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Litigation Financing for Avoidance Applications: Investment Opportunities and Value Maximisation under the Insolvency and Bankruptcy Code

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ABSTRACT

*The insolvency resolution process of a distressed company is akin to the proverbial 'Gordian knot'. The insolvency professional attempts to resuscitate the company and maximise recovery for its stakeholders. Much like Alexander trying to untie the Gordian knot, the insolvency professional looks for efficient and creative solutions to maximise value in the company. The insolvency professional detects and pursues applications to reverse 'avoidable transactions' – in order to reset the company's asset pool and increase recoveries for the stakeholders. In India, the Insolvency and Bankruptcy Code, 2016 (**IBC**) has made strides in revamping the Indian insolvency regime, but avoidance applications have witnessed miniscule recoveries for stakeholders. This article analyses the scope of litigation financing in serving as 'Alexander's sword' for insolvency professionals to realise value from avoidance applications during the insolvency and liquidation process. First, the article outlines the present framework for pursuing avoidance applications and the systemic issues in value realisation. Second, it weighs the viability of implementing litigation financing structures under the extant IBC framework and foreign exchange-control regime. The article concludes that while litigation financing offers a genuine avenue for value maximisation, the extant legal regime is restrictive*

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and that regulators should consider altering the law to incentivise financiers and create a robust litigation financing market.

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I. INTRODUCTION

Insolvency is a stage of dire straits which a company reaches owing to a plethora of reasons, including liquidity mismanagement, market forces or even, in some cases, fraud and financial misconduct. In the period leading up to insolvency, i.e., the 'twilight period', the company's management, in a 'Hail Mary' effort, may engage in suspect transactions / non-ordinary course transactions, such as disposing assets at less-than-fair value, siphoning funds from the company, providing preferential treatment to certain lenders, or engaging in similar strategic manoeuvres.[1] Such suspect transactions, also termed 'avoidable transactions', deplete the company's value, and the eventual outcome is the unjust enrichment of certain persons against the interests of *bona fide* creditors.

It is a matter of public policy that violators of the law should be punished. It is equally important that public money invested in an insolvent company, as well as the interests of *bona fide* stakeholders, are not

[1] United Nations Commission on International Trade Law, 'Legislative Guide on Insolvency Law' (United Nations publication 2005) 135 <https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf> accessed on 24 August 2023.

jeopardised by such avoidable transactions. As a result, jurisdictions across the world have incorporated provisions relating to the treatment of avoidable transactions in their insolvency laws, enabling the claw back of unjust gains. As succinctly put by the United Nations Commission on International Trade Law in its Legislative Guide on Insolvency Law, avoidance provisions are:

> *"[P]rovisions of the insolvency law that permit transactions for the transfer of assets or the undertaking of obligations prior to insolvency proceedings to be cancelled or otherwise rendered ineffective and any assets transferred, or their value, to be recovered in the collective interest of creditors"*[2].

In the Indian context, prior to the enactment of the IBC, the law governing insolvency and liquidation was scattered across legislations, which provided for the creation of multiple fora for adjudication, resulting in undue delays and ineffective resolution.[3] The provisions relating to avoidable transactions were covered under the Provincial Insolvency Act, 1920 and the Presidency-Towns Insolvency Act, 1909 in case of insolvency, and the Companies Act, 2013 in case of liquidation. These provisions covered only a restricted set of suspect transactions within its ambit and had a short look-back period for scrutiny. There was a lack of uniformity regarding the laws relating to avoidable transactions and thus, inefficient adjudication of avoidance applications.

The lack of teeth in the legislations provided little benefit in pursuing litigation against avoidable transactions. As a result, the Bankruptcy Law

[2] Ibid [4].
[3] *Innoventive Industries Ltd v ICICI Bank* [2017] 140 CLA 39 (SC).

Reforms Committee (**BLRC**) highlighted the requirement to empower the insolvency professional to scrutinise past transactions with a longer lookback period. The recommendations of the BLRC fructified into the enactment of the IBC, a comprehensive legislation that emphasises on a time-bound resolution process that results in maximisation in value of assets.[4]

II. TREATMENT OF AVOIDABLE TRANSACTIONS UNDER IBC

The IBC mandates the resolution professional (**RP**) (in case of corporate insolvency resolution process (**CIRP**)) or the liquidator (in case of liquidation) of the corporate debtor (**CD**) to scrutinise the affairs of the CD, identify any avoidable transactions and file applications before the National Company Law Tribunal (**NCLT**). These applications are termed as 'Avoidance Applications'. Avoidable transactions under IBC are broadly bucketed into:

- Preferential transactions;
- Undervalued transactions;
- Extortionate credit transactions;
- Transactions defrauding creditors;
- Fraudulent trading transactions; and
- Wrongful trading.

The NCLT has vast powers in dealing with Avoidance Applications, which vary based on the type of avoidable transaction. These powers include reversal of the benefits or property transferred as part of the avoidable

[4] *Swiss Ribbons (P) Ltd v Union of India* AIR [2019] SC 739.

transactions, directing beneficiaries under the transactions to pay compensation, modifying the terms of the transaction, restoring the position as it existed prior to such transaction, or pass such orders deemed appropriate by the tribunal.

The treatment of avoidable transactions may be better explained using the milestone events of the CD under IBC: (i) treatment from commencement of CIRP till approval of a successful resolution plan by the NCLT; (ii) treatment under a resolution plan; and (iii) treatment post-unsuccessful CIRP, i.e., during liquidation process.

A. Pursuing Avoidance Applications during CIRP

The scheme of IBC requires the RP to form an opinion on the existence of any avoidable transactions and institute proceedings before the NCLT within 130 days from the insolvency commencement date.[5] These timelines are discretionary, and courts have permitted the RPs to file Avoidance Applications even after approval of a resolution plan by the committee of creditors (**COC**).[6]

B. Treatment of Avoidance Applications under a resolution plan

The approval of a resolution applicant's resolution plan by the NCLT consummates the CIRP. However, Avoidance Applications are not automatically terminated on the approval of a resolution plan. This, in

[5] IBBI (Insolvency Resolution Process for Corporate Persons) