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THE TIPS & TRICKS OF LITIGATION FUNDING

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SAM LUTTRELL, AMANDA MURPHY & RODOLPHE RUFFIE

INTRODUCTION

- The natural resources sector generates a high volume of disputes – business versus business and business versus government.
- But litigation and arbitration are costly processes and companies often either lack the funds required or conclude that they would prefer to spend their money on more profitable activities.
- For some time now, Litigation Funders have presented themselves as a solution to this problem. While Litigation Funding has ensured access to justice for many mining and energy companies in recent years – including in high-profile expropriation claims against African governments – experience shows that the devil is in the detail and, when it comes to Litigation Funding Agreements, it is essential to understand how the key factors of risk, cost, time and quantum interact.
- In this seminar, we will look at:
  - What Litigation Funding is and how the Litigation Funding market has evolved.
  - Why Litigation Funders are attracted to cases in the natural resources sector.
  - How Litigation Funders vary in the way they participate in a case.
  - The typical terms of a Litigation Funding Agreement (and terms to avoid).
  - The economics of Litigation Funding and the factors that affect a company's overall recovery, using a hypothetical case (and economic model) to illustrate the key points.
- We will focus on funding of claims against foreign governments, as these claims are of greatest interest to Funders, but most of what we say applies equally to the funding of commercial (company versus company) cases.

WHAT IS LITIGATION FUNDING?

- Generally speaking, "*Litigation Funding*", or "*Third-Party Funding*" (**TPF**), means any arrangement in which a third party (the **Funder**), who is not a party to the dispute, finances the costs of a legal proceeding (litigation or arbitration) in return for a success fee if the funded party (the **Claimant**) wins.
- Typically, Litigation Funding is provided on a non-recourse basis, meaning the Claimant has no obligation to pay back the Funder's investment if the claim fails and the Claimant is only bound to pay the Funder if there is a "*success*" event. Usually, the Funder's only security will be a charge over the future proceeds of the claim.
- The Funder's success fee will normally be calculated based on a time-weighted multiple of the Funder's investment (the amount expended at the date of success) or a percentage of the proceeds received by the Claimant upon success (whichever is higher). Some Funding Agreements provide for fixed success fees – though the multiple/percentage combination is more common.
- Litigation Funding in its modern form first emerged in Australia, one of the first jurisdictions to relax the old common law rule that deemed it unlawful for a party with no prior interest in a legal proceeding to finance the proceeding with a view to sharing in the property to be gained if the proceeding is successful (this is known as the "*doctrine of champerty*").
- Since its birth in Australia, Litigation Funding has become a booming global industry. As a result, the term "*Litigation Funding*" now has a broader meaning, including everything from After-the-Event (**ATE**) insurance products to direct investments by private equity in law firms (i.e. arrangements that see a Funder commit to pay the cost of a portfolio of cases being run by a firm, rather than just a single action).

WHY FUNDERS ARE ATTRACTED TO THE NATURAL RESOURCES SECTOR

- In recent years, Funders have had some big wins backing natural resources companies, particularly in claims against foreign governments. For example, the Funder that backed Crystallex in its expropriation claim against Venezuela is reported to be entitled to USD 800 million of the USD 1.4 billion arbitral award made in Crystallex's favour.
- This example and other cases have made Litigation Funders very interested in the natural resources sector: indeed, some funders are even specialising in the natural resources sector, seeking only mining and energy cases. The main reasons Funders are attracted to the natural resources sector are:
  - The natural resources sector consistently sees a steady flow of large-scale transactions and investments, often in high risk jurisdictions, meaning there is a greater than usual chance of disputes arising and the sums in dispute are often large.
  - The natural resources sector is diverse, with many single-asset mining and energy companies (often exploration stage) who may lack the cash-flow needed to cover the costs of a long court case or arbitration, even though they may well have a good claim.
  - Mining and energy companies are established users of arbitration (rather than litigation) to resolve disputes – especially cross-border disputes – and Funders tend to like arbitration more than litigation (especially in countries where the courts are not reliable).
  - The natural resources sector generates a high volume of investor-State disputes (expropriation/nationalisation cases) and these disputes are often resolved by international arbitration under Bilateral Investment Treaties (**BITs**) and Free Trade Agreements (**FTAs**). Mining disputes account for approximately 25% of cases at the International Centre for Settlement of Investment Disputes (**ICSID**) in Washington DC.
- Thus, any natural resources company that is party to an international dispute to be resolved by arbitration and is considering Litigation Funding should be aware that, provided it has a good claim, it will usually have numerous Funders to choose from. The key thing to recognise is that, if your company is in such a dispute, your claim is an asset and you are entering a different asset class.

