THE FEASIBILITY OF A THIRD-PARTY FUNDING MARKET FOR ARBITRATION CLAIMS IN PUERTO RICO

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I. INTRODUCTION

Arbitration has become an increasingly desired mechanism for dispute resolution for its "quicker, less expensive, and more private alternative to litigation."[1] Therefore, businesses turn to binding arbitration to lower costs and time of claims. However, it seems to be that even arbitration cannot offset the risks associated with the costs of pursuing or defending from claims. Hence, recurring to market investors to bring solvency to the legal claim industry could prove a viable solution to reduce the cost and accessibility to dispute resolution.
Third-Party Funding (hereinafter "TPF") is a type of financing for legal claims that has taken a rise in recent years. TPF occurs when an unrelated party to a legal claim provides financial support to a party related to the case. In exchange the TPF receives a portion of the proceedings of the claim if successful.[2] If the claim is unsuccessful and no favourable outcome is rendered, then the TPF receives nothing.[3] The party to the claim being funded is transferring all or part of the financial risk of pursuing the claim to the TPF. TPF may rise in litigation and arbitration claims, however, this paper is focused in arbitration claims only.

This article contemplates how the interaction of TPF and arbitration could form a powerful mix in providing effective legal claim resolution to parties,

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[1] Murray S. Levin, *The Role of Substantive Law in Business Arbitration and The Importance of Volition*, 35 AM. BUS. L.J. 105, 106 (1997).
[2] *See* Jennifer A. Trusz, *Full Disclosure? Conflicts of Interest Arising from Third-Party Funding in International Commercial Arbitration*, 101 GEO. L .J. 1649, 1653-54 (2013).
[3] *Id.*

specifically businesses. It has been noted that "the use of third-party funding in major arbitration cases is a development that is here to stay[4]," and Puerto Rico should, if possible, capitalize in this growing international trend. It is expected that TPF will continue with the tremendous growth it has shown in the past decade and will likely play a large role in transnational legal claims.[5] Puerto Rico may offer an untapped market for established TPF companies looking to expand internationally.[6] Cassandra Robertson argues that "[o]utside funding can also affect forum choice, potentially offsetting the traditional magnet effect in the U.S. and making it easier to maintain suit in other countries."[7] By developing a TPF market, Puerto Rico can become a magnet forum for transnational cases. The parties in international disputes may choose a country as a dispute resolution forum, based upon whether arbitration financing is available. The end result may translate into greater business development and foreign investments, as Puerto Rico becomes a dispute resolution headquarter.

TPF is a great opportunity to examine arbitration from a multidisciplinary perspective. This paper undertakes the examination of the current arbitration framework as a variable in the risk assessment functions of financial-economy theories. TPFs' investments depend on an evaluation of financial risk, which requires the use of financial models and economic theories to grasp its extent. An important variable of such a model is legal risk. Therefore, this paper will not follow traditional legal analysis, because arbitration claims will be evaluated as assets, and arbitration's legal environment as a variable of the risk assessment of TPF's investment analysis.

The purpose is to provide a framework to evaluate the feasibility of a TPF market in Puerto Rico. To achieve such a framework, it is necessary to determine the factors that affect the valuations performed by TPF on arbitration claims. TPFs are looking for a fair return on their risky investment. It is my contention that if arbitration law and jurisprudence is too hostile for parties using arbitration to solve disputes, the value of arbitration claims in Puerto Rico will be reduced, and a TPF market will not surge. By identifying the factors that affect the valuation of an arbitration claim, a hospitable legal environment can be created for a TPF market to grow. In determining such factors, I use a real options valuation approach to determine how current arbitration doctrines would increase or decrease the valuation that TPF performs. However, before entering to discuss the profitability and surge of a TPF market in Puerto Rico, it is necessary to examine whether such type of legal claim financing is legal in our jurisdiction.

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[4] *Id.*

[5] Cassandra Burke Robertson, *The Impact of Third-Party Financing on Transnational Litigation*, 44 CASE W. RES. J. INT'L L. 159, 168 (2011).

[6] *Id.* (The author argues that "countries such as Spain, Brazil, Mexico, Argentina, Bulgaria, Latvia, and Estonia may offer an untapped market for established companies looking to expand out of Australia, the U.K., or the U.S.").

[7] *Id.* at 163.

II. LEGALITY OF TPF IN COMMON LAW JURISDICTIONS

Australia and the United Kingdom have significant experience in the TPF market.[8] Australia was the first jurisdiction to develop a TPF market for litigation and arbitration claims.[9] However, these common law jurisdictions faced a hostile legal environment, which prevented the surge of a TPF market, based upon the *maintenance* and *champerty* doctrines. These doctrines are the primary barriers for the development of TPF in common law jurisdictions. "Champerty is . . . 'an agreement to divide litigation proceeds between the owner of the litigated claim and a party unrelated to the lawsuit that supports or helps enforce the claim' . . . ."[10] The maintenance doctrine refers to "assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the case."[11] These doctrines proscribe investors with no relation to the claim from funding and obtaining a share of the rendered award if successful. In the U.S., "while a minority of states have abandoned champerty restrictions, the majority of states retain and enforce the prohibition with varying degree of zeal."[12]

