of investment in the case is a small percentage of the budget, which may increase the tolerance for jurisdictional merits risk. Loss on liability at a late stage merits hearing will usually involve having spent most, if not all, of the maximum investment. Moreover, because jurisdictional issues tend to be less uncertain, it is easier for third-party funders to assess the merits.

[c] *An Example of a Matrix Approach to Valuing a Claim Used by Calunius Capital*

Matrix approaches are common in claims valuations. A matrix is a table of numbers, but where the numbers in the rows and columns may represent different scenarios. One general use of such a matrix is to use all the numbers en masse to estimate a particular aspect of the future.[10] Below, we adopt such a use to estimate the future value of a claim.

The matrix, as we know and use it today, was originally created by Arthur Cayley, a barrister in London.[11] Cayley, a mathematician who turned to law to pay the bills, invented the matrix to track invoices for conveyancing and drafting services he provided.

Let us demonstrate the matrix approach with the example of a hypothetical case being heard before an ICC Tribunal seated in Paris. Imagine a dispute between a medium-sized European family engineering business (FAM S.A.), which has produced high quality specialist engine parts for over half a century, and a global automotive manufacturer (CARCO).

FAM S.A., the claimant in the arbitration, alleges that CARCO has wrongly rejected delivery of parts under a multi-year supply contract. FAM S.A. suspects that CARCO has found a cheaper, alternate parts supplier. The claimant estimates its net damages (after counterclaims) at between USD 30 million and USD 40 million. CARCO has subsequently counterclaimed for damages, alleging that the parts were substandard and it was forced to seek an alternative supplier.

Both parties have instructed well-paid lawyers and experts such that the cost of the arbitration to each side including tribunal fees at the upper end is estimated to be USD 2 million. It is expected that the case will take two years to reach an award, with jurisdictional issues to be heard by the end of year one.

Lawyers to FAM S.A. approached a third-party funder to enquire whether it might be interested in funding the case. The third-party funder has conducted its prima facie assessment of the case materials and views the probability of eight possible outcomes in the case (at the end of the Year 1 and Year 2) as being described in Table 2.1.[12]

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10. The word matrix derives from mater, the Greek word for "womb," the idea being that the rows and columns of the matrix are the place from which something else originates.
11. Cayley practiced at 2 Stone Buildings, Lincoln's Inn, London. During this time, he published his "Memoir on the theory of matrices" in 1858. (Mathematician and sometime author Charles Dodgson (better known as Lewis Carroll) surprisingly objected to the term "Matrix," preferring the more prosaic term "Block." Unlike the adventures of Alice this term did not catch on).
12. The sum of the 8 probabilities in the Outcome Probability matrix is 100%, i.e. the case has to terminate in one of these 8 outcomes.

Table 2.1 Outcome Probability Matrix

Outcome Probability	Post-Jurisdiction (1 Year) (%)	Post-Award (2 Year) (%)
Probability of Loss	5	20
Probability Settle at 50%	20	10
Probability Settle at 70%	10	15
Probability Win 100%	0	20

This matrix combines the risks associated with items 1 and 2 from section 2.02[C][4][a] being Jurisdiction and Merits, which leaves the third-party funder needing to incorporate quantum, duration, and recovery to establish an expected value for the claim. This expected value can then be compared with the cost to see if the third-party funder could provide litigation funding with the correct return characteristics.

Continuing with duration and recovery, the third-party funder can adjust the percentages in the Matrix to reflect the risk that CARCO "can't pay" in the future. CARCO has publicly issued bonds outstanding from which the third-party funder estimates a discount rate to be applied to the potential future sums payable by CARCO. This means that the third-party funder discounts CARCO's possible future payments by an additional small percentage to reflect the probability that CARCO "can't pay" at that time.

To assess quantum, the third-party funder constructs a similar matrix with quantum amounts associated with each of these possible eight outcomes. Having analyzed the quantum analysis provided by the claimant, the third-party funder takes a conservative approach and estimates the most likely outcome on damages to be USD 30 million. Working with this figure generates the Quantum matrix in Table 2.2.[13]

Table 2.2 Quantum Matrix

QUANTUM (USD million)	Post-Jurisdiction (1 Year)	Post-Award (2 Year)
Loss	0	0
Settle at 50%	15	15
Settle at 70%	21	21
Win 100%	30	30

13. These numbers would usually be adjusted further to reflect the award of interest on the amounts claimed and the possibility of recovering at least some of the costs.

Finally, the third-party funder uses these eight possible quantum outcomes to work out an expected value of the claim, by simply multiplying the relevant entries from the Probability Matrix with the equivalent entry in the Quantum Matrix and adding them together.[14] This calculation gives an expected value of the claim of roughly ***USD 15 million*** (when adjusted for the future recovery risk against CARCO).