HOW FUNDERS VARY IN THEIR APPROACH

- The global boom in Litigation Funding has fundamentally changed the composition of the sector: where even five years ago, the market was for the most part dominated by a small group of major Funders in Australia, London and New York, the market today is deep, diverse and decentralised.
- In the last five years, a new generation of Funders has emerged, backed by private equity, with business strategies and approaches to case management that are quite different to the incumbents. As a result of this change, businesses who are considering Litigation Funding need to be aware of the different "*species*" of Funder and how they vary in their approaches.
- Today, broadly speaking, there are three main species of Funder, each with a distinct approach:
  - **Passive/debt-oriented**: this "*classical*" species of Funder will typically participate in the claim under a traditional, non-recourse (debt) Funding Agreement (with a multiple and/or percentage-based success fee), having no day-to-day input on the conduct or management of the case (but with a right to monthly updates on case progress and a right to be consulted on settlement offers).
  - **Intermediate/product-oriented**: this species of Funder will also usually participate under a non-recourse (debt) Funding Agreement but will have the right to be consulted on matters of case strategy and will offer various services (including legal project management) to the Claimant, and if these services are used their cost will be recovered by the Funder in the event of success (in addition to the multiple/percentage component of the Funder's success fee).
  - **Active/equity-oriented**: this species of Funder will participate in the case by taking an equity position in the Claimant company (either solely or in combination with some form of debt participation), and will have a reasonable degree of control over the claim, either through a contractual mechanism or through representation on the board of the Claimant company (or both). Funders in this species tend to become involved in the case early, before legal proceedings are commenced, and often provide commercial and strategic advisory services in addition to capital support.
- One of the key distinguishing characteristics of Funders generally is the extent to which they are interested in non-cash outcomes. For example, Funders who specialise in backing claims against foreign governments often have an appetite for bonds and other sovereign debt instruments that traditional (litigation-focused) Funders do not. Similarly, some Funders are interested in owning resources assets, where others are not.

TYPICAL TERMS OF A LITIGATION FUNDING AGREEMENT

Funders of the passive/debt-oriented species will typically propose a Litigation Funding Agreement containing the following key terms:

- **Definitions**: "*Claimant*" (the funded party), "*Claim/Proceedings*" (the case being funded), "*Proceeds*" (cash or non-cash equivalents received under an arbitral award, court judgement or settlement), "*Success*" (trigger for Funder's entitlement to Proceeds), "*Funder's Outlay*" (how much the Funder will spend), "*Funder's Fee*" (how much the Funder will get), "*Material Adverse Decline*" (**MAD**) (events that adversely impact Claimants' prospects of success), "*Lawyers*" (law firm appointed to run the Claim), etc.
- **Funder's commitments**: Funder to pay the Claimants' costs in accordance with the Agreed Budget (which will be detailed in an annex); Funder may also pay for ATE/Adverse Costs (if Claimant loses).
- **Claimant's commitments**: Claimant to diligently prosecute (and not compromise) the Claim/Proceedings, to follow the advice of the Lawyers, to pay the Funder's Fee in the event of Success, to disclose MAD events to the Funder, to consult the Funder in the event a settlement offer is received.
- **Warranties**: Claimant's disclosure of all material information on the Claim/Proceedings, solvency, authority, anti-money laundering/anti-bribery, etc.
- **Recovery**: method of calculating the Funder's fee (time-weighted multiple on Funder's Outlay or percentage of Proceeds, whichever is higher) – normally linked to an annex.
- **Priority**: Funder has priority claim over the Proceeds, such that the Funder's Outlay will be paid first if Proceeds are received by the Claimant; Claimant will enter into a separate Priorities Agreement (in form prescribed) to lock-in the Funders ranking as a creditor and secure its priority interest in the Proceeds.
- **Trust**: Proceeds will be held on trust for the Claimant and the Funder, either by the Lawyers or an independent agent (escrow).
- **Dispute resolution**: regime for disputes over MAD events (expert determination by QC/SC); arbitration for all other disputes between Claimant and Funder that arise under the Funding Agreement.

ECONOMICS OF LITIGATION FUNDING

- In most Funding Agreements, the key economic drivers are:
  - **Risk**: the probability of success by Claimant and recovery of the Proceeds (changing over time).
  - **Cost**: the amount the Claimant draws from the funding facility provided by the Funder.
  - **Time**: the effect that the passage of time has on the amount the Claimant must repay the Funder.
  - **Quantum**: the effect that the amount of Proceeds the Claimant receives has on the Funder's entitlement.
- Under most Funding Agreements, the amount the Funder pays in the Proceedings (the Funder's Outlay) will normally be subject to a time-weighted multiple (i.e. a multiplier that increases over time). For example:
  - the multiple in the first 12 months of the action may be 2x, such that the Funder is entitled to be repaid double any amount it has spent if there is Success in the first year;
  - the multiple in the second 12 months of the action may be 2.5x, such that the Funder is entitled to be paid 2.5 times any amount it has spent if there is Success in the second year; and
  - the multiple in the third 12 months of the action may be 3x, such that the Funder is entitled to be paid triple any amount it has spent if there is Success in the third year.
- Thus, with a time-weighted (escalating) multiple, the longer it takes the Claimant to win or settle the case, the more the Claimant will have to pay the Funder (and the less the Claimant will keep from the Proceeds). Conversely, if the Claimant can win or settle the case quickly, with minimal expenditure from the funding facility, the Claimant's portion of the Proceeds will be maximised.
- Note that the Funder will usually also be entitled to full repayment of its Outlay, in addition to the multiple or percentage it takes. This will usually be the first item in the "*waterfall*" of payment.
- The quantum of Success is also a critical factor, because it will usually be what determines whether the Funder gets a multiple on its outlay or a percentage of the Proceeds: the lower the quantum of damages received, the more likely it is that the Funder will take a multiple (rather than a percentage); the higher the quantum, the more likely the Funder will take a percentage.

