Sovereign Awards – Untapped Yield For The Intrepid Investor An investigator's view

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Investor-state arbitral awards have emerged as a new and dynamic asset class for investors seeking new sources of yield. The returns can be high, but value relies heavily on the holder's ability to collect – something that is often highly technical and challenging, but very lucrative if executed properly. Ashley Messick explores the growing market in the arbitral space.

Most of my career has been spent recovering funds from states and state-owned companies, typically on behalf of arbitral award holders. As an investigator, clients hire me to trace assets, develop a recovery strategy and support global enforcement campaigns, many of which can last years. When I started out, my clients were – in the main – victors in a legal dispute or creditors with an enforceable debt. With the rapid onset of litigation funding and the increased appetite by third parties to invest in various stages of litigation/arbitration, my client base has changed. This market and those invested in have taken a natural progression from investment in arbitration to the commoditisation of arbitral awards. Now viewed as tradeable assets – a secondary market for sovereign awards has quietly emerged. Hedge funds now recognise that this new asset class represents a unique opportunity – potentially high yielding, uncorrelated to the market and an alternative to traditional sovereign debt investments.

My work on debt recoveries in 2020 – particularly in the sovereign space – has been dominated by this new breed of clients; something I anticipate will continue to accelerate into 2021 as more funds turn their attention to this new asset class.

What is an investor-state award?

Investor-state dispute settlement (ISDS) is a legal mechanism that allows an investor to bring about arbitral proceedings directly against the nation in which it invested. Often lengthy and expensive, if the claimant is successful, the end result comes in the form of the tribunal issuing a monetary award for damages. In many instances, particularly in the investor-state context, this is only half the battle. The award must be recognised and enforced, and enforcement can take just as long (if not longer) and cost just as much (if not more) than winning the dispute. These awards, which range in the millions to billions of US dollars, are now viewed by some investors as a tradeable sovereign asset.

With the increase in cross-border foreign investment globally, coupled with the uptick in developed countries investing in emerging markets, it is no surprise that investor-state disputes have been on the rise. In addition to more awards being granted, the past few years have seen the rise of 'mega awards' – i.e. those in excess of USD 1 billion. Claimant P&ID's nearly USD 10 billion award against Nigeria and Tethyan Copper Company's USD 6 billion award against Pakistan are probably the two most well-known 'mega awards' currently in play, but there are many more in the pipeline.

Arbitration debt: a growing and evolving sovereign asset class

Litigation finance has emerged as a growing asset class in recent years, attracting billions of dollars of investment. It can generate big returns, it is uncorrelated to the market, and risk exposure can be managed. As a consequence of this, rather than financing a claim, a market has developed for the buying and selling of awards. This is particularly the case when enforcement of the award is challenging as challenging equates to cost, time and in some instances, risk.

Awards are purchased in part or in full for a fraction of the award value, with the investor taking on the enforcement responsibility. When dealing with a state or a state-owned entity, this can be a big responsibility. Everyone remembers the success story of hedge fund Elliot Capital Management and other hold-out creditors following the aftermath of the 2001 Argentinian debt crisis. Following Argentina's default, dozens of hedge funds commenced legal proceedings against Argentina in New York courts for full repayment. While not a sovereign award, but a judgement stemming from defaulted bonds, this case shows what time, resources and a robust enforcement campaign can achieve. Although taking over a decade and significant resources – both legal and investigative – Argentina eventually paid their debt at face value – resulting in almost unheard-of returns for those who bought Argentinian's bonds at distressed level. The hedge fund and third-party funder Tenor Capital Management's investment in the Crystallex case against Venezuela is another example of a protracted fight that – although ongoing – looks likely to yield high returns. The key takeaway here is that both Elliot and Tenor were prepared for a long and aggressive fight.