Against this expected value, the third-party funder is asked to fund costs of up to USD 2 million. Assuming these costs split equally over both years, the Outcome Probability matrix suggests there is a 35%[15] probability the case ends at the end of year 1 and 65% at the end of year 2. This implies that the third-party funder expects to spend ***USD 1.65 million*** on the case.[16]

The third-party funder is now equipped with an expected value for the claim and an expected investment amount. Here the third-party funder can see that three times is roughly USD 5 million (being three times USD 1.65 million of expected costs), i.e. about one-third of the expected value of the claim. Accordingly based on the prima facie assessment, it makes financial sense for the third-party funder to offer terms where the third-party funder would receive around one-third of any award or settlement. The third-party funder thus offers terms to FAM S.A. where it receives the return of its investment plus the greater of (a) two times its investment, or (b) a percentage of the proceeds stepping up from 20% to 35% over two years.

[d] Qualitative Assessment of the Claim

The quantitative assessment described above can only carry the third-party funder so far. While the LFA is negotiated and due diligence is carried out, the third-party funder must carry out an equally important qualitative assessment of the other elements that make up the strength of the claim.

At this point, the third-party funder steps away from the spreadsheet and appraises those less tangible variables such as the background story, the claimant's likely credibility as a witness, the potential tribunal composition, and the exposure to significant disclosure of unseen documents. The process of assessing these variables is described in section 2.03 below. In the end, only claims that hold up on a quantitative and qualitative basis are funded.

14. Mathematical purists might point out that this is not quite how Matrix arithmetic works under Arthur Cayley's rules, but this author would contend that the spirit is the same—the idea that the value of the claim originates from these possible outcomes.
15. By adding the probabilities in the column "Post-Jurisdiction (1 Year)".
16. It is also common for a third-party funder to be asked to provide additional capital either by way of provision for a future adverse cost orders, or for security for costs. This element of funding is not explored here.

§2.03 CASE DUE DILIGENCE

[A] Purpose of Due Diligence

The purpose of due diligence is for the third-party funder to verify the basis for investing in a particular case and to conclude any additional legal or other analysis not previously undertaken.

Similarly to how lawyers report that the last few weeks before trial are the moment when they agonize over every last detail, this initial due diligence period is the time of most intensive activity for a third-party funder (as opposed to case monitoring). At the end of the due diligence period, the third-party funder must decide whether to say yes or no, knowing that from this moment onwards they are exposed to the full range of risks associated with the case. However, due diligence is not an exercise in identifying only cases without risk; rather a third-party funder in due diligence seeks to confirm that the case carries the right balance of expected return versus expected risk, assessed on both the quantitative and qualitative bases described herein.

[B] Role of Claimant Lawyer

Claimants' lawyers often ask what is expected of them in the due diligence period. In the model adopted by third-party funders in the common law market, the third-party funder is clear that this is a non-reliance relationship. In other words, the claimant's lawyers assume no fiduciary or advisory role towards the third-party funder. That is not to say that the third-party funders will not ask claimant's lawyers for their view on case prospects or the quality of evidence. However, these questions are asked to enable the third-party funder to calibrate its assessment of the case and the people involved.

Claimants' lawyers also often inquire into the likely time burden of responding to the third-party funder due diligence questions and providing case materials. Demands on claimants' lawyers' time can be considerable if the case is in early stages, e.g. pre-pleadings and witness statements. However, if the claimant's lawyers have already taken the step to seek funding, then they have almost certainly committed to some risk regarding time investment, based on an initial view that the case is worth pursuing. Occasionally, some third-party funders may invest small amounts to develop early stage cases, but if neither the claimant nor the lawyers are prepared to take some risk at this stage, then it is tough to sell the case prospects to a third-party funder.

In a late stage investment, where the case is advanced and the third-party funder can have full sight of the case documents, the demands on the lawyer's time to answer questions are greatly reduced. Either way, lawyers usually ask, and third-party funders usually agree to pick up the cost retrospectively of dealing with these due diligence enquiries, rolling it into the case budget if the third-party funder proceeds.

[C] Verification of the Prima Facie Assessment of Merits and Quantum

For lawyers with experience handling corporate transactions, such as public offerings of shares, verification is well understood. In the context of an offering of shares with an investment memorandum (IM), the management of the company will have put together a bible of documents which support or justify each of the key statements in the memorandum as to the future prospects of success for the company.

Just as lawyers must collect documentation on forthcoming corporate transactions, so too must the third-party funder request all the key documents supporting the case. Whatever the quality of the materials, the third-party funder must then build the case "IM" which will determine whether or not a third-party funder finances a case.

Any lawyer who has written an Offering Memorandum for corporate securities knows that this is a demanding exercise. The third-party funder will need supporting evidence for all key items in the IM. This IM will also extend beyond case features and may cover other key items such as background on the claimant, prospects of recovery, lawyer's track record, analysis of an arbitrator's previous decisions and of course the potential reward and financial risks of the investment.

The IM will typically be written after the prima facie analysis described in section 2.02[C][4] has been done and the financial terms have been set. The key task within the IM process is verifying the initial assessment of merits and quantum.