CASE STUDY
ACE RESOURCES LTD – MOUNT SMITH

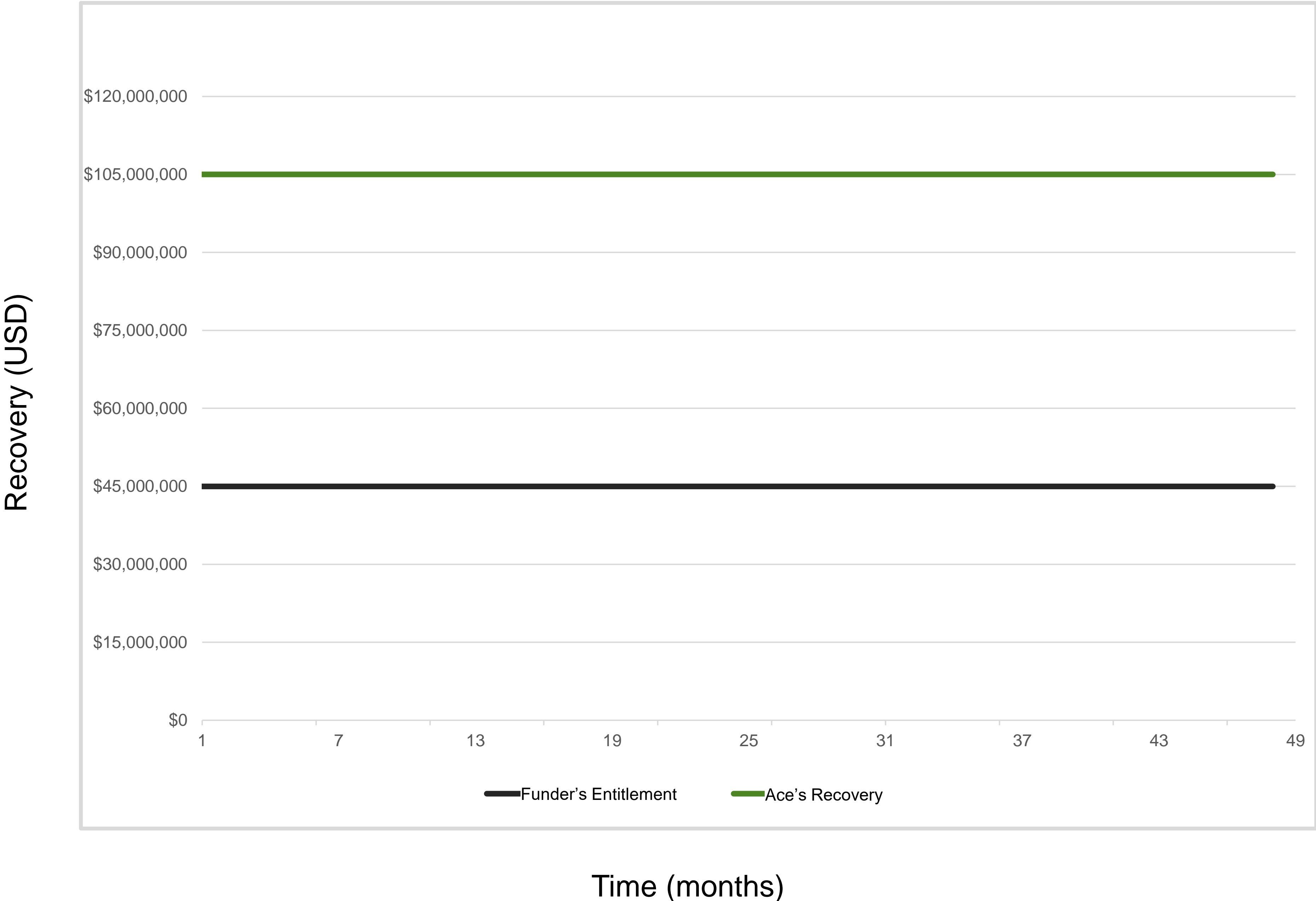
- Eight years ago, Ace Resources Limited (**Ace**), an ASX-listed company, discovered a highly prospective gold deposit at Mount Smith in Ruritania, a country in West Africa, and was in the process of developing a mine when there was a change in government.
- Following the change of government, Ace Resources received a letter from the Mining Department of Ruritania saying that its licenses for Mount Smith had been cancelled as they did not comply with new laws introduced by the government.
- At this stage, the Mount Smith mine had not entered production, but Ace Resources had spent over USD 50 million on exploration, resource development, pre-feasibility studies, bankable feasibility and associated costs. The company had 2.5 million oz of Reserves at Mount Smith and a market cap of USD 200 million.
- Aware of sovereign risk, before Ace made its investment in Ruritania, Ace adopted a corporate structure that provides it with a right to refer investment disputes with the Government of Ruritania to international arbitration at ICSID.
- Ace intends to bring international arbitration proceedings against Ruritania to seek compensation for the cancellation of the Mount Smith licences and the resulting losses.
- Because Mount Smith was Ace's only asset, it does not have the cash to fund the claim, and the company is now in talks with several litigation funders.
- One Funder, XCO, offers a funding agreement for Ace's consideration. XCO is a passive/debt-oriented Funder based in London.