In their origins, the "maintenance and champerty were a crime, any contract to maintain an action was therefore illegal and unenforceable. Furthermore, maintenance and champerty were tortious acts giving rise to an action for damages under the common law."[13] TPF can be traced to feudal England, were TPF for lawsuits was prohibited.[14] It was considered "detrimental to the developing legal system with little offsetting benefit.[15]" "According to Blackstone, champerty thereby 'perverted the process of law into an engine of oppression'."[16] Since "feudal lords often took an interest in the real property at issue in the litigation, using their funding agreements to expand their holdings and ultimately to consolidate land wealth in fewer hands."[17] "Restrictions on champerty and maintenance traveled with English common law into the U.S."[18] England embraced TPF through the Criminal Law Act of 1967, which "abolished criminal and civil liability for champerty."[19] Another important development for

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[8] Dr. George R. Barker, *Third-Party Litigation Funding in Australia and Europe*, 8 J.L. ECON. & POL'Y 451 (2012).
[9] *Id.* at 452.
[10] Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1286 (2011).
[11] *Id.* at 1287
[12] *Id.* at 1289.
[13] Barker, *supra* note 8, at 460.
[14] Robertson, *supra* note 5, at 164.
[15] *Id.*
[16] *Id.* at 164 (citing Thallhimer v. Brinckerhoff, 3 Cow. 623 (N.Y. Sup. Ct. 1824) (internal quotations omitted)).
[17] *Id.*
[18] *Id.*
[19] Steinitz, *supra* note 10, at 1280.

TPF in England occurred in 2005. In *Arkin v. Borchard Lines Ltd*,[20] the English Court of Appeal "held that, while third-party funding is acceptable and even desirable as a way of increasing access to justice, the funder does not control the management of the litigation."[21]

Initially, Australian courts, like many common-law jurisdictions, had prohibited Third Party Funding of legal claims for many years.[22] The hostility towards TPF in Australia changed with two landmark cases[23] that resulted in the acceptance of TPF "with the funder having broad powers to control the litigation."[24] The *Fosfit* decision was a result of a growing in the demand of legal claim funding in Australia.[25] Through the years, Australians had demanded a greater access to justice, met by allowing TPF to fund legal claims.[26] In 2009, "the Australian High Court interpreted its decision in *Fostif* to be a ban on any general rule prohibiting the funding of litigation for reward."[27]

III. LEGALITY OF TPF IN PUERTO RICO

Civil law jurisdictions as Puerto Rico, deal with the common law figure of *champerty* in a unique fashion.[28] In Puerto Rico, if a plaintiff sells all or part of his claim, "the defendant may extinguish the claim by redeeming it from the purchaser for the price he paid plus interest and costs." [29] This right surges from Article 1425 of Puerto Rico's Civil Code, which establishes that:

> When a litigated credit is sold, the debtor shall have the right to extinguish the same by reimbursing the assignee for the price the later paid for it, the judicial costs incurred by him, and the interest on the price from the day on which the same was paid.
>
> A credit shall be considered as litigated from the day the suit relating to the same has been answered.

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[20] 2005 EWCA (Civ) 655 (Eng.).
[21] Steinitz, *supra* note 10, at 1281.
[22] Steinitz, *supra* note 10, at 1279.
[23] Campbells Cash and Carry Pty. Ltd. v. Fostif Pty. Ltd. (2006) 229 CLR 386 (Austl.) (recovery in the tobacco industry); Mobil Oil Australia Pty Ltd. v. Trendlen Pty. Ltd., (2006) 229 ALR 51 (recovery in the petroleum license fee).
[24] Steinitz, *supra* note 10, at 1279.
[25] Campbells v. Fostif (2006) 229 CLR 386.
[26] *Id.*
[27] Steinitz, *supra* note 10, at 1280 (citing Jeffery & Katauskas Pty. Ltd. v. SST Consulting Pty. Ltd. (2009) 239 CLR 75, 92 (Austl.) (addressing the issue of indemnity for costs by litigation funders.)
[28] Ari Dobner, *Litigation for Sale*, 144 U. PA. L. REV. 1529, 1552 (1996).
[29] 31 L.P.R.A. § 3950. (translation by the autor).

> The debtor may make use of his right within nine (9) days, counted from the day the assignee should demand payment of him.[30]

This legal approach to *champerty*, favours debtors/defendants by giving them the capability of extinguishing the claim by reimbursing the price plus cost and interest to the investor, but it is still less restrictive than the total restriction imposed by the *champerty* doctrine in common law jurisdictions. Therefore, in Puerto Rico, "the investor will at least get his money back, plus interest and costs."[31] Whereas in common law jurisdiction with *champerty* restrictions "a champertous agreement may be held invalid, and the investor may lose all of his money."[32]