To verify the merits of the claim, both as to jurisdiction and liability, some third-party funders utilize due diligence questionnaires (DDQs) along the lines of those used in corporate finance to ensure that they cover all the key questions each time they review a case. Within that they will typically ask to see some or all of the following documents:

(1) The key contracts underlying the commercial dispute;
(2) Documents evidencing ownership of key assets, such as licenses and shareholder registers and certificates, including for any indirect holding companies;
(3) Any witness statements; and/or
(4) Any legal opinions provided by the claimant's lawyers.

This list is not exhaustive, and once the third-party funder has digested it, there will be supplementary requests for information. To the extent that the due diligence on the claim identifies technical legal issues on jurisdiction or liability, it is common for the third-party funder to rely on advice from its own lawyers to supplement its analysis.

To assess the quantum of a claim, a third-party funder may want to see some combination of the following:

(1) Accounts (ideally audited);
(2) Invoices or bank statements; and/or
(3) Any available expert reports on damages.

These items are not always necessary, in that it may be very clear from an underlying contract how the relevant amount of damages should be measured. A common example is a contract for the provision of brokerage or introduction services. In more technical claims, such as those involving the supply of engineered products, or construction projects, in the likely case that a funder lacks in-house technical expertise, it may draw on its own advisers, as well as the technical advice provided to the claimant.

In the context of quantum in investment treaty claims a distinction is usually drawn between "sunk" investment costs and damages based on market-value assessments. Frequently, a third-party funder will focus its due diligence on the former, knowing that if a tribunal awards damages on a market-value basis, these would usually be greater, and that verification based on audited financial statements, rather than future cash-flow models based on expectations of profitability, is far more reliable and comforting.

Ultimately, successful verification depends on the quality of the documents available and the speed with which they can be provided. In general, publicly listed companies working in conjunction with well-resourced law firms can quickly organize large volumes of information into indexed due diligence websites with secure access for third-party funders to analyze the materials.

[D] Exposure to Defendant Discovery

As described above, a third-party funder makes its assessment based on expected returns and risks. By definition, cases that carry with them unexpected risks are less attractive. These are the dreaded "known unknowns." In particular, cases where the merits will be heavily determined by discovery of documents from the respondent are difficult. Patent infringement and misuse of confidential information cases can fall into this camp, though there is a separate industry of specialist third-party funders whose focus is IP litigation.

By contrast, in investor-state expropriation cases, or commercial matters following on from proven criminal activity such as fraud or cartel pricing, there may be a presumption that discovery can only add to an already very strong case.

Between these two ends of the spectrum are general commercial claims, typically originating from breach of contract where liability will be determined by a combination of the wording of agreements and witness testimony as to the intention of the parties. Here, the third-party funder's due diligence will focus heavily on its assessment of the key evidentiary documents and the claimant and the respondent parties as described below.

[E] Use of Outside Lawyers and Other Advisers

It is common for a third-party funder to rely on advice from its own lawyers on some of the issues arising on a case. Because this cost is absorbed by the third-party funder, most third-party funders attempt to restrict the scope of any such analysis to a small number of critical issues (typically local law questions in novel jurisdictions) to minimize cost and time taken. In an ideal world, any such analysis will be compressed into a two- to three-week period. Of course, if the case does not raise new issues, a third-party funder may decide it does not need external advice.

[F] Background on Claimant and Respondent, and Related Entities and Witnesses

As highlighted above, a key component of the due diligence period is for the third-party funder to assess qualitative factors around the claimant. This will incorporate the standard background checks that are now required by law to ensure that the third-party funder "knows its counterparty" and may go further depending on case circumstances. Much of the third-party funder's comfort will come simply from spending time with the claimant and witnesses to understand the story behind the claim.

When assessing the respondent and its ability to pay in the future, there is only so much useful work that can be done given that different circumstances may well exist by the time the claimant has obtained a favorable award. As discussed above, this analysis may boil down to answering the question: "Based on current information, is there any reasonable basis to believe that the respondent cannot be compelled to pay?"

§2.04 CONCLUSION

The observations in this chapter draw upon the author's practical experience of operating in a new industry where new participants emerge regularly, and where the approach of practitioners, both legal and financial, evolves week by week.[17] During the course of writing this chapter, much of the content of this chapter was reshaped to reflect the reality of live commercial negotiation and public debate.

This chapter is clearly not the last word on the themes contained herein, partly because different third-party funders have different approaches, but principally because all third-party funders are constantly adapting to the evolving market. For example, the issue of disclosing the existence of funding, mentioned above, continues to invite discussion. Likewise, the extent to which different judicial forums and jurisdictions permit the active involvement of third-party funders in cases, and the desire (or absence thereof) to regulate the industry, is being constantly debated.

This debate is important and inevitable given that the dispute resolution funding industry is now, even on conservative estimates, a billion dollar industry. Further evolution is a good thing, and the industry will improve with increasing harmonization of contractual provisions and regulation.

17. The observations herein also draw heavily on the experience of the author's fellow partners at Calunius Capital, namely Mark Wells, Christian Stuerwald and Leslie Perrin, without whose assistance and dedication over the years, this chapter would not have been possible, and to whom the author owes an immense debt of gratitude.