INSIGHT

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LITIGATION FINANCE IN INDIA

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LAWYERS OF TOMORROW

I INTRODUCTION

1) Litigation finance is an arrangement between a third party and a party to a litigation or an arbitration, where the former agrees to fund legal expenses in relation to the dispute, including lawyers' fees, disbursements and other costs, in exchange for a share in the claim proceeds. Litigation finance was traditionally a resource for funding when one could not afford to pay one's own legal fees. This perception has now changed, and law firms and companies are increasingly utilizing litigation finance as a strategic risk-mitigation and cash-flow management tool to transform disputes from cost-centres to revenue generators. However, this change in perception does not undermine or do away with the underlying principle of access justice. This concept of open access to justice for all, is still a fundamental purpose and characteristic of litigation finance.

2) With globalization of businesses and transnationalization of disputes, commercial claims are increasingly viewed as an asset by third-party financiers, who provide the necessary financial tools to monetize these assets. This present and sophisticated avatar of litigation finance was 'invented' in Australia, with LCM, along with IMF Bentham (now known as Omni Bridgeway) and LLS as the pioneers. Despite being 'invented' in Australia, litigation financing has grown rapidly elsewhere, especially in the UK[i] and the US[ii], with billions of dollars under management and a broad array of financial products.[iii] Today, litigation finance is increasingly gaining momentum in Asia as well, and countries like Singapore and Hong Kong have made statutory provisions allowing litigation finance in international arbitrations.[iv]

II POSITION IN INDIA

3) While there is a lot of debate amongst practitioners on the permissibility of litigation finance in India, it has been recognized as an accepted form of finance by Indian courts, since at least the 18th century. The Privy Council has, as early as 1876,[v] opined that "a fair agreement to supply funds to carry on a suit in consideration of having a share of the property, if recovered, ought not to be regarded as being, per se, opposed to public policy". It went on to identify one such category of agreements as those which intended to assist plaintiffs "who had a just title to property, and no means except the property itself" to recover that property. The Privy Council found such an agreement to be in "furtherance of right and justice, and necessary to resist oppression." This has since been recognized as the leading authority on permissibility of litigation finance by various courts in India.[vi] More recently, in 2018, the Supreme Court of India[vii] has confirmed that "there appears to be no restriction on third parties (non-lawyers) funding the litigation and getting repaid after the outcome of the litigation."

4) A good example of such claimants today (who have no means to recover property) are financially-stressed engineering, infrastructure and oil and gas companies, having large claims against the state and state-owned enterprises, but little or no capital available to pursue those claims. Financing legal costs for such companies, including by banks and financial institutions, in exchange for a share in the recovered proceeds, is therefore permitted by law.

5) The Privy Council has also explained that to assess if the litigation finance agreement is a fair agreement to supply funds "it is essential to have regard not merely to the value of the property claimed but to the commercial value of the claim." Moreover, the commercial value of the claim has to "be estimated by the parties in advance of the result; and where they have weighed the probabilities in a manner which has not operated unfairly, it is more reasonable to regard this as confirming their shrewd estimate of the chances, than to condemn the agreement outright as unfair, by reason only of the possibility that a great gain to the claimant would have had to be shared with the financier." Significantly, courts have granted credence to a financier receiving exceptional advantage under such arrangement and explained that "the proportion to be retained by the claimant is an important matter to be considered when judging the fairness of a bargain made at a time when the result of the litigation is problematical. The uncertainties of litigation are proverbial; and **if the financier… risk(s) losing his money he may well be allowed some chance of exceptional advantage**."[viii] **(Emphasis supplied)**

6) Thus, even agreements where the financier receives its costs plus 50% or 60% of the claim proceeds, based on the risk profile of the case, would be regarded as fair agreements, if the commercial value of the claim is pre-estimated and the parties have weighed the probabilities of success in a manner which does not operate unfairly.

