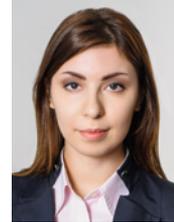


Alternative Techniques for Financing Arbitration Proceedings



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According to the traditional scenario, in order to protect violated rights in arbitration proceedings, a party usually has to rely on its own financial resources. Since the total costs of international arbitration may be significant, before advancing any claim to arbitration, a prospective claimant faces the dilemma of whether to initiate the arbitration proceedings at all in view of the potential financial burden.

This article considers the available techniques for the prospective claimants, who lack the ability to assume all risks and costs of the arbitration, to ensure financing of the arbitration proceedings.

WHAT ARBITRATION COSTS TO EXPECT

When it comes to arbitration-related expenses, the parties may expect to incur the administrative expenses of the hosting arbitration institution, the arbitrators' fees and expenses, and the party's costs, which mainly consist of legal fees and expenses. Notably, the party's costs may form up to 80% of the total cost spent in the arbitration proceedings.

The administrative fees of the hosting arbitration institution and arbitration fee payable to the arbitrators can also run into hundreds of thousands of US dollars depending on the amount of the claim. For example, in case of arbitration proceedings under the ICC Rules of Arbitration with a typical three-arbitrator tribunal and with a claim of USD 10 million, average administrative and arbitration fees will amount to almost USD 400,000. This sum does not take into account other possible significant expenses associated with engaging legal and other experts. Moreover, under the some of the arbitration rules the claimant may be

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required to solely pay all the administrative and arbitration fees. In total, the entire amount that needs to be spent by the claimant in the above example of an ICC arbitration proceeding could exceed USD 1 million.

Further distribution of costs of arbitration between the parties in the final arbitral award is not always fully predictable. In fact, the arbitral tribunal retains quite broad discretion on how to apportion the incurred costs of the arbitration as between the parties. While doing such exercise, the arbitral tribunal will take into account a number of circumstances, such as the outcome of the case, each party's contribution to the efficiency and speed of the arbitration, as well as any other relevant circumstances.

Accordingly, a claimant always bears a risk of liability for the certain part or the entire amount of costs of the arbitration proceedings depending on the outcome of the case.

The above exposure to the significant financial obligations in the course of the arbitration proceedings and not fully predictable decision of the arbitral tribunal on the distribution of costs in the final arbitral award may be a significant hurdle for a party when taking a decision on commencing arbitration.

ALTERNATIVE FINANCING TECHNIQUES

The costs of initiating and participation in arbitration proceedings can be reduced in different ways. The traditional way involves various fee arrangements with the legal counsel representing the claimant, e.g. alternative billing schemes that may be implemented between a client and its legal team, including fixed fee, application of blended rates irrespective of the seniority of lawyers working on the case, or various success fee mechanisms.

However, as already noted, legal costs do not represent the whole cost of arbitration. A prospective claimant would still need to directly cover administrative and arbitration costs, costs for engaging experts, etc. In view of this, prospective claimants may also consider alternative sources of financing, which generally imply financial involvement in the arbitration of a fiscally independent investor, known as a third party funder.

In addition, it is possible to seek financing for the arbitration proceedings through loan agreements or insurance mechanisms.

THIRD PARTY FUNDING

Third party funding is a financing model, in which an independent funder finances all or part of the arbitration costs, and in return, receives an agreed percentage of proceeds from the award. In any event, the risk of an adverse outcome of the arbitration is fully shared with the funder, thus the return of the funder is dependent on the success of the case. This type of financing is very developed in Western jurisdictions.

The functions of a third party funder can be performed by specialized institutional financiers, whose sole business rides on the funding of arbitration claims, as well

as “one-off” investors. In order to appoint a third party funder, a prospective claimant may either choose a specific third party funder or engage a third party broker that would prepare offers as to the most suitable third party funders for each particular case. Claimants and their advisers must do careful due diligence on the funders they approach in order to obtain funding.

The tactical benefits of third party funding include the increased certainty about the cash flow required for the case. In addition, arbitration is more likely to be settled faster as the opposing party understands that the other party has means to pursue the claim.

One of disadvantages of third party funding is that involvement of third party funders in arbitration may raise ethical issues such as level of independence of a legal counsel and choice of arbitrator, extent of intervention of third party funder in building the arbitration strategy and conduct of arbitration proceedings, etc. In addition, after disclosure of the third party funding arrangement in course of arbitration, there is a risk that the claimant will be asked to provide security for costs, leading to increased expenses.