In *Consejo de Titulares v. C.R.U.V.*,[33] the Supreme Court of Puerto Rico had the opportunity to examine the extent and applications of Article 1425. The Court defines litigated credit as one that cannot come into existence until a court's ruling confirms it.[34] As a condition for Article 1425 to apply, the litigation must be centered upon the existence of the credit and not merely about its consequences.[35] The Court went as far as to limit the sale of litigated credits based upon mental anguish to interested parties, and also stating that only the price plus cost and interest can be recovered.[36] The Court argued that such limitation precludes speculation on the suffering and misfortunes of others.[37] In the same way, *Pritzker v. Yari*[38] is an example of TPF in Puerto Rico and the application of Article 1425. The case was a highly litigated breach of contract suit "between Paul S. Dopp and Jay A. Pritzker (the D/P Litigation) concerning the ownership of two hotels, situated on approximately 1,000 beachfront acres, in the Commonwealth of Puerto Rico."[39] Dopp, in order to finance the high cost of litigation, assigned "various portions of the anticipated proceeds of the D/P Litigation to third parties," in exchange of funding.[40] In response, Pritzker tendered payment to the investors, pursuant to Article 1425, and sought extinguishment of the litigated credit. The controversy presented was whether the financing agreement entered by Dopp to finance its litigation was subject to Article 1425. In its conclusions, the First Circuit Court categorized Article 1425 as "a very unusual animal", and expressed that its purpose "is to prevent the illegal trade of litigious credits which were purchased for a price below their

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[30] *Id.* (translation by the autor).
[31] Dobner, *supra* note 28, at 1553.
[32] *Id.*
[33] Consejo de Titulares v. C.R.U.V., 132 D.P.R. 707, 132 P.R. Offic. Trans. 707 (1993).
[34] *Id.* at 726.
[35] *Id.*
[36] *Id.* at 735.
[37] *Id.*
[38] Pritzker v. Yari, 42 F.3d 53 (1st Cir. 1994).
[39] *Id.* at 57.
[40] *Id.* at 58.

actual value, and then the actual price was recovered from the debtor and big profits reaped."[41] The Court concluded "that the financing agreements [entered by Dopp with third parties] fall squarely within the purview of article 1425."[42] The facts in *Pritzker* draw the traditional TPF agreement. As the case shows, TPF is permissible as long as the debtor/defendant's right under Article 1425 is not undermined. The other important limitation to TPF, established in *Consejo de Titulares*, is that the sale of litigated credits, based upon mental anguish, is restricted to interested parties and that only the price plus cost and interest can be recovered.

In Puerto Rico, *champerty* transcends the typical common law prohibition towards litigation financing and, in its quest to deter such practice, a rule of law that has the potential to effectively price claims and induce settlements has surged. From a practical perspective, Article 1425 uses a financial deal entered among parties for a litigated credit, in order to force a settlement. Its novelty surges from the fact that it uses the financial agreement between the funder and the plaintiff to price the claim and afterwards, gives defendant the opportunity to settle the case for such price. The reasoning behind the Article is that if a plaintiff is willing to part from his claim for *X amount*, then such amount should be the settlement between the parties, therefore pricing the claim. In fact, Article 1425 achieves such results. If a TPF buys the totality of the claim from a plaintiff, the defendant could pay the funder the price paid plus cost and interest, and extinguish the claim. Therefore, the result is that the claim can be settled by the defendant for the amount paid by the TPF.

Even though, Article 1425 can be considered an ingenious policy to deal with *champerty* and settlements, it is not favorable to TPF. Before undertaking any investment in legal claims, a TPF must undergo an extensive due diligence in order to decide whether the investment is worth it. The riskiness inherent to legal claims makes such endeavor difficult, and the TPF will have to use its resources extensively to identify ideal claims to invest in. Therefore, TPF will not embark in such a journey if a defendant can easily pay them back their investment and leave them with no returns. The legal structure of *champerty* in Puerto Rico leaves certain questions unanswered in regards to its application to arbitration. Two fundamental questions are to be raised: (1) whether Article 1425 applies to arbitration claims and (2) whether the parties, through an arbitration agreement, preclude its application. These questions will not be addressed for being outside the topic's scope.

[41] *Id.* at 65 (citing Consejo de Titulares, 132 D.P.R. 707 (internal quotations omitted)).
[42] *Id.* at 66.

IV. FACTORS AFFECTING THE PREVALENCE OF A TPF MARKET: A VALUATION APPROACH

There is still the question whether TPF would invest in Puerto Rico as a forum for international and domestic arbitration claims. The answer to this question lies in the valuation of arbitration claims, and whether such valuations show a desirable return for investment. An "investor in an economic venture seeks to maximize profit and minimize loss and risk."[43] "The market convention is that one should undertake risk only if there is a commensurate prospect of increased return."[44] In an arbitration claim, as in the stock market, risk will surge from two broad sources of uncertainty. The first risk arises from the legal environment that has been formed through doctrines that regulate arbitration. For example, if arbitration doctrines do not permit Courts to effectively enforce an arbitration's award, then this translate to a risk for a TPF, which profits depend on that award. This type of risk is analogous to the market risk that comes from conditions in the general economy.[45] As with market risk, the risk that arises from legal doctrines that regulate arbitration, cannot be diminished through a diversified portfolio of distinct legal claims. Such a systemic risk might only be reduced or transformed through new judicial doctrines, legislation or arbitration agreements. The second risk arises from the specific facts of the case. As investors reduce firm specific risk through diversification,[46] a TPF can devise a diversification strategy through a wider portfolio of legal claims. These two types of risk will be determinant in the pricing of arbitration claims, and the profiting of TPF.

