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In Practice

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Dealing with sovereign wealth funds: immunity concerns and practical steps to mitigate them

Immunity can increase the risk of transacting with a sovereign wealth fund (SWF). In this In Practice article the authors consider these risks and steps to mitigate them in contractual arrangements.

In the last two decades the number of sovereign wealth funds (SWFs) has grown approximately five-fold, from 20 in 2000 to approximately 100 today, and the assets under management in SWFs across the world are estimated to hover around US$15trn. SWFs are active players in the world's financial markets, investing across a wide range of asset classes such as equities, fixed income, structured products and alternative assets (such as private equity, real estate, and hedge funds). SWFs engage in the use of derivatives to optimise their portfolio and to hedge unwanted risks. They are also active in the loan markets and, in recent times, a number of SWFs have been reported to be looking at margin loans in the billions of dollars backed by equity investments.

In short, in light of this activity, dealing with SWFs has become increasingly common, including for banks and financial institutions. In many senses SWFs are like any other private commercial actor, but because they are established by sovereigns or governments (States) to hold, manage, or administer assets to achieve financial (and sometimes political) objectives, transacting with SWFs may involve additional counterparty risks. In particular, their creation by the State raises the spectre of whether they benefit from immunity from jurisdiction and execution against assets, and how this can be addressed to ensure effective enforcement of their obligations and liabilities.

DO SWFs BENEFIT FROM IMMUNITY?

As SWFs are ultimately creations of States, the question of whether they may benefit from immunity is a highly relevant one to any party exposed to the risk of an SWF defaulting on its obligations. If an SWF does benefit from immunity, this may operate as a jurisdictional bar to bringing claims against the SWF or enforcing an arbitral award or judgment against the SWF's assets.

As to the question as to whether an SWF will benefit from immunity, the answer unfortunately is, it depends. First, it is important to remember that immunity is a procedural defence, so the question of whether an SWF will be able to assert immunity depends on the law of the jurisdiction in which proceedings are being brought. Second, many States apply a so-called "restrictive doctrine" of immunity, meaning immunity will not apply where a State engages in commercial activities and where assets are in use or intended for use for commercial purposes, even if no specific waiver has been given (eg the UK (under the State Immunity Act 1978) and the US (under the Foreign Sovereign Immunities Act 1976)). There are, however, States such as China and Hong Kong, where such exceptions do not apply. Third, there is the crucial threshold question of whether the SWF should be equated to the State so as to enjoy immunity. Whilst it is convenient to discuss SWFs as a homogenous group, not all SWFs are structured in the same way, including in terms of their legal structure, governance, extent of their autonomy from the State, the purpose for which they have been set up and their explicit aims or mission. These factors are likely to be relevant to a determination of whether the SWF and its assets benefit from immunity.

CASE STUDY UNDER THE UK STATE IMMUNITY ACT 1978

To illustrate the complexities in evaluating the risk of an SWF benefiting from immunity, it is instructive to consider, at a high level, the English law approach. In the UK, immunity can be claimed by "(a) the sovereign or other head of that State in his public capacity; (b) the government of that State; and (c) any department of that government" (s 14(1) of the State Immunity Act 1978 (Act). Whether an SWF will fall under the scope of s 14(1) requires consideration of its status under its own national law. Some SWFs constitute a pool of assets without separate legal personality (such as Chile's Social and Economic Stabilization Fund). The State, as the owner of the assets, then exercises the functions of the governing body through one or more of its departments or ministries or delegates those functions to an entity such as a Central Bank.

However, many SWFs are established as separate legal entities with a legal personality distinct from that of the State (such as the UAE's ADIA and Singapore's Temasek). Under the Act, a "separate entity" – being an entity which is distinct from the executive organs of the government of the State and capable of suing or being sued – may be immune from jurisdiction if "(a) the proceedings relate to anything done by it in the exercise of sovereign authority; and (b) the circumstances are such that a State […] would have been so immune" (s 14(2) of the Act).

If an SWF is a "separate entity", the enquiry moves to the question of whether the activities of the SWF which form the basis of the dispute were done in the exercise of sovereign authority, and the circumstances were such that a State would have been immune.

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Again, this would require consideration of the specific nature of the SWF's activities, in the context of both the specific transaction at issue and its official purpose, including the extent to which the SWF is fulfilling the State's political, as well as economic, objectives.

Finally, and assuming that an arbitral award or judgment has been obtained against the SWF, the SWF may seek to prevent execution against its assets on the grounds of immunity. The Act contains an exception from immunity in respect of assets that are "in use or intended for use for commercial purposes". An SWF may, for example, argue against the application of such an exemption by reference to a general or specific public purpose, eg that its assets are intended to fund local social and economic development.

MITIGATING ENFORCEMENT RISK WHEN DEALING WITH SWFs

As is clear from the above discussion, assessing the risk of an SWF raising a successful defence of immunity may be difficult and must be carried out on a case-by-case basis. Even an unsuccessful claim to immunity can delay resolution of disputes and exacerbate the costs of any litigation.

To mitigate immunity risk, it is therefore recommended that parties contracting with SWFs address potential immunity concerns in their contractual arrangements. This would usually mean including:

- a clear and unequivocal submission to the jurisdiction of the relevant courts; or
- an arbitration clause and a submission to the courts of any jurisdiction for the purposes of proceedings in support of arbitration; and
- a waiver of immunity from the jurisdiction of the relevant courts (including, if relevant, for the purposes of proceedings in support of any arbitration); and
- a submission to the jurisdiction of any courts for the purposes of execution;
- written consent to execution against the SWF's assets in respect of both interim relief and final judgment or award; and
- a waiver of any immunity from which those assets would otherwise benefit.

In summary, an SWF may make an attractive investor or contractual partner, but those dealing with SWFs need to tread carefully to ensure that the obligations of the SWF can be effectively enforced. ■