7) That said, the courts have held litigation finance agreements which consisted of unconscionable bargains and were of an extortionate nature, to be invalid by virtue of Section 23 of the Indian Contract Act, 1872[ix]. Some examples of prohibited transaction are as follows:

(a) where the lawyer was funding the clients' dispute.[x]

(b) where the financier demanded proceedings to be dropped off as part of the consideration[xi] ;

(c) where the funder had influence over the deciding authority[xii];

(d) where the financier asked for 3/4th share of the property[xiii];

8) It is also noteworthy here that amendments by states like Maharashtra, Gujarat, Madhya Pradesh and Uttar Pradesh to the Civil Procedure Code 1908 ("CPC"), make express provisions recognizing and providing rules in relation to litigation finance. For example, Order 25 of the CPC, as amended for the State of Maharashtra [xiv], states that in cases where a third party is financing a plaintiff for some returns, "the Court may order such person to be made a plaintiff to the suit, if he consents" and, within a time to be fixed by it, "either of its own motion or on the application of any defendant order such person to … give security for the payment of all costs incurred and likely to be incurred by any defendant". Thus, funded cases before courts in metros like Mumbai, Noida and Ahmedabad have an established legislative framework which acknowledges such litigation finance.

III POSITION UNDER THE FOREIGN EXCHANGE MANAGEMENT ACT

9) India has a limited market, with almost no home-grown litigation funders. This means Indian companies often have to rely on foreign funders to raise litigation finance. Thus, it is crucial to assess the permissibility of a litigation finance agreement with a foreign investor under the Foreign Exchange Management Act 1999 ("FEMA").

10) FEMA classifies foreign exchange transactions into two broad categories – Capital and Current Account transactions. While the former is prohibited unless permitted, the latter is permitted unless prohibited. FEMA provides an exhaustive definition of the term 'Capital Account Transaction' and means a transaction which alters the:

(a) assets or liabilities, including contingent liabilities, outside India of persons resident in India, or

(b) assets or liabilities in India of persons resident outside India.

On the other hand, a 'Current Account Transaction' is a transaction other than a Capital Account Transaction. Thus, if a litigation finance agreement does not classify as a Current Account Transaction, it would be a regulated transaction, which would either have to be expressly permitted or would require prior approval of the relevant regulator.

11) Whether a litigation finance agreement is a capital or current transaction would depend on the facts and circumstances of each case, and would be assessed on the basis of the following 6 criteria:

(a) Nature of the transaction:

(i) The first and most important criterion for raising litigation finance from a foreign funder is to ensure that the entire funding arrangement is non-recourse (i.e. the funder's return must be secured only against the claim proceeds).

(ii) If the transaction is not non-recourse, it could be viewed as a debt transaction and would require compliance with the regulations in relation to External Commercial Borrowings.

(b) Repatriation of proceeds to the funder:

(i) Another important criterion for the transaction to remain a Current Account Transaction is that the claim proceeds are transferred to the funder, at the time of entering into the agreement, in the form of assignment of interest in the future 'fruits of litigation', and not as a payment obligation of the litigant towards the funder, upon receipt of the claim proceeds.

(ii) This is because the latter could lead to creation of an asset in India for the funder, upon realisation of the claim proceeds by the litigant, if the litigant's debt towards the funder is situated in India. A 'debt' may be considered as situated in India where the litigant, the seat for dispute resolution under the funding agreement, or enforcement of the ensuing decision, is in India. If this is more than one place, the 'debt' may be considered situated at the place to which it has the most real connection. This would depend on several factors, including the place where the 'fruits of litigation' were obtained, and where they are enforceable. This would also result in a conflict between the various applicable laws, leading to a complex debate. This could arguably characterise the transaction as a Capital Account Transaction upon realisation of claim proceeds by the litigant, prior to repatriation of those proceeds to the funder.