CASE STUDY

KEY COMPONENTS OF CASE AND XCO FUNDING OFFER

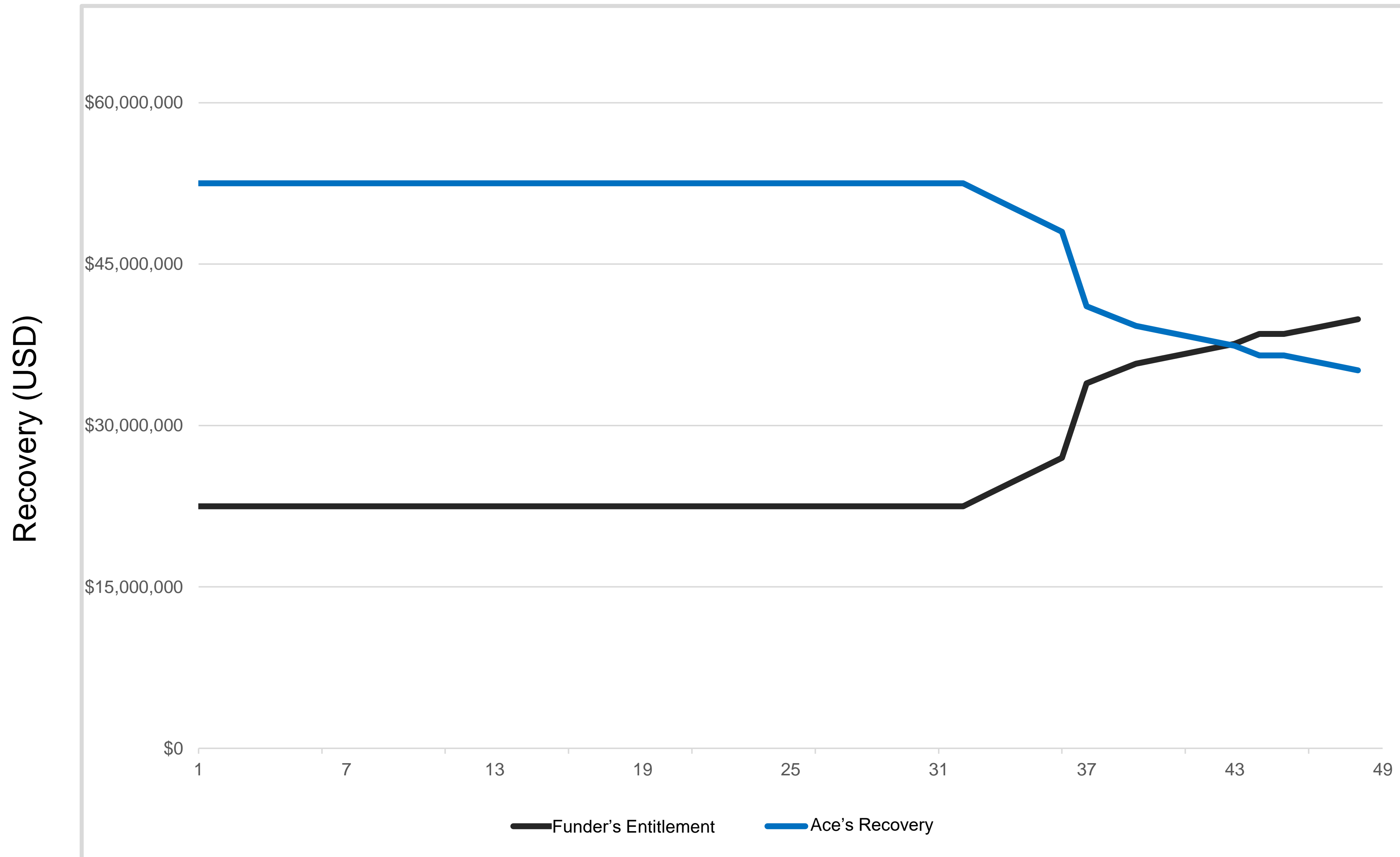
- Using Ace's sunk costs (USD 50 million) as a benchmark for its likely damages, XCO offers Ace a funding facility of USD 7.25 million (i.e. XCO commits roughly $1 for every $7 spent by Ace on the Mount Smith Project).
- Under the funding terms proposed, if there is Success, XCO is entitled to be repaid its outlay plus a Success Fee calculated based on a time-weighted multiple of its outlay or a percentage of the Proceeds (whichever is higher). The multiple is:
  - 1.5x where Proceeds are received in the first year of the Proceeding;
  - 2.5x where Proceeds are received in the second year of the Proceeding;
  - 3.5x where Proceeds are received in the third year of the Proceeding; and
  - 4.5x where Proceeds are received in the fourth year of the Proceeding or any time thereafter.
- Alternatively, XCO is entitled to 30% (flat) of the Proceeds.
- On the advice of its lawyers, Ace prepares an economic model of XCO's offer, with the following cost assumptions:
  - USD 2 million is spent in the first year of the proceedings (legal fees for the Request for Arbitration and Statement of Claim; disbursements for arbitrator and expert fees);
  - USD 2 million is spent in the second year (legal fees for document production/discovery and Ace's Reply to the State's Defence; disbursements for arbitrator and expert fees);
  - USD 2 million is spent in the third year (legal fees and disbursements for a 10-day hearing, including hearing preparation by Ace's lawyers); and
  - USD 1.25 million is spent in the fourth year (legal fees for post-hearing briefs and enforcement of the arbitral award against Ruritania).
- Ace prepares an economic model illustrating three conservative recovery scenarios: low (USD 35 million damages), mid (USD 75 million damages) and high (USD 150 million).