The resources and resolve needed to take on such a fight may explain why many corporate award holders – after often protracted and expensive arbitration proceedings – either do not have the stomach for another battle or recognise that they do not have the expertise and resources to successfully realise the maximum value from the award. Other award holders might have their hands tied due to reputational issues or due to ongoing investments in the debtor country. Other claimants may simply be driven by a desire to 'get even' with the host state – pursuing a range of doomed recovery tactics. Without the resources, will and expertise, sovereign awards can remain unpaid for years or never realise their full value. With increasing awareness of the possibility to monetise, award holders are now open to the idea of selling their award at the beginning of enforcement proceedings – even if only to recover a fraction of the value. This is particularly true given the current economic downturn, which is pushing award holders towards outright sale as opposed to funding or going it alone. The growing impact of the global economic downturn is increasingly putting developing states under pressure. This is where the opportunity lies for investors seeking alternative strategies.

Market conditions are also favourable for this new form of sovereign debt: sovereign bonds offer low yields and investors in highly distressed sovereign bonds are currently operating in an environment that may limit the actions they can take – particularly as the public view on hardball negotiating is not favourable.

Most of the investors in the sovereign award market are specialised hedge funds, which are experienced in buying and monetising distressed debt instruments and/or have had a history of enforcing monetary judgements. As I will discuss, the challenge lies not in finding a distressed award to purchase; the challenge lies in collecting. Therefore, for those funds who benefit from prior experience in creditor lawsuits and enforcement against sovereigns, sovereign awards represent the next big thing and a relatively untapped opportunity.

What makes sovereign awards attractive compared to other forms of sovereign debt?

There are a number of characteristics of a sovereign award that makes it attractive compared to more traditional forms of sovereign debt.

(i) They can be enforced across multiple jurisdictions

Due to the New York and Washington Conventions, arbitration awards can be enforced with relative ease within signatory states. Compared to defaulted sovereign bonds, which typically must first go through the New York courts (or others specified in the issuance) and then plod through legal proceedings – jurisdiction by jurisdiction – arbitral awards can be fast tracked on a more global scale. Worldwide enforceability also allows for an aggressive enforcement campaign supported by swift action – the equivalent of a global 'dawn raid' – something that is important particularly when dealing with an unruly and unscrupulous state which may attempt to evade enforcement and hide assets.

Venezuela presents an interesting example of this. Those holding defaulted Venezuelan/PDVSA notes have had little recourse, while a number of award holders, such as Crystallex, Rusoro and ConocoPhillips, were able to take swift legal action against Venezuelan assets. While still not fully satisfied, these award holders are ahead of the pack compared to bondholders.

(ii) Investments in arbitral awards can be under the radar

Most investments in arbitral awards are never reported and disclosure requirements are limited to non-existent. With most awards remaining in the name of the initial claimant, investors are able to operate away from the media spotlight and hide behind the party that first brought the claim forward. This is why, despite being a growing asset class, many investors know very little about them. I know of a number of large hedge funds that have purchased sovereign awards and are actively bidding in the secondary market for further awards. There is nothing in the public domain to evidence their ownership or investment in these awards.

(iii) They typically have high interest rates

Awards often come with chunky interest rates. According to available data the range tends to be 3% to 9% – and sometimes even higher. This can help soften the blow when the time to enforce takes longer than expected. There are a number of outstanding awards which, due to non-payment, are now moving towards the mega-award value. The P&ID award against Nigeria mentioned above, started out initially at USD 6.6 billion in 2017 and over time has now risen to the astronomical value of USD 9.98 billion (and counting).

(iv) This asset class is not for the faint-hearted

and rules out most of the investment herd. It needs upfront funding and a long-term outlook. This limits the investor pool and tips the scales in favour of the purchaser

Even if highly discounted, given that the face value of sovereign awards can be in nine figures, a purchase requires a large upfront payment – something that hedge funds can deploy quickly when an opportunity presents itself. Enforcement requires further investment often in covering a timeframe that can run for many years before the investment begins to bear fruit. For example, a USD 800 million award changing hands for 10 cents on the dollar would require an upfront payment of 80 million. Legal, investigative and other fees may range in the multiple millions each year – with peaks and troughs of financial commitment depending on the enforcement cycle. With more and more awards coming on the market and only a few funds tapping into it, it is currently a buyers' market.

