Kluwer Arbitration Blog

LIDW 2024: Bank Collapse and ISDS: Arbitration Strategy and Dramatis Personae

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As part of the 2024 edition of the London International Disputes Week ("LIDW"), Reed Smith LLP hosted a panel on "Bank Collapse and ISDS: Arbitration Strategy and Dramatis Personae". The panel, moderated by Lucy Winnington-Ingram (Reed Smith), comprised Kathleen Garrett (Reed Smith), Cameron Miles (3 Verulam Buildings), Lorena Fatás Pérez (Ministry of Justice of Spain), Timothy Mayer (LCM Finance), and Kiran Sequeira (Secretariat).

The panel kicked off with a hypothetical scenario of the life cycle of an international investment dispute arising out of the collapse of a bank, where each panellist assumed a role and shared their views following the steering questions of the moderator.

Given last year's "shotgun wedding" of Credite Suisse with UBS, the hypothetical scenario is not a distant reality: the rapid collapse of a bank triggers a prompt reaction of the state to restore trust on the financial system; the solution lies in another bank pledging to take over the collapsed bank but insisting the bad bonds be cancelled. The regulator of the state gives its blessing and authorises the writing-off of bad bonds from the collapsed bank. The reaction of the investors whose bonds were cancelled is expected: possible claims in investor-State Dispute Settlement ("ISDS") against the state.

With this fact pattern, Lucy Winnington-Ingram set the scene and proceeded to a four-layered discussion.

Analysis of the Case

Lorena Fatás Pérez opened the discussion by giving the host states' perspective when facing the risk of such claims. A quick analysis of the situation is therefore warranted. Questions ranging from how the situation may evolve into an ISDS case, whether it is possible to deal with the potential dispute inhouse or how to establish the tender procedure for outside counsel require immediate attention by the state.

Kathleen Garrett followed up with the other side of the coin: the considerations from in-house counsel of one of the major debt holders. Whilst "simplicity" is the key here, one should be aware of a variety of issues including whether other bondholders are in the same situation and it is

possible to join forces, the viability of the bonds, the regulatory regimes that might influence the bonds, the particular terms of the bonds and the bondholders' expectations, but most importantly, the exact circumstances leading to the cancellation of the bonds: "the devil is in the details".

It was then Cameron Miles' turn to provide the investment arbitration counsel's perspective. There are two legal points to preliminary consider: from the investors' side, the bonds as such must be assessed (e.g. their risk, value, and terms) whereas from the state's side, and the write-off of debt to intervene a systematically important bank may be of an existential nature. But the economic side of the claim cannot be left aside: one must thus consider whether there is a group of similarly-affected bondholders, and whether third-party funders are needed. It would be rather unique if bondholders are from the same jurisdiction (see e.g. *Abaclat v. Argentina*); thus, the jurisdictional requirements and substantive standards of protection under each applicable treaty are to be checked.

Timothy Mayer brought to the spotlight, the key issues that funders in such an ISDS case would be interested in. The "endgame" of funding such a claim comes to the forefront, particularly whether it is likely to be an outcome resulting in payment of damages. But this comes with added questions such as the timing envisaged for the entire case (and thereby the funder's return in its investment), the number of bondholders and the existing of "anchor" clients having enough portion of the claim as well as being solid on the merits thereof. Overall, funders seek to establish the viability of the ISDS case, which turns out difficult in cases of bank's bondholders given the novelty of the issue.

Kiran Sequeira then shifted the discussion to the quantum expert's role. First, a quantum expert must identify the type of investments subject to the ISDS claim (e.g. shares of the bank or bonds issued by the bank), who are the bondholders, how much was paid for the bond, and what was the expected return. Second, a quantum expert also ought to work with counsel in issues such as establishing the date of valuation. Third, from a more technical angle, a quantum expert must set the boundaries of the but-for scenario, consider market metrics among other considerations. He emphasised that the failure of Banco Popular in Spain proved the technicalities involved in the financial sector, which are of significant relevance for a quantum expert.