HIGH RECOVERY: $150 MILLION (LOST PROFITS/LOSS OF CHANCE)

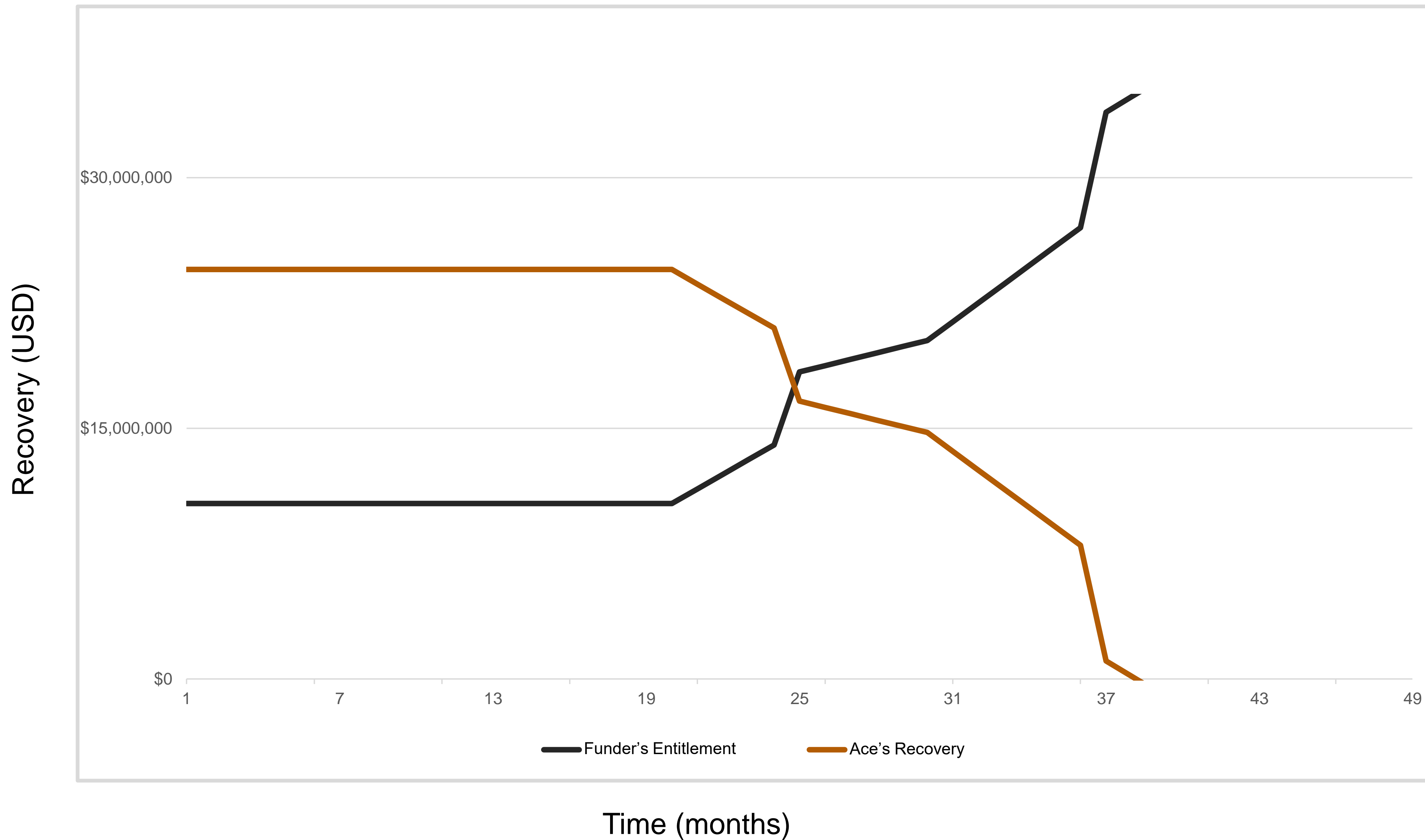


Time (months)

MID RECOVERY: $75 MILLION (FULL SUNK COSTS PLUS COMPOUND INTEREST)



LOW RECOVERY: $35 MILLION (DISCOUNTED SUNK COSTS)