TPF "have an obvious stake in the question of how to price legal claims."[47] TPF not only put their "capital on the line but also solicit capital from investors based on a business model that presumes that funders can – and are good at – assessing the value of the investments they purchase for investors."[48] Scholar Maya Steinitz has raised two important questions in regard to pricing legal claims: (1) "whether they [TPF] can price the claim with some degree of confidence in the soundness of their prediction regarding the claim value, and, if not, [(2)] how to devise an 'incomplete contract' that allows them to reprice with minimum transaction costs."[49] She proposes that a practical solution for pricing legal claims "lies with *staged funding* in a manner similar to the funding of start-ups by venture capitalists."[50] She argues that "[w]hen the pricing of legal claims is

[43] Robert J. Rhee, The Effect of Risk on Legal Valuation, 78 U. COLO. L. REV. 193, 197 (2007).
[44] *Id.*
[45] Investopedia, Types of Investment Risks, INVESTOPEDIA, http://www.investopedia.com/exam-guide/finra-series-6/evaluation-customers/types-investment-risks.asp?header_alt=b
[46] *Id.*
[47] Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1892 (2013).
[48] *Id.* (remarks in regard to litigation funding firms).
[49] *Id.* at 1903.
[50] *Id.* at 1893.

adjusted using staging to accommodate for fluctuations in transaction costs and the value of asset and option, efficiency and fairness are maximized for both claimants and the financier."[51] Therefore, she is presenting a contractual approach to reduce the risk that comes from the specific facts of the case. Steitnitz's proposition should become the norm regarding the financial agreement between TPF's and claimants. Since, "litigation financing contracts are confidential"[52], which precludes an analysis of the current contractual norm used by TPF, it will be assumed that TPF use an incomplete contract to be able to re-price the claim as new information becomes available.

A. Analyzing TPF of Arbitration Claims through a Real Options Approach

Analyzing TPF investment from the perspective of an incomplete financial agreement that may re-price the value of the investment through new information requires departing from traditional financial valuation methods.[53] Traditionally, in finance, "value is the sum of the risk-adjusted cash flows."[54] The generally used technique for asset valuation is the discounted cash flow method (hereinafter "DCF"), which discounts the expected future cash flow "by the cost of capital, a measure of the firm's risk."[55] In the investment world, however, valuation analysis through DCF has "been supplemented by 'real options' approach."[56]

"Real options" surge as a response to the incapability of the DCF to capture, in its valuation, new and unexpected developments.[57] The traditional DCF "assume[s] a fixed commitment to full investment at the outset, real option theory models the investment process as a series of decision points at which investors have the option of adjusting their investments in response to new information."[58] Following the assumption that TPF agreements are incomplete contracts that permit a reevaluation of the investment with an embedded option to discontinue the funding, real options are a better fit than the traditional DCF to assess the value of TPF investments in legal claims. A real options model allows new information and the option of abandonment to be taken into consideration in the

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[51] *Id.* at 1895.

[52] Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 719 (2014).

[53] Rhee, *supra* note 43, at 195 ("By analogizing lawsuits to investments, scholars view legal valuation not from the perspective of standard cost-benefits analysis, which ideally requires information completeness, but from the perspective of risk management, which assumes that uncertainty is the governing condition.").

[54] *Id.* at 203.

[55] *Id.*

[56] Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1273 (2005)(internal quotations omitted) (emphasis added).

[57] *Id.*

[58] *Id.* at 1273-74.

valuation of the claim. Therefore, I will use a real options valuation approach to identify the factors that affect the potential returns of TPF in arbitration claims in Puerto Rico. Steinitz herself asserts that "[m]ultistage or sequential investment decisions are an important class of real options with embedded managerial flexibility."[59] The use of a financial valuation model for the developed framework is for determining how distinct arbitration doctrines can affect the valuation performed by a TPF, and ultimately, its returns.

It is not the first time that real options are used to understand a variety of legal themes.[60] "Modern option pricing theory traces its roots to the Black-Scholes model of the value of an option to buy common stock."[61] An option derives its value from an underlying asset.[62] In finance, "a call option, you get the right to buy the underlying asset at a fixed price, called a strike price."[63] Since the holder has the right and not the obligation to buy the underlying asset, the option is exercised only if the value of the underlying asset exceeds its strike price.[64] Applying the option approach to arbitration, leads to the examination of the claim as if it were the underlying asset and the TPF as the holder of the option.[65] A TPF pays a claimant the cost of pursuing the arbitration claim in exchange of a percentage of the claim. The TPF has the option of not continuing to fund the case if he expects that no award will be rendered or that the proceedings from the outcome will be less than the cost.[66] This would be the equivalent of not exercising the option and letting it expire. The TPF will lose the funds that, up to that point, were invested in the claim. On the other hand, the TPF has the option of continuing to fund the arbitration claim if he expects that the proceeds from the rendered award exceed the funding costs. Therefore, the decision of a TPF in continuing funding the claim can be mathematically expressed as follow:

$$FC * (1+RR) < AW * (P)$$

- FC: Expected funding costs
- RR: Required rate of return

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[59] Steinitz, *supra* note 47, at 1897.

[60] *See* Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 J. LEGAL STUD. 173 (1990) (introduces a model using real options that "produces several intuitive predictions regarding the relation between legal procedure, legal practice, and the incentive to sue".); William J. Blanton, *Reducing the Value of Plaintiff's Litigation Option in Federal Court: Daubert v. Merrell Dow Pharmaceuticals*, Inc., 2 GEO. MASON L. REV. STUDENT ED. 159 (1995) ("[I]n this comment, option pricing theory is used to evaluate the effects of the Daubert decision on a plaintiff's incentive to litigate.").

[61] Blanton, *supra* note 59, at 159.