The high premium rates payable for the services of third party funders are also disadvantageous. A prospective claimant may have to pay a sum, which may be significantly higher than the amount, which the third party funder had initially invested.

At the same time, all the above disadvantages lose their importance in light of the fact that a third party funder finances the whole proceeding and bears a risk of losing a case and, respectively, all money invested in the proceedings. The claimant simply risks nothing.

PRECONDITIONS FOR ENGAGING A THIRD PARTY FUNDER

The financing party assesses any arbitration claim as a budgeting opportunity and once financially involved, it has a direct economic interest in the favourable to the claimant outcome of arbitration. This leads to another tactical benefit of financing arbitration from alternative sources. Disclosure of financing of a claim by an independent investor sends the message to the arbitral tribunal that the claim has a high chance of success.

On the other hand, the above means that only claims with high prospects of success may attract third party funders. Therefore, prior to the provision of any funds most outside financiers would carry out evaluation of a prospective claim, assessing various parameters such as financial capacity of the

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claimant to potentially finance a share of the costs itself, the ratio between the realistic amount to be recovered and the likely legal costs and disbursements, possibility to enforce the award and solvency of the respondent, as well as a legal team working on the case. It is no surprise that prospective outside financiers will favour claims with strong arguments that can be quickly resolved.

In addition to the due diligence of the prospects of a claim, the third party funder will most likely insist on the due diligence of the respondent’s solvency and available assets against which it might be possible to enforce the arbitral award. Such due diligence will usually involve an asset tracing exercise performed by a specialised firm.

OTHER ALTERNATIVE SOURCES TO FINANCE ARBITRATION

Among the alternative methods for financing the arbitration, third party funding discussed above appears to be the most suitable tool for potential Ukrainian claimants. Moreover, there are already examples on the market of successful use of these mechanisms by Ukrainian parties.

At the same time, there are also other sources to finance arbitration, which although more typical for English courts proceedings, may also be considered by Ukrainian parties on a case-by-case basis, including in combination with third party funding.

Loan

One of the ways to find funds for arbitration is by borrowing funds specifically for that purpose. Typically, this is documented in the form of a loan agreement secured by collateral provided by the claimant. The collateral may include a portion of the proceeds from any favourable arbitral award.

One of the most evident advantages of this type of financing is that prospective claimant retains full control over the claim and arbitration strategy contrary to the third party financing.

This type of financing is not typical on the Ukrainian market and not familiar to Ukrainian banks. Therefore, this mechanism may only be accessible to those companies with appropriate experience in attracting foreign financing and dealing with foreign banks directly.

Alternatively, a company may obtain a loan to finance arbitration from its business partners on the terms agreed by the parties.

Insurance mechanisms

While it is possible to have “Before-the-Event” (BTE) Insurance in place as a safeguard against potential arbitration costs associated with future arbitration, this is a very rare arrangement which is mostly not known by Ukrainian parties.

At the same time, “After-The-Event” (ATE) insurance could be a very helpful technique of attracting outside finance after a dispute has arisen. The ATE insurance is a tool, mostly used by a claimant in already pending arbitration, to cover the opposing party’s costs in the event of unsuccessful arbitration. The ATE insurance contract prescribes the premium paid to the ATE insurer by a party to arbitration. The premium may be determined as a percentage of the total sum of insurance provided or as a certain amount increasing as the arbitration progresses. The premiums, which a claimant would have to pay to the ATE insurer, may be quite high but the payment of premiums is usually spread over the entire course of the proceedings.

The ATE insurance does not cover the liability under the claim itself and should typically be used in conjunction with other outside methods of financing, and may not serve as universal protection against adverse costs in arbitration. At the same time, with the assistance of a legal team, ATE insurance may be carefully structured to serve as a reliable tool for freeing cash flow and payment for all or a proportion of legal costs in the adverse scenario of a case being lost.

CONCLUSION

While number of cases and the sums in disputes submitted to international arbitration are increasing with each year, parties are equally becoming increasingly concerned with the costs they incur in arbitration. The alternative techniques outlined to finance arbitration proceedings may be useful for companies who have potential arbitration cases but limited funds to access international arbitration.

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