(iii) The transaction can tilt further in favour of being considered a Current Account Transaction, if the "debt" is regarded as an unpaid business expense for the litigant. A possible solution to strengthen this view towards the funder's return is by claiming the cost incurred for the litigation funder's share as part of the costs claimed in the dispute by the litigant.

(iv) However, this debate can be avoided entirely by assigning an interest in the future 'fruits of litigation' to the funder immediately on entering the funding agreement. By doing so, on the date of the agreement there would only be a beneficial interest of the funder in the future 'fruits of litigation'. This interest would be an intangible asset situated where the funder is located.

(v) Upon the 'fruits of litigation' coming into existence, there would be an assignment of the funder's share in these fruits, to the funder. This would be assignment of interest, by law, and not a transfer of an asset. This interest would be an intangible asset of the funder, and will be located where the funder holds this asset.

(vi) This would also create a 'trust' on the funder's share in the 'fruits of litigation', immediately upon its coming into existence, in favour of the funder. This 'trust' may be situated where the funder is located or the place of the law governing the funding agreement.

(vii) Moreover, the funder could require the litigant to receive the 'fruits of litigation' in an escrow or lawyer's trust account, and such a fiduciary can be made responsible to determine and distribute to both the litigant and funder their respective shares in the 'fruits of litigation'. This avoids receipt of payment into the litigant's bank accounts, and any ensuing arguments that the funder's repayment was a 'debt' obligation.

(viii) Thus, throughout the repatriation process there may not be any alteration of the funder's 'asset in India', or of the litigant's 'asset outside India'.

(c) Nature of claim:

(i) Another important criterion is the nature of the claim. Claims for damages are contingent assets and are usually not part of the litigant's balance sheet. Therefore, such claims do not create any complications under FEMA at the time of the litigation funding transaction; especially when there is no transfer of the asset itself but only beneficial interest in the income from the asset. However, claims for debt (such as agreed sums and indemnity) are usually reflected as assets/ receivables on the litigant's balance sheet, and litigation finance in relation to these claims could lead to a capital account transaction in the following situations.

- When the debt is situated outside India, (i.e. if the debt is recoverable or enforceable outside India, and if this is more than one place, the place to which it has the most real connection is outside India), and a portion of that debt is transferred to the foreign funder.
- When the debt is situated in India, (i.e. if the debt is recoverable or enforceable in India, and if this is more than one place, that place to which it has the most real connection is in India), and a portion of that debt is transferred to the foreign funder.

(ii) Similarly, the eventual decision/ settlement agreement in favour of the litigant would be recorded as an asset on the litigant's balance sheet on the date of decision/ settlement. A transfer of this decision/ settlement to the funder may also arguably trigger either an alteration of the funder's assets in India (if the decision/ settlement is situated in India), or of the litigant's assets outside India (if the decision/ settlement is situated outside India).

(iii) However, this would not be the case if only a beneficial interest is created in:

- the contingent debt, i.e. an award, decree or a right to payment settlement agreement, resulting from perusing an action of the claim of debt; or

- another future asset, i.e. the money, paid by the defendant to the litigant under such a decision or settlement,

by assigning the funder its share in the future 'fruits of litigation' on the date of entering into the funding agreement.

(iv) In the first option, the assignment by law would take place when the decision/settlement comes into existence, while in the second option, the assignment by law would take place on the date the 'fruits of litigation' are remitted to the litigant. In both cases, the transaction would be regarded as assignment of interest in the 'debt' under the settlement agreement or decision, and not as transfer of the 'debt 'itself. This means funder would only retain interest in asset, and this 'interest' is itself an intangible asset located where the funder holds the asset.

(v) In both cases, the law governing the settlement agreement, or law of the seat of the award, or the law governing the contract between the litigant and defendant, may be the law governing the assignment. The mutual obligations of the funder and the litigant would be governed by the law governing the funding agreement.