[62] Rhee, *supra* note 42, at 204.

[63] ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 294 (3d ed. 2010).

[64] *Id.*

[65] *See* Steinitz, *supra* note 47, at 1903 ("The claim is the asset in which a funder is purchasing 'shares' (and thus equivalent to a company that is issuing stock).").

[66] *See id.* at 1902 (describing a third-party funding agreement, which allows the investor "to exit the investment and, therefore, to control risk.").

- AW: Expected monetary award
- P: The percentage of the award belonging to the TPF

Three variables, "FC," "RR," and "AW," depend on information regarding how well the arbitration claim is going. Since information is constantly flowing in an arbitration claim, especially during the discovery phrase, the formula's result is constantly changing. The 'P' variable, however, is predetermined in the TPF agreement, thus it does not change with the flow of information. Therefore, when analyzing new case law, new regulation or arbitration agreements, the effects they might have on the presented variables have to be taken into account when analyzing the feasibility of a TPF market, in order for the formula to identify high return claims.

A "real options model" also sheds light to an important variable in identifying profitable claims: variance. Variance is one of six variables that determine the value of an option.[67] In financial economics, variance is defined "as the statistical mean squared deviation from the expected value, which is the risk of an expected return [or] . . . as the measure of one's belief about the possible deviations of a judgment from expectation . . . ."[68] In the valuation of options, increasing the variance of the underlying asset increases the value of the option. The reasoning behind such assertion is that "the holder of options can never be forced to exercise an option, which protects them against downside risk but preserve upside potential."[69] As a holder of a call option, a TPF's down-risk is limited to the amount that has been invested in the funding of the claim. Its maximum down-risk is limited to the expected total amount of funding needed to fulfill the arbitration claim. However, the upside for recovery is not limited. TPFs have a right to a percentage of the claim and, therefore, the higher the award is the higher will be the return for the investor. Since a TPF's risk is limited to the amount invested in funding the arbitration claim, it will intend to maximize its profit without worrying if such initiative increases risk. In such scenario, the question a TPF will confront is how to maximize the potential upside of the investment. The option pricing theory answers this by asserting that the value of the option will increase with an increase in the variance of the underlying asset's value.

In order to apply this financial principle to arbitration claims, a fundamental question has to be answered: how can the variance of an arbitration claim be increased in order to increase its value? I argue that variance is maximized in the arbitration agreement, when in such contracts the parties do not choose a substantive law to be applied by the arbitrator. In such case, arbitrators would not be bound to resolve the controversy on legal grounds and may use principles of equity to reach a solution. This is not to say that arbitrators

[67] DAMODARAN, *supra* note 62, at 294.
[68] Rhee, *supra* note 42, at 199.
[69] DAMODARAN, *supra* note 62.

are completely free to reach any determination they feel appropriate. However, arbitrators will have a greater scope to reach its decision if no law is chosen in the arbitration agreement. If the agreement requires for a substantive law to apply, and the arbitrator departs from such law, then the rendered outcome may be vacated on the grounds that the arbitrator exceeded its power. A greater variance in the possible outcomes of the arbitration awards is reached when the parties do not establish a substantive law in the arbitration agreement and, therefore, arbitrators can apply principles in equity to reach a solution. Since under the option valuation approach, a greater variance results in a higher valuation, then TPF will want to invest in claims in which no applicable law has been chosen.

The aforementioned argument leads to the conclusion that a TPF market will be more prone to develop in jurisdictions were arbitrators have a greater scope of grounds to make its ruling. Some jurisdictions in the U.S. permit a scope beyond the applicable law, in which an arbitrator can make its determination. The Supreme Court of Alaska has expressed that "[t]he general rule in both statutory and common law arbitration is that arbitrators need not follow otherwise applicable law when deciding issues properly before them, unless they are commanded to do so by the terms of the arbitration agreement."[70] In New York, it has been established that "[a]bsent provision to the contrary in the arbitration agreement, arbitrators are not bound by principles of substantive law or rules of evidence."[71]

B. Understanding TPF through Venture Capital Funds

Steinitz's analogy between litigation funders and venture capitalists is an important starting point in developing an effective framework to understand how a TPF market develops. Litigation funders and venture capitalists "have a similar risk profiles: they invest in high risk assets with the hope that, even if many of their investment fail, a handful will be wildly successful."[72] Understanding TPF from a venture capitalist perspective requires departing from the standard market conceptualization of risk and its primary management tool, diversification. Peter Thiel, founder of PayPal, states that "[t]he biggest secret in venture capital is that the best investment in a successful fund equals or outperforms the entire rest of the fund combined."[73] He states that venture capitalist must "only invest in companies that have the potential to return the value of the entire fund."[74] This pronouncement is sustained by the venture capitalist market data; even though "total venture capitalist investments account for less than 0.2% of the GDP", "ventured back companies generate an outstanding 21% of the GDP."[75] Applying this rule to TPF leads to a departure from diversification techniques, to reduce