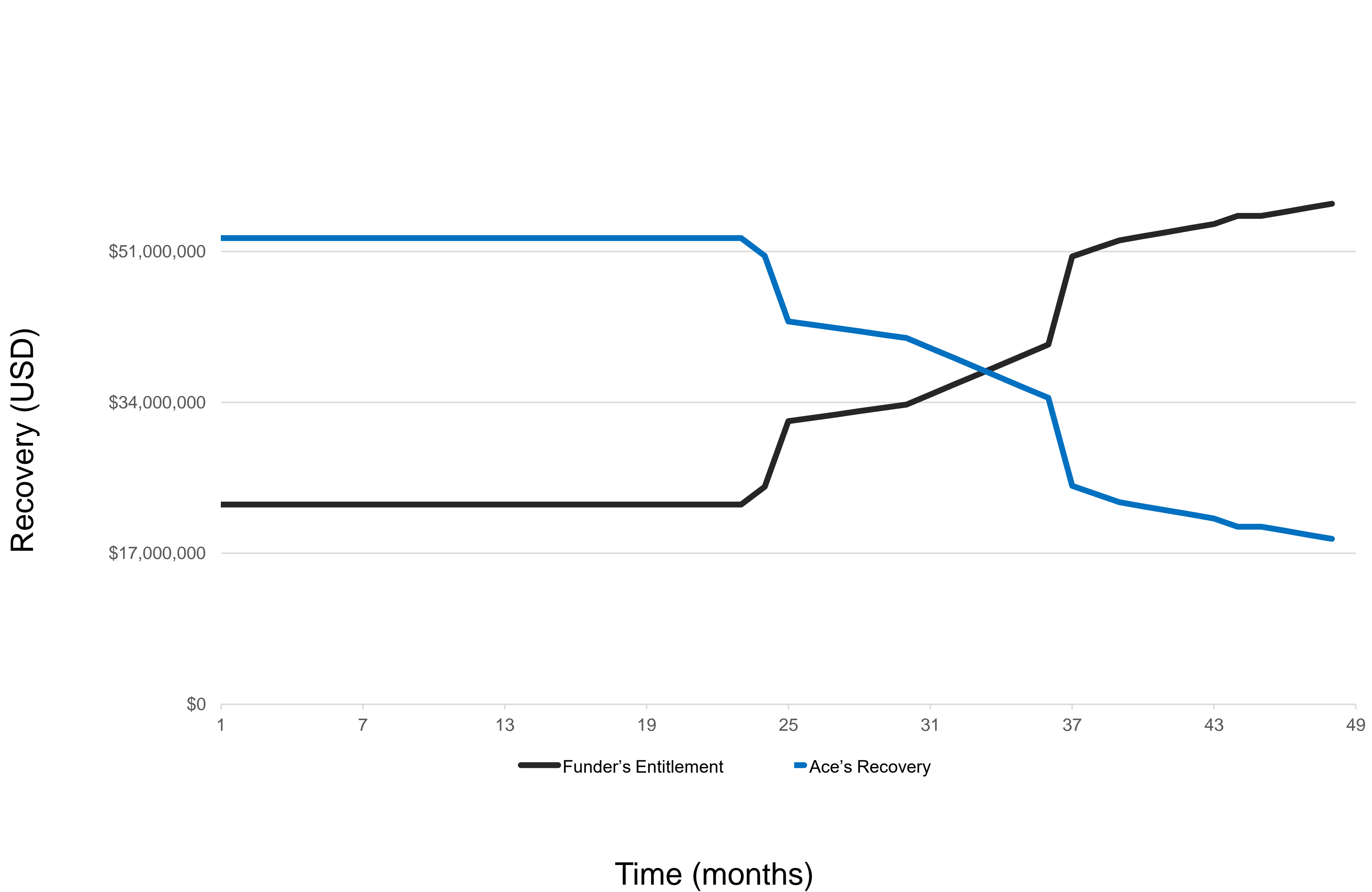
OBSERVATIONS ON XCO FUNDING OFFER TO ACE

- In the high-recovery scenario, where Ace receives damages for lost profits (or loss of chance), the XCO terms work well for Ace: if Ace wins USD 150 million in damages from Ruritania, Ace will walk away with USD 105 million regardless of when Success occurs – this is because the Funder's percentage of the Proceeds (30% flat) will always be more than the multiple of the Funder's Outlay (i.e. time is irrelevant in the high-recovery scenario).
- In the mid-recovery scenario, where Ace receives sunk costs plus compound interest, the agreement still works well for Ace for the first 32 months: up to this point, Ace will walk away with USD 52.5 million of the total USD 75 million received in damages (i.e. Ace will recover all its sunk costs on the Mount Smith project).
- However, in the mid-recovery scenario, from the 32nd month onwards, the multiple of the Funder's Outlay will exceed the value of its flat percentage, meaning the percentage becomes irrelevant from the 32nd month onward as the Funder will always take the multiple. Over time, this drives down Ace's recovery considerably: from the 43rd month onwards, Ace is giving more than half of the Proceeds to the Funder.
- The low-recovery scenario is where the funding agreement is least friendly and Ace's return is most affected by the passage of time: from the 25th month onwards, Ace is giving more than half of the Proceeds to the Funder, and by the 38th month (just over three years), Ace gives *everything* to the Funder.
- Although Ace and its advisers may have good reason to expect the mid-recovery scenario (damages equal to full sunk costs plus compound interest), Ace must properly consider the likelihood of the low-recovery scenario. It is quite common for international tribunals to discount the sunk costs of a claimant company for various reasons, such as inefficiencies in the project or lack of nexus with the disputed investment (i.e. some of the sunk costs claimed were actually incurred on another project).
- If Ace's sunk costs are discounted in any material way, it will quickly find itself edging into the low-recovery scenario where, after just over three years of arbitration, Ace will receive *nothing* even if it wins. As most investor-State arbitration cases take four years to be completed, Ace's position at the three-year mark is critical to consider.
- Fundamentally, if Ace considers that the low-recovery scenario is a reasonable possibility, Ace should seek offers from other Funders and only accept XCO's offer as a last resort.