(vi) The impact of this may be better understood when looked at through the jurisprudence under the Income Tax Act, to assess the tax treatment of this transaction. First, what would be subject to tax in the hands of the litigant would be only the payment received against the debt claims, minus the cost to recover the debt. Capital receipts such as payments for claim for damages, will not be regarded as income, and thus would not be subject to tax. Second, the litigant would record the entire payment received against the debt claims and damage claims in its books, and the funder's share would be deducted only as a cost. Thus, the litigant's assets would remain intact throughout the transaction, without any 'alteration' to it. For the funder, if this is regarded as business income, and the funder has no permanent establishment in India, the 'income' would be subject to tax only as per the laws at the funder's residence.

(d) Form of the 'fruits of litigation':

(i) That said, this entire analysis, at 11 (b) and (c), is based on the presumption that the 'fruits of litigation' are in the form of money. If this is not the case, it could lead to further debate. For example, if the 'fruits of litigation' is a land parcel situated in India and the funding agreement creates an assignment of a portion of that land in favour of the funder.

(ii) These complications can be avoided by excluding non-cash 'fruits of litigation' from the funder's assignment, and requiring the litigant to immediately convert these into cash on receipt. The funder's assignment should take effect only upon the litigant completing the conversion from non-cash to cash. Till such time, the funder should retain only a beneficial interest in income from those assets, under the funding agreement.

(e) Security Interest in favour of the funder:

(i) Similarly, if the funding agreement seeks to create any charge on the litigant's immovable assets, movable assets and/or financial securities, or seeks issuance of corporate or personal guarantees, to secure the repatriation of the funder's share in the 'fruits of litigation', the transaction may no longer remain a Current Account Transaction.

(ii) This would not include a 'security interest' in favour of the funder, created by assignment of the funder's share in the 'fruits of litigation' to the funder.

(f) Accounting method followed by the funder:

(i) Another crucial criterion is the accounting method to be followed by the funder with respect to litigation funding contracts in progress. There are two prevalent approaches in the market at present: one which is followed by the funders in Australia, LCM and Omni Bridgeway, and another which is followed by a funder in the US, Burford. While the Australians recognise litigation funding contracts in progress as intangible assets, Burford recognises litigation funding contracts in progress as financial assets.

(ii) In case of the former, while the litigation funding contract would alter the asset side of the funder's balance sheet, the situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset. Therefore, this asset may not amount to an "assets in India of persons resident outside India" and thus would not be Capital Account Transaction under FEMA.

(iii) On the other hand, in case of the latter, a financial asset may be regarded as a situated in India, leading to alteration of the funder's "asset in India". This may not only make the transaction a Capital Account Transaction, but may also potentially expose the transaction to scrutiny by the income tax department in India. Moreover, this could also open a debate into the transaction being classified as a derivative transaction.

IV CONCLUSION

12) Courts in India have repeatedly reiterated that the abuses associated with champerty are not the inevitable result of all varieties of contingency fee agreements, and that a fair agreement to supply funds to carry on a suit in consideration of having a share of the property, if recovered, is not opposed to public policy. Thus, there can be no debate that litigation finance is permitted in India.

13) So far as compliance with FEMA is concerned, each transaction would need to be structured on a case-to-case basis, depending on the facts and circumstances of each case. If the 6 criteria specified above are satisfied, the litigation funding agreement would most likely be a permitted Current Account Transaction.

14) The best way to avoid these complexities, would be for funders to establish a structure to cater for India deals. This could be created under the Alternate Investment Funds (AIF) regime in India.

15) As evident from above, funders and litigants face a myriad of challenges. Moreover, most funding transactions involve understanding of more than one dispute resolution and debt recovery systems, which poses challenges that can significantly affect deal value. It is thus crucial to have lawyers that can navigate through this complex environment.

16) Our team is exceptionally well-positioned to do this. With our in-depth understanding of cross-border disputes, global enforcement, debt recovery, investigations and asset tracing, we provide a one-stop solution to both litigants and funders. Our innovative commercial and highly strategic approach to complex international disputes helps clients identify the true potential of their claim portfolio.