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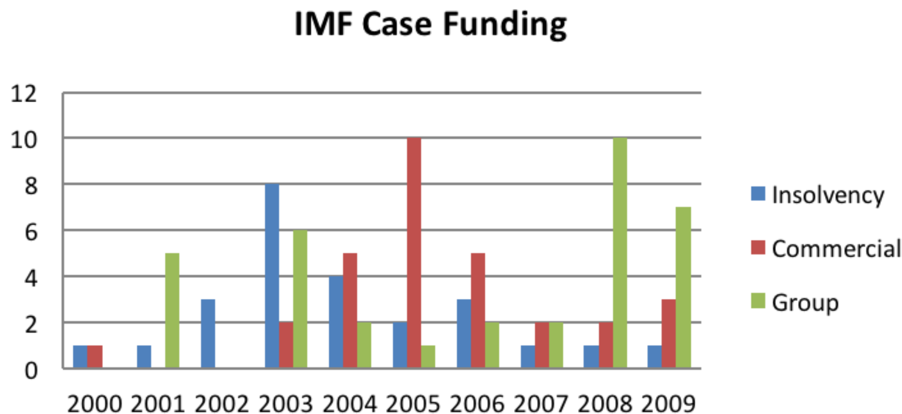
[70] University of Alaska v. Modern Construction, Inc., 522 P.2d 1132, 1140 (1974).
[71] Lentine v. Fundaro, 278 N.E.2d 633, 635 (1972).
[72] Steinitz, *supra* note 53, at 723.
[73] PETER THIEL, ZERO TO ONE 87 (2014).
[74] *Id.*
[75] *Id.* at 89-90.

risk towards the few legal claims that can be catalogued as overwhelmingly valuable. The rule also supports the aforementioned variance principle, that TPF will prefer arbitration claims with a greater variance because they present greater profit potential, even though uncertainty is also increased.[76]

Data collected from a TPF's investment sustains the venture capitalist analogy used to build the proposed framework. IMF Bentham is a listed public company in Australia, which offers funding for litigation claims with a claim value of at least AUD$5 million, and for arbitration claims, from AUD$10 million[77]. As part of their investments practices, "IMF Bentham looks to fund international commercial arbitration and investment treaty claims" with a claim value in excess of AUD$10 million.[78] A look at the historical trends of IMF's portfolio sheds light on how TPF invest and the type of cases they undertake. Dr. George R. Barker[79], using information provided by Malcolm Stewart[80], presents insightful data regarding the amount of cases funded by IMF and its segmentation by case type. Here is his data using a bar graph[81]:



The graph illustrates two important aspects of IMF's portfolio: (1) the relatively few cases funded yearly, and (2) that funded cases come from three case categories. "In total there is a reasonably even spread of cases by category, with group actions most common at 39%, commercial actions next at 33%, and

[76] *See* Grundfest, *supra* note 55, at 1276 (From a litigation perspective, "[i]n the real options framework, variance is a critical determinant of a lawsuit's settlement value because the larger the variance, the more dramatic and potentially valuable the information waiting to be disclosed [...] and the larger the value of the plaintiff's option to continue or to abandon the litigation in response to that information.").

[77] IMF Bentham, *About Us*, IMF BENTHAM, https://www.imf.com.au/about-us (last visited Dec. 25, 2015).

[78] IMF Bentham, *Arbitration*, IMF BENTHAM, https://www.imf.com.au/funding/arbitration (last visited Dec. 25, 2015).

[79] Barker, *supra* note 8.

[80] Paul Fenn, Neil Rickman & Malcolm Stewart, Third Party Funding of Commercial Disputes: A Framework for Comparative Analysis, (unpublished manuscript) (2011).

[81] The data includes both litigation and arbitration claims.

insolvency actions at 28%."[82] Unless integrated to a group action, cases involving recoveries for mental anguish are not typically funded by TPF. Therefore, the decision of Puerto Rico's Supreme Court in *Consejo de Titulares*, which prohibits the selling of litigated credits involving mental anguish, has a very limited impact in the investment opportunities of TPF. The reason for such case preference surges from the fact that "[f]unding commercial proceedings are considered less risky, as the award is more easily quantifiable by reference to the financial loss suffered by the claimant."[83] Also, proceedings involving personal injury "are generally considered too risky for funders that are engage in proper due diligence, particularly when success is less certain."[84]

V. LEGAL ENVIRONMENTS AND THIRD PARTY FUNDING

A. Market Determinants Model

From the aforementioned analysis, a simple model can be deduced from which new case-law, regulations and arbitration agreements may be analysed to determine their positive or negative effects on the development of a TPF market. The model I present is a reformulation of the supply and demand framework presented by Dr. George R. Barker.[85] My model integrates the presented real options valuation approach into a TPF supply function. The model can be expressed as:

$$\text{TPF S} = F\left((-)\ RR, (+)\ PR, (-)\ AC, (+)\ CF, (-/+)\ \alpha\right)$$

- **RR: Required Return**- It shall be measured as a function of the riskiness of the arbitration legal environment. A primary factor to measure such a risk would be the proclivity of courts to vacate rendered arbitration awards.
- **PR: Potential Return**- It can be described as the variance of the arbitration claim's expected return. Also, be measured through the ability of an arbitrator to depart from substantive law, and apply equity principles or commercial practices to reach a determination.
- **AC: Arbitration Cost**- It can be measured as the investment provided by the TPF to finance the arbitration claim.
- **CF: Category Frequency**- Level of arbitration cases that can be categorized as insolvency claims, commercial claims and class actions.

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[82] Barker, *supra* note 8, at 481.

[83] *Id.* at 478.