WHAT IF THERE IS A COST BLOWOUT IN THE ARBITRATION?

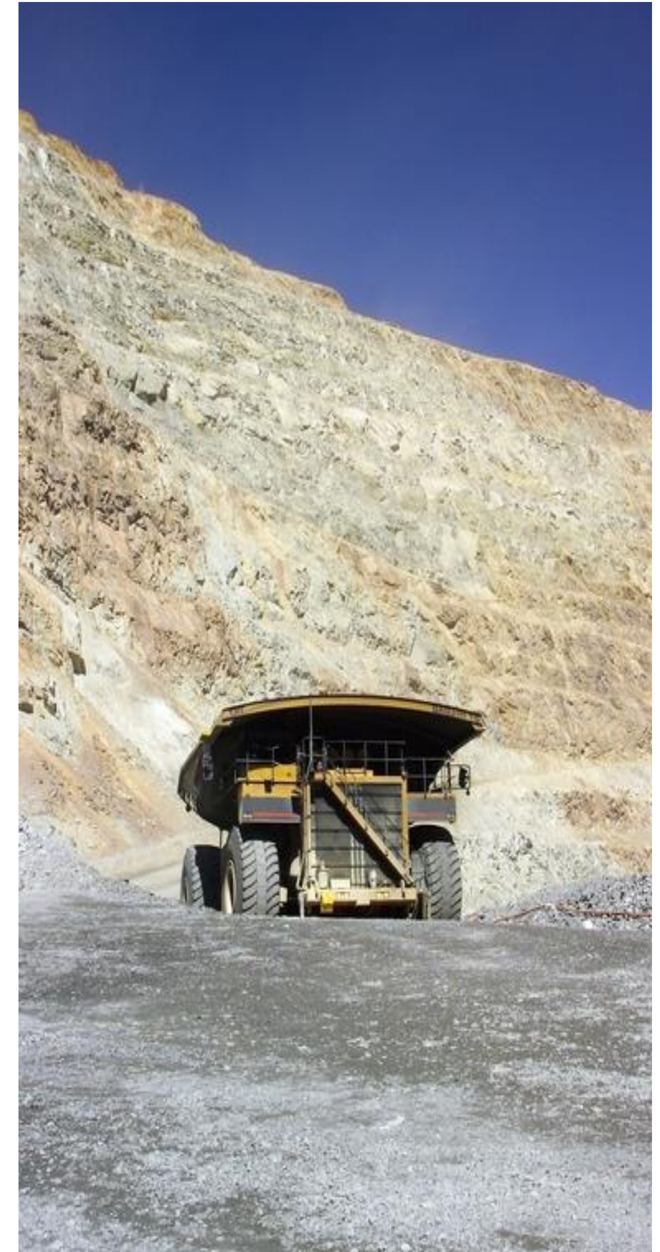
- Now imagine that Ace accepts the funding offer from XCO but the arbitration against Ruritania does not go as Ace's lawyers planned.
- In the second year of the arbitration:
  - rather than spending USD 2 million as planned, Ace's lawyers spend USD 3 million (legal fees and disbursements); and
  - further, following an application by Ruritania, the ICSID tribunal orders Ace to post USD 2 million as security for costs. To comply with this order, XCO provides a USD 2 million bank guarantee in favour of Ruritania (which XCO is entitled to treat as an outlay under the terms of the Funding Agreement, which therefore results in a USD 2 million increase in the overall funding facility).
- As a result, there is a USD 3 million cost blowout in the second year: XCO's outlay by end of the second year of the arbitration is USD 7 million, rather than USD 4 million as planned by Ace's lawyers.
- Ace ultimately wins the case, receiving an award for USD 75 million (i.e. the mid-recovery scenario). At the date of Success, XCO's outlay is USD 10.25 million.

MID RECOVERY: $75 MILLION (BUT WITH $3 MILLION COST BLOWOUT IN YEAR 2)



