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Why litigation financing is witnessing a sudden surge in popularity in India

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- The IBC overhauled liquidation laws in India, making it easier for creditors to institute insolvency resolution proceedings against defaulters within a deadline.
- Large conglomerates in the infrastructure and EPC sector are entering into TPF arrangements with investment management companies in an attempt to deal with stressed assets.

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Litigation funding, often referred to as third party funding (TPF), has become fairly commonplace in jurisdictions such as the United Kingdom, the United States and Singapore. Its popularity has skyrocketed to the extent that globally, TPF as an asset class has outperformed private equity and hedge funds.

TPF is relatively rare in India. However, due to various recent legal

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developments, large conglomerates in the infrastructure and EPC sector are entering into TPF arrangements with investment management companies in an attempt to deal with the problem of stressed assets and ongoing high-value litigations that are known to plague the sector as a whole.

Conducive environment for litigation finance in India

It must be noted that despite a sudden surge in popularity, TPF has never been explicitly barred in India. In fact, Maharashtra, Gujarat, Madhya Pradesh and Uttar Pradesh have enacted amendments to Order XXV, Rule 1 of the Code of Civil Procedure, 1908, thereby explicitly stating that courts have the power to secure costs for litigation by asking the financier to become a party and depositing costs in court. Further, there is no statutory bar on litigation financing in the rest of India.

One of the most common arguments against the legality of litigation financing in India was that a contract thereof would be a champerty contract, i.e., one where the return / consideration is contingent on the outcome of the case. However, the Supreme Court has clearly stated that such a contract is not illegal unless the advocate is the party receiving the contingent consideration. TPF, as the name suggests, only runs the risks of contingent returns for a third party who undertakes the same.

The various legal developments that have led to an increase of instances in TPF in this sector include *inter alia* (i) the recent amendment to the Specific Relief Act, 1963 (SRA), whereby specific performance of a contract has been made a mandatory relief, as opposed to a discretionary relief that may be granted by the court if there is no monetary remedy available, (ii) another amendment to the SRA, which inserted a provision whereby in infrastructure project contracts, the court shall not grant an injunction in any suit, where it would cause hindrance or delay in the continuance or completion of the infrastructure project, (iii) amendments to the Arbitration and Conciliation Act, 1996 (Arbitration Act), which introduced tighter deadlines for the passing of awards, as well as the concept of fast-track arbitrations, and (iv) the Bombay High Court's recent order dated March 7, 2019 which effectively holds that law graduates may engage in the business of litigation finance, provided they are not advocates registered under the Advocates Act, 1961.

However, the root cause for the burgeoning popularity of TPF in the EPC sector is probably the distressed debt that is now characteristic to the sector, and the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC). The IBC has overhauled insolvency and liquidation laws in India, making it easier for creditors to institute insolvency resolution proceedings against defaulters within a time-bound 270-day deadline. One of the grounds for filing an insolvency application against a company is an adverse judicial order/arbitral award regarding a debt owed by such a company to its creditor. Therefore, it has become increasingly essential for conglomerates in the EPC sector to resolve their litigation claims for two reasons: firstly, they are time-consuming, and not resolved in the short term, thereby affecting

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short-term liquidity, and secondly, the threat of the corporate insolvency resolution process under the IBC is a looming reality in the event of an unsuccessful claim.

Structures adopted in recent TPF arrangements in the news

There has been a lot of public speculation regarding the litigation finance arrangements by EPC heavy weights, such as Hindustan Construction Company Limited (HCC) and Patel Engineering Limited (Patel Engg.) with global investment players.

HCC has been embroiled in long-drawn arbitrations with various government entities and public sector utilities such as the National Highways Authority of India (NHAI) and the National Thermal Power Corporation Limited (NTPC) amongst others. In order to mitigate the resultant strain placed on its finances, HCC announced that it shall be assigning all its beneficial interests and rights in a pool of claims and arbitration awards, amounting to a value of roughly Rs 2,000 crore, to an SPV controlled by a consortium of investors led by BlackRock. As consideration for this assignment, HCC will receive Rs 1,750 crore from this consortium.

This move is intended to spearhead HCC's 'financial turnaround' as it will be considerably deleveraged as a result of this transaction, wherein Rs 2,000 crore of working capital assets (the value of the claims) will leave its balance sheets, consequently partially writing down HCC's net-worth. Management representatives of HCC have also reportedly stated that the actual cover given to investors is effectively over twice the amount invested in the SPV because the amounts expected as receivables from these claims and awards is Rs 4,000-4,500 crore, despite their value being Rs 2,000 crore on HCC's balance sheets as of now.

Similarly, Patel Engg.'s Annual Report for FY 2017-2018 avers that it has assigned its beneficial interest in certain actionable claims and other rights in real estate assets, along with the corresponding debts and liabilities thereto, to a wholly-owned subsidiary of Patel Engg. called Hitodi Infrastructure Limited, 51% of the equity of which is held by the prominent investment management company, Eight Capital. This move was attributed to a huge timing difference in debt servicing requirement vs. expected realizations" and this was *inter alia* a step that could be taken to realign debt with the expected cash flow.

Possible structures for litigation financing

The structuring of litigation finance transactions is essential to the determination of a third party funder's interests in the proceeds of the claims being financed. Internationally, there are three common structures of a TPF transaction: (i) the litigant holds the proceeds from its claim(s) in a trust, in which the third party funder is one of the beneficiaries; (ii) the litigant assigns the proceeds from its claim(s) to the third party funder; or (iii) the litigant assigns the claim(s) in itself/themselves to the third party funder.

As we can see in the instances of HCC and Patel Engg., a variant

of option (iii) seems to have been the preferred course of action. However, the financiers involved so far have not been dedicated litigation financers such as Burford or Harbour, but private equity players such as BlackRock and Eight Capital. Further, in both these transactions, the claims are not being directly assigned. Instead, they are being assigned to SPVs, where multiple investors hold equity interests. Regardless of the entities involved, the core of the transaction seems to be a contingent contract, where the gains a third party financier makes are dependent on the success or failure of the assigned claims. While such a transaction has a significant upside in the event of the success of the litigant's claims/counterclaims, the obvious disadvantage is that the third party funder walks away virtually empty-handed if the litigant loses the case. Further, any sort of compensation of the third party funder by the litigant may not be possible because, as we can see in India, the litigant is invariably in a situation of financial distress and has elected to enter into a TPF arrangement to alleviate the same.

The obvious solution, i.e., structuring the transaction as a loan, wherein the litigant must return the entire upfront amount received from the third party funder, with interest accrued, is untenable. A loan is an obligation to repay debt and not a contingent liability. Further, there must be a fixed rate of interest, and a maturity period. In a TPF arrangement, there is a huge likelihood that the outcome of the litigant will not be favourable and as stated above, if the litigant is under formal insolvency proceedings, it is unlikely to meet its repayment obligations. Additionally, the categorisation of third party funder as a financial creditor in order to have valid claims against the litigant as a defaulter/corporate debtor under the IBC is also risky because of the possibility of 'haircuts' (write-offs), which are typical of any corporate insolvency resolution process.

Therefore, it seems likely that the structuring of these deals will continue by way of contractual arrangements, where funds may be channelled through SPVs, or possibly Alternative Investment Funds.

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