Luxembourg SIFs: the investment vehicle of choice to structure third-party funding activities

Olivier Marquais, attorney at law, Loyens & Loeff

Olivier Marquais
Attorney at law, Loyens & Loeff
Olivier.marquais@loyensloeff.com

Basic principles of third-party funding

Over the past thirty years, third-party dispute funding has experienced an exponential growth in civil and common law jurisdictions. As the common law doctrines of maintenance and champerty were softened or even abolished (most often in the context of international arbitration proceedings), third-party funding became a viable option for companies which cannot otherwise afford the costs of bringing the dispute forward, and for companies which prefer to take the legal costs off their books (for example to free up funds for other investments) by diverting the costs of the dispute to a third-party in exchange for a percentage of the anticipated proceeds.

A third-party funder will most often be contacted by a potential claimant's counsel about a case and will have to review dozens of cases before finding one that meets its investment policy, economic criteria and reputational standards. Before deciding whether to finance a case, a funder will define the budget required, conduct an extremely thorough due diligence (which may take from a few weeks to several months) assessing very conservatively issues of jurisdiction, merits, quantum and likelihood of recovery, and negotiate the terms of a funding agreement with the potential claimant and its counsel.

When looking for funding on behalf of its client, a potential claimant's counsel should be ready to discuss the case with a number of different funders, which may be time consuming and not necessarily successful. In practice, several documents are exchanged at a very early stage of the relationship and before the funder reviews the case. These often include non-disclosure agreements (since confidential information is shared as of the first contact with the funder) and exclusivity agreements preventing other funders' review of the case.

The counsel's input – as well as its reputation, experience and expected ability to conduct the case successfully to a final award in its client's favor – play a crucial role in the funder's decision to finance the case. Once the decision is made, the claimant's counsel will become the funder's preferred interlocutor and will be requested to provide frequent updates on the developments of the proceedings.

The degree of control negotiated by the funder in the funding agreement may bring about new challenges and give rise to disputes as to the strategy between the claimant (or its counsel) and the funder. It is in all parties' best interests to anticipate the emergence of disputes and provide for dispute resolution clauses and clear termination scenarios in the funding agreement. Escalation clauses are preferred. While the funder appears in a stronger bargaining position since it may pull the plug on the financing – and thus on the arbitration/litigation – it is not in its interest to do so as the amounts already invested would be lost.

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Structuring and investment management advice to funders

From a funder's perspective, assessing and selecting cases, and managing the assets once the decision to finance the case is made, bears some similarities with private equity investments. When the global financial crisis hit, private equity fund managers often turned away from offshore jurisdictions and looked for the easiest ways to comply with investor protection regulations and anti-money laundering procedures. This led them to consider, among others, the Grand Duchy of Luxembourg which positioned itself early on as the jurisdiction of choice for onshore funds structuring. Indeed, taking EU legislative developments as a driving force, Luxembourg modernised its legal system and created a state-of-the-art regulatory environment while maintaining a compliant yet highly flexible approach in its offering of investment vehicles and corporate structures.

Luxembourg law makes available a number of options which suit the particular needs of cautious third-party funders, and in particular specialised investment funds (SIFs) which are subject to an efficient regulated regime set out by the Law of 13 February 2007 and are regulated by the CSSF (Commission de Surveillance du Secteur Financier). As SIFs are reserved for well-informed investors, they are subject to little investment rules and restrictions (other than the risk spreading principle) and allow for flexible investment strategies which third-party funders often appreciate.

Institutional and professional investors likely to invest in dispute-funding entities will appreciate the CSSF's approval of the constitutive elements of the SIF and of the depository, its supervision over the choice of SIF directors and the risk management systems set up to safeguard investors' interests. Heavier transparency and investor communications requirements, when the SIF qualifies as an alternative investment fund (AIF) under the scope of the Alternative Investment Fund Managers Law of 12 July 2013 (the AIFM Law, also provide assurances to investors that the SIF is not misrepresenting its returns. Further, under Luxembourg law, SIFs must also comply with numerous measures aiming to prevent the financing of terrorist activities and the use of the financial system for money laundering purposes. These impose a particularly strict due diligence as to the identification of the client and the origin of the funds.

Examples of well-established funders taking advantage of the Luxembourg investment management regime include Profile Investment, a Paris-based third-party funder which conducts its activities globally. Profile Investment set up its investment structure as a SIF under the corporate form of an investment company with variable capital (société d'investissement à capital variable or SICAV). Setting up a SICAV-SIF in Luxembourg, managed by an authorised alternative investment fund manager that performs the portfolio and risk management functions, contributes to reducing the opacity of these often not very well-known form of investments, in the investors' interests. Further, as both its funds (LF IC1 and LF IC2) qualify as AIFs, Profile Investment benefits from the AIFM Law and the AIFMD passport permitting the marketing of shares in any EU member states while also enjoying considerable tax advantages since Luxembourg SIFs are not subject to net wealth tax, corporate income tax and commercial business tax, but merely to an annual subscription tax of 0.01% of its net assets. ■