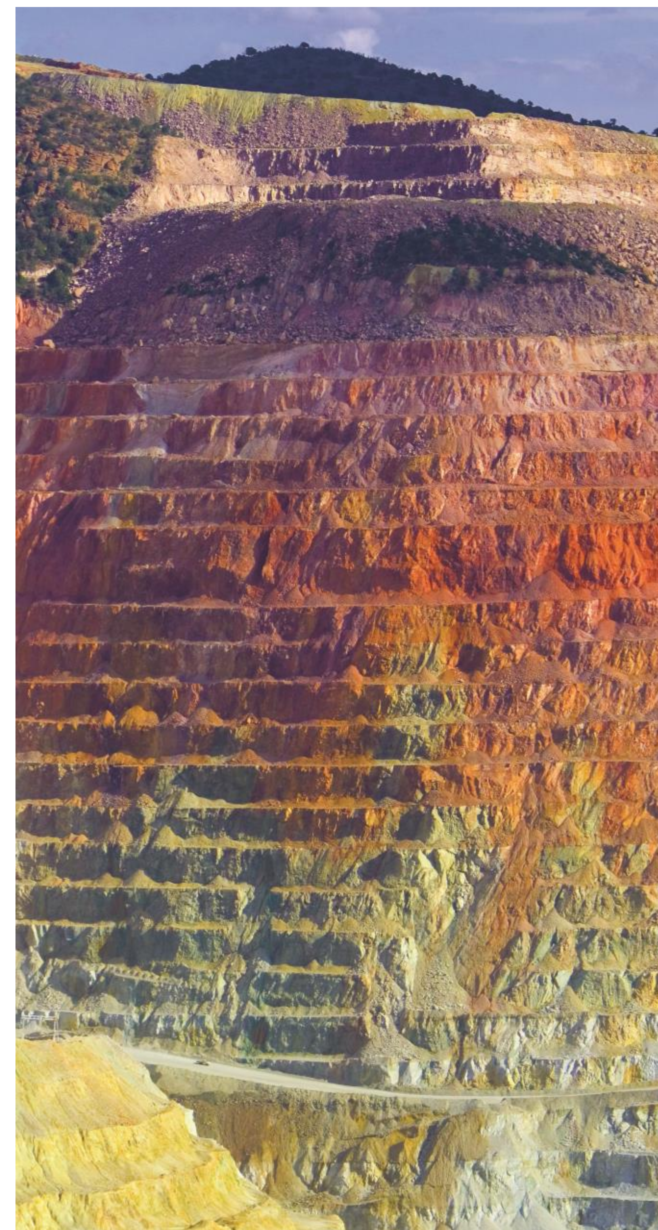
POST-LITIGATION FUNDING: THE ENFORCEMENT STAGE

- The investor-State dispute settlement system is designed to incentivise States to voluntarily comply with arbitral awards rendered against them (in most cases, the State does pay voluntarily, often in the form of a post-award settlement with the investor).
- However, it is not uncommon for States to refuse to pay the damages awarded to investors (especially where the rule of law is not strong, and traditions of accountability are not well established, in the debtor State).
- When a State refuses to comply, the investor must enforce the arbitral award (i.e. convert it into a local judgment) in the jurisdiction(s) where the debtor State has assets and then execute the award against those assets (i.e. use the award as basis to seize the assets of the debtor State).
- But the enforcement process takes time and will usually require court actions in multiple jurisdictions.
- The commercial question is whether it is better to include enforcement funding in the Funding Agreement or exclude it and deal with enforcement funding later (if the State refuses to pay and formal enforcement proceedings are necessary):
  - the upside of including enforcement funding is that it locks-in capital support for the enforcement process, if it is necessary; but
  - the downside of including enforcement funding is that the enforcement stage may add years to the Funding Agreement, and therefore increase the adverse impact that the passage of time will have on the Claimant's recovery.
- If enforcement funding is included in the Funding Agreement, the additional time required for enforcement must be factored into the economic model.
- Businesses need to be aware that most Funders have a strong appetite to finance enforcement and it is also possible to sell arbitral awards to Funders.



CONCLUSION

- Natural resources companies are amongst the current favourites of Litigation Funders worldwide, especially for claims against foreign governments.
- For companies that have good claims but lack the funds needed to prosecute them, Litigation Funding will often make good commercial sense and, indeed, it may be the company's only way of accessing justice.
- However, companies considering Litigation Funding need to understand that there are now several different species of Funder, each varying in the way they approach cases: some Funders are passive, standing back and paying the bills, while other Funders are active, wanting more control over their investment in the case. There is a time and place for each species of Funder and each approach has its pros and cons.
- Ultimately, it is the economics of the Funding Agreement that matter most - understanding the economics requires an awareness of how the key drivers of risk, time, cost and quantum interact.
- In assessing an offer of Litigation Funding, or comparing offers from different Funders, it is critical that the company prepare an economic model for each of the agreements under consideration.
- The model must be realistic, addressing at least three recovery scenarios: low, medium and high. In the assessment of whether the agreement is good for the company, the focus should be on what the Company will keep from the Proceeds in the *low* scenario, on the assumption the case does not settle.
- The last thing you want to do is go through four years of litigation or arbitration and end up giving everything to the Funder and the lawyers.
- But with the right Funding Agreement, and the right lawyers, you should be able to avoid this undesirable outcome.



C L I F F O R D
C H A N C E

SAM LUTTRELL
Partner
Clifford Chance

T +61 (0) 456 871 886
E sam.luttrell
@cliffordchance.com

C L I F F O R D
C H A N C E

AMANDA MURPHY
Senior Associate
Clifford Chance

T +61 (0) 423 264 760
E amanda.murphy
@cliffordchance.com

C L I F F O R D
C H A N C E

RODOLPHE RUFFIE
Associate
Clifford Chance

T +61 (0) 412 104 856
E rodolphe.ruffie
@cliffordchance.com

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