Tribunal Selection

The panel subsequently moved to considerations on tribunal selection. Lorena Fatás Pérez stressed the difficulty for state in-house counsel to identify arbitrators at an early stage of the proceedings since the requests for arbitration usually do not display how the arguments will be pleaded. Yet, there are some signposts such as selecting an arbitrator that is not exclusively "commercially-minded", who has previously rendered awards on the right to regulate, or if the particular state is subject to the directions of an international organisation, an arbitrator who is knowledgeable about the intricacies of the said organisation.

Playing the investor's counsel role, Cameron Miles pointed out the opposite attributes for an arbitrator: someone who understands banks (and preferably bonds) at a commercial level, but also someone with credibility on issues such as admissibility of mass claims, who may sway the tribunal's decision-making process. And in cases where the claim is third-party funded, an arbitrator that the funder approves.

Early Applications

Cameron Miles outlined the multitude of early applications that counsel may submit for the tribunal's consideration. For instance, applications to break the group in a mass claim; this will render the proceedings increasingly more expensive for the claimants, potentially lengthier and ultimately dispose of a number of claimants. Other applications include objections to the tribunal's jurisdiction, requests for bifurcation (between jurisdiction and liability, but also quantum), security for costs or provisional measures. However, claimants are less likely to bring early applications because it implies more costs.

Timothy Mayer followed up with funders' perspective, particularly with respect to security for costs. Funders are no longer worried about applications for security for costs as they have seen such applications many times. On this point, funders rely heavily on counsel's advise but they also consider carefully the amount requested as security. If needed, funders may resort to insurance arrangement to cover the security. Interestingly, applications for bifurcation are looked with different lens by funders: if the claimant and its funder are "going to lose the case, better at an early stage".

Considerations for the Merits

As a last point, the panellist addressed the considerations for the merits. Typically, for cancellations of bonds, two possible breaches come to mind (i) expropriation; and (ii) fair and equitable treatment ("FET") standard.

Cameron Miles underscored that circumstances have changed since 2015 (see e.g. *Poštová Banka v. the Hellenic Republic* and previous coverage on this here and here); in 2024, the state's "power to regulate the financial sector is well-established". Claimants are thus well-advised to steer away from classical requirements for an FET breach or the finding of expropriation. Rather, a more granular search will be required, for instance, vestiges of arbitrariness or discrimination in the process of the bonds' cancellation (e.g. priority to certain bondholders or the bank's shareholders).

From the state's perspective, Lorena Fatás Pérez opined that the right to regulate provides a good defence in this type of cases. One may also evaluate issues of attribution if an international organisation is involved. But mass claims require the state to identify the singular claimants as in some cases, investors from the host state (who would not be allowed to bring an ISDS claim) are found in the group of claimants. This also brings the issue of due diligence of each investor, which might provide the state with arguments to defend itself from certain claimants of the group.

Kathleen Garrett briefly touched upon whether domestic law issues may affect the arbitration. The key matter pertains to the viability of the bonds as such. Although with regard to financial regulations, one may consider the content of the regulation, how it was introduced, or why it was belatedly implemented.

Finally, Kiran Sequeira closed the substantive discussion with the last "gate" before quantum which is causation. He asserted that sometimes, quantum assessment may be less complicated than causation. This may bring about the need for engaging regulatory and financial experts that provide their expertise in the arbitration.

Conclusions

The global financial system may be systematically more resilient after the 2007/2008 financial crisis. Yet, this does not prevent banks from defaulting. Bank collapse is no longer an anomaly and the insights gained during this event highlight the multifaceted considerations surrounding a potential ISDS claim from affected bondholders. A sober assessment of a potential bondholder's claim dives into the understanding of the financial system and the functioning of the particular bond, as well as the circumstances leading up to its cancellation.

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