[84] *Id.*

[85] *Id.* at 455-56 (he draws his model upon the work of Paul Fenn, Neil Rickman, and Malcolm Stewart, Third-Party Funding of Commercial Disputes: A Framework for Comparative Analysis (2011) (unpublished manuscript) (paper presented to the European Association of Law and Economics Conference 2011)).

- **α: Alpha**- Includes all future regulations that can be imposed to TPF. It also compiles the effect of lesser variables.
- (+): Represents a Direct Relation
- (-): Represents an Inverse Relation

These variables have to be examined through three different spheres: (1) international arbitration, (2) federal arbitration, and (3) domestic arbitration. An example would be looking to the enforceability of arbitration award, an important determinant of risk in arbitration claims, from the proposed three legal environments. This examination will give an insight as to the required return variable of the presented model.

B. International Arbitration Perspective

The New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards[86] (hereinafter "Convention") "seeks to provide common legislative standards for the recognition of arbitration agreements court recognition and enforcement of foreign and non-domestic arbitral awards." The Convention assures the effectiveness of arbitration claims in an international context. Article V of the Convention establishes seven legal grounds in which the recognition and enforcement of the award may be refused. Professor David M. Helfeld[87] recognizes that two of them will have a greater weight in convincing a court to vacate the rendered arbitration award. These are Article V-2:

> (a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
>
> (b) The recognition or enforcement of the award would be contrary to the public policy of that country.[88]

Through these subsections, the Convention gives ample leeway for a country's law or public policy to determine whether the award is to be sustained or vacated. Therefore, even in the international stage, the country's legal environment regarding arbitration will play a vital role in the final judgment of the arbitration claim. TPF will have to take into consideration the laws and policies of the country where recognition and enforcement of an arbitration award is sought, in order to have a better measurement of the risks that the

[86] Convention on the Recognition and Enforcement of Foreign Arbitral Awards with respect to the United States, June 10, 1958, 10 U.S.C. § 201 (2012).
[87] David M. Helfeld, *La Jurisprudencia Creadora: Factor Determinante en el Desarrollo del Derecho de Arbitraje en Puerto Rico*, 70 REV. JUR. U.P.R. 1, 45 (2001) (translation by the autor).
[88] *Id.*

award may be vacated. This analysis will affect the required return variable, since it is a valuation of the level of risk the international arbitration claim faces.

The application of the aforementioned discussion can be examined in *Mitsubishi Motors v. Soler Chrysler-Plymouth*,[89] which is a leading case in Internal Commercial Arbitration. A car distribution company from Puerto Rico (hereinafter "Soler") entered into distribution and sales agreements with Mitsubishi, a Japanese car manufacturer. The sales agreement contained a clause providing for arbitration by the Japan Commercial Arbitration Association, for disputes that may arise from the agreement. After a dispute surged, Mitsubishi brought an action seeking to compel arbitration, and Soler countered claimed causes of actions under the Sherman Act. One of the controversies was whether a Sherman Act claim could be subject to arbitration in an international forum. The United States Supreme Court solved the controversy in the affirmative expressing, among other reasons, that:

> Having permitted the arbitration to go forward, the national courts of the United States will have the opportunity at the award-enforcement stage to ensure that the legitimate interest in the enforcement of the antitrust laws has been addressed. The Convention reserves to each signatory country the right to refuse enforcement of an award where the "recognition or enforcement of the award would be contrary to the public policy of that country." Art. V(2)(b), 21 U.S.T., at 2520.[90]

A look at *Mitsubishi* through the lens of the proposed framework raises a red flag in the decision. The Court's aforementioned expression expands the scope for judicial review to the merits of an award, in order to assure that the interests of national antitrust laws are addressed. It is well known that "[t]he enforcement of awards is critical to the viability of the arbitral process. If arbitrator determinations were not enforceable at law, there would be little, if any, incentive to proceed with arbitration."[91] *Mitsubishi* exponentially increases the required rate of return for TPF financing a claim, because it increases the risk that the rendered award could be vacated by exposing the award to judicial review in its merits. "Soler never got to arbitrate the case due to lack of economic resources."[92] A TPF could have financed Soler's claims in arbitration. However, after *Mitsubishi*, a TPF will hardly be incentivizing to finance such a case because it runs the risk of a Court finding the award rendered by the Japanese arbitrators inconsistent with the policy of the Sherman Act. Such a result would increase another variable in the presented model arbitration costs, since a TPF would be forced to continue financing through litigation or lose the investment.

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[89] Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614 (1985).
[90] *Id.* at 638.
[91] THOMAS E. CARBONNEAU, ARBITRATION LAW AND PRACTICE 34-35 (West 2012).
[92] Helfeld, *supra* note 86, at 48 (translation by the author).