To find out more, please contact:

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[i] *Some UK based litigation funders include Augusta, Affiniti, Balance Legal Capital, Bench Walk, Harbour, Innsworth, Redress Solution, Profile Investment, Therium, Vannin and Woodsford*

[ii] *Some US based litigation funders include Burford, Blue While Legal Capital, Delta Capital, Lake Willihans, Legalist, Longford Capital, Pravati Capital and VGL Capital.*

[iii] *LCM – IPO on the ASX Management Presentation November 2016 (https://www.lcmfinance.com/wp-content/uploads/2016/11/LCM-IPO_FINAL.pdf)*

[iv] *Singapore permits this in insolvency cases as well. There is also some acceptance that litigation finance would be permitted in cases before the Singapore International Commercial Courts.*

[v] *Ram Coomar Coondoo v. Chunder Canto Mookerjee, 1876 SCC OnLine PC 19*

[vi] *Baldeo Sahai v. Harbans, (1911) ILR 33 All 626; Unnao Commercial Bank Ltd. v. Kailash Nath, AIR 1955 All 393*

[vii] *Bar Council of India v. A.K. Balaji, AIR 2018 SC 1382*

[viii] *Lala Ram Sarup v. The Court of Wards, AIR 1940 PC 19*

[ix] *Gayabai and Ors. V. Shriram and Ors., 2005 (2) MPLJ 574*

[x] *G, A Senior Advocate, (1955) 1 SCR 490*

[xi] *Khaja Moinuddin Khan v. S.P. Ranga Rao, AIR 2000 AP 344*

[xii] *Rattan Chand Hira Chand v. Askar Nawaz Jung, (1991) 3 SCC 67*

[xiii] *Nuthaki Venkataswami v. Katta Nagi Reddy, AIR 1962 AP 457*

[xiv] *Order 25 of CPC was amended for Maharashtra by Bombay High Court Notification P. 0102/77 dated 5-9-1983. This same amendment has been adopted by Gujarat and Madhya Pradesh. Allahabad has added only R. 2 of Or. 25, which states that costs may be secured from the third-party funding the litigation.*

About Us

Singularity is an Asia and Africa focused international disputes boutique, established in August 2017. Since then, we have handled over US$ 2 billion in cross-border disputes across jurisdictions and industries.

These disputes were in various parts of the world including Egypt, India, Israel, Indonesia, Kazakhstan, Nigeria, Malaysia, the Philippines, Turkey, UK, UAE, Sierra Leone, Singapore and Somalia.

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About Our Third Party Funding Practice

We help funders identify the true potential of a claim portfolio, and help litigants raise finance as a strategic tool to transform disputes from cost-centres to revenue-generators. Our key engagements include:

- Representing a leading global litigation funder for its investment in an Indian portfolio concerning 10 mega infrastructure projects.
- Representing a multinational company to raise finance for a portfolio of disputes across their energy, resources, engineering, shipping and dredging divisions in Singapore, UK, UAE and India.
- Representing an energy company to raise finance for a billion dollar dispute against a state-owned entity.
- Representing an Indian company to raise finance for a multi-million dollar dispute.
- Advising an English litigation funder on entry strategies into and structures for the Indian market
- Representing a leading global litigation funder for its investment in a portfolio concerning 2 mega infrastructure projects in Saudi Arabia.

About the Author

Prateek Bagaria is a partner with Singularity and an international disputes specialist with a decade of experience in complex commercial cross-border disputes. Legal 500 describes him as "responsive and dynamic" and "a very driven individual and a good lawyer who handles clients well". He possesses the domain expertise in advising funders and litigants seeking litigation finance.

Client Testimonial:

"Prateek Bagaria leads an exceptional up and coming team with a commercial and highly strategic approach to complex international disputes. One of the best international disputes offerings in India.

- **Mr. Tom Glasgow, CIO (Asia) of Omni Bridgeway**

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