The key challenges – it all comes down to the ability to collect

There are plenty of examples of award holders, years after the award was rendered, holding what amounts to a very expensive piece of paper. Some award holders lacked the tools needed to recover and many still do. Attaching sovereign assets and forcing a state to pay is no easy feat. That said, if one has the right tools and invests in the right opportunity – a sovereign award can be an extremely lucrative investment.

The most important 'tool' is a central point of command. A global, holistic strategy must be developed, asset tracing and recovery specialists engaged, jurisdiction specific and often niche lawyers hired, budgets managed, strategic communication and lobbying factored in, all of which requires an experienced and strong command and control structure to drive the enforcement campaign and coordinate what inevitably will be a multiyear, multi-pronged and often arduous task.

From my experience this is true for any large-scale recovery initiative; however, having managed both multi-billion commercial enforcement and sovereign enforcement, I recognise that the unique nature of sovereign enforcement requires a more specialised team and specialised skillset.

First, there are practical hurdles one must consider. Compared to commercial awards, there are a number of legal hurdles associated with sovereign enforcement that creates challenges for collection – chief amongst them is the question of sovereign immunity. Although the obstacle created by the question of sovereign immunity has been chipped away over the years, it still presents a challenge that has not been made easier by the diversity of legal definitions and the application of these to the defence of sovereign immunity. Each jurisdiction has a different legal regime – meaning in one country, an asset may be protected by that country's view of sovereign immunity while in another, the same asset would be fair game. This diversity of legal regimes extends to other aspects of enforcement.

As a consequence of this, I always recommend that at the onset, prior to taking steps towards recognition proceedings and engaging enforcement lawyers, a holistic assessment of a state's assets, the mechanisms through which they operate internationally, and the potential pressure points are identified, mapped and assessed. This requires specialised asset tracing and investigative support so that a comprehensive and overarching 'road map' is in hand. Only then can a robust strategy be developed and redeveloped as time passes because enforcement is a continually evolving process.

In addition to a dynamic and evolving approach, any successful strategy will go beyond the pursuit of state assets abroad. Attaching foreign assets is one way to recover debts owed but, as one can imagine, to satisfy a large debt this could be an arduous process. An oil cargo in transit or real estate abroad owned by a state-owned company's foreign branch may help recover a fraction of an award when the value of the award exceeds a certain value. A multi-pronged strategy will focus not only on bringing proceedings to enforce against multiple assets; it will also consider what pressure can be exerted on the debtor state. We are always looking for pressure points to bring about settlement – this might involve disrupting the state's ability to operate abroad, looking for reputational weak spots, or simply persuading internal stakeholders to push for compromise.

Over the years there have been many examples of assets being seized and governments being put under pressure by award creditors. Take for example the infamous (and ongoing) Stati and others v. Kazakhstan enforcement battle which saw the BNY Mellon freeze assets worth more than USD 22 billion held at the bank by the country's sovereign wealth fund. The frozen amount constituted over 40% of the assets held by the sovereign wealth fund and, although eventually lifted, served as leverage. In another long running enforcement matter, the company Commisimpex which has an award against Congo Brazzaville, recently seized a presidential plane when it landed in France for maintenance. Although Commisimpex lost on a number of other motions in France, namely enforcement against real estate due to sovereign immunity issues, the seizure of the presidential jet certainly was a cause for embarrassment.

Despite the publicity around some sovereign enforcement campaigns, many success stories have gone unnoticed with award holders quietly collecting what amounts to significant returns on their investment. These quiet collectors have emerged as my new client base. They are ahead of the curve in recognising the significant value of this new asset class. In this era of yield chasing, our advice is to explore this developing asset class and – if you have a long-term view – these are potentially highly lucrative investments. **THFJ**