C. Federal Arbitration Perspective

The aforementioned analysis demonstrates the influence that federal statues and case law have in the feasibility of the development of a TPF market in Puerto Rico. Therefore, an examination of the effects of the FAA and federal case law is indispensable. I will use Mastrobuono v. Shearson Lehman Hutton[93] to illustrate the application of another variable in my model: potential returns. In *Mastrobuono*, the plaintiffs had signed a standard client's agreement, which included an arbitration clause providing for the application of New York law to the agreement. Thereafter, an arbitral tribunal awarded $400,000 in punitive damages to the plaintiffs. Shearson, the defendant, appealed arguing that under the Garrity rule[94] arbitrators are prohibited from awarding punitive damages. The United States Supreme Court faced the question "whether a contractual choice-of-law provision may preclude an arbitral award of punitive damages that otherwise would be proper."[95] The Court held in the negative, establishing that, unless the contract specifically precluded punitive damages, they would be allowed. First, it established "that if contracting parties agree to include claims for punitive damages . . . , the FAA ensures that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration."[96] It also held that if a similar contract, without the choice of law provision, had been signed, "punitive damages would be allowed because, in the absence of contractual intent to the contrary, the FAA would pre-empt the Garrity rule."[97] With regards to the facts of the case, the Court reasoned that the choice of law "provision might include only New York's substantive rights and obligations, and not the State's allocation of power between alternative tribunals."[98] Therefore, it can be concluded from *Mastrobuono* that the powers of an arbitrator have to be limited expressly in an arbitration agreement and not through the choice of law provision, since such provision can be interpreted as to only cover substantive rights.

Mastrobuono undoubtedly increases the potential return variable of my model, and would favour TPF investments. It increases the potential returns of a claim by permitting punitive damages, and establishing that, unless expressly established in the arbitration agreement, the FAA would pre-empt the Garrity rule. Under the FAA, the TPF will have the certainty that if in the arbitration agreement is no expression of punitive damages, the arbitrator can grant them. Punitive damages are a substantial part of a plaintiff's potential monetary return. In *Mastrobuono*, punitive damages represented 71% of the total monetary award

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[93] Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995).
[94] *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976).
[95] Mastrobuono, 514 U.S. at 55.
[96] *Id.* at 58.
[97] *Id.* at 59 (emphasizes added).
[98] *Id.* at 60.

rendered. Therefore, TPF have a greater certainty in the potential returns it can obtain from a claim, and a greater earnings potential through punitive damages, thus increasing the feasibility of a TPF market.

To illustrate the category frequency variable, I will analyse the Supreme Court decision in *AT&T Mobility LLC v. Concepcion*.[99] The ATT service agreement with Concepcion "provided for arbitration of all disputes, but did not permit class-wide arbitration."[100] When a dispute surged and ATT filed a motion to compel arbitration, the Concepcion's opposed. They argued that the "arbitration agreement was unconscionable and unlawfully exculpatory under California law because it disallowed class wide procedures."[101] The Supreme Court had to decide "whether § 2 [of the FAA] pre-empts California's rule classifying most collective-arbitration waivers in consumer contracts as unconscionable", known as the *Discover Bank* rule[102]. The Court held that:

> [t]he overarching purpose of the FAA, evident in the text of §§ 2, 3, and 4, is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA.[103]

AT&T Mobility severely affects the probabilities of class-wide arbitration and class action litigation to surge. Therefore, it adversely impacts the category frequency variable of the model presented. This variable was deduced from data regarding case distribution by category from IMF Bentham. TPF have category preferences regarding legal claim type, from which class actions are the most common. By limiting class-wide arbitration and permitting class action waiver in arbitration agreements under the FAA, the Supreme Court limited the potential market for TPF. The decision directly affects Puerto Rico under the Supremacy Clause. "When state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA."[104] The Supreme Court goes beyond the limits of the case's facts and expresses that "[a]rbitration is poorly suited to the higher stakes of class litigation."[105]

An important aspect of *AT&T Mobility* is that the facts of the case surge from an adhesive arbitration agreement. In consumer arbitration such contracts

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[99] AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011).
[100] *Id.*
[101] *Id.* at 337-338.
[102] *Id.* at 340.
[103] *Id.* at 344.
[104] *Id.* at 341.
[105] *Id.* at 350.

are necessary from a cost and economics perspective, but to also permit a waiver from class actions seems to be far extended. In an analysis of *Mitsubishi*, Professor Heldfeld points out that parties of an arbitration agreement are not in a position of equal strength and, therefore, there will be favourable terms in the self-interest of one of the contracting parties. It has to be remembered that parties in a weaker position are usually those most in need of TPF.

VI. Conclusion

This paper introduces a framework based upon a valuation perspective, in which new arbitration case-law and regulation can be examined, and in order to determine how they may impact the development of a TPF market. The framework is simplified into a market determinants model composed of six variables that interact with the supply of TPF in the market. It provides a new vision on arbitration, as it promotes the idea to analyse arbitration claims as an asset that can be priced. Through new case-law and regulation, the legal environment changes the market for arbitration claims and, therefore, its value for Third Party Funders. It is also necessary to keep an eye on the evolution of legal financing regulation that can change the Third-Party Funding's landscape.

An examination of three normative arbitration cases through the market determinants model shed light into how it works, with some compelling results. The presented cases raise a red flag to the development of a TPF market. Could parties from a position of economic strength structure arbitration agreements as to prevent TPF of future controversies? The case analysis seen from the proposed framework seems to give an affirmative answer. A party in a position of power will exclude punitive damages and waive class actions, adversely affecting the potential return variable and the category frequency variable of my model and therefore, limiting TPF market supply. Also, *Mitsubishi* increases the riskiness of arbitration in the international context by increasing the chances that the rendered award could be vacated. The case-law examined is just a small sample of what is necessary to have a complete understanding of the interaction of the legal environment with a Third-Party Funding. Nonetheless, the propose framework will permit others to add a new perspective into the examination of the law and new developments in Third-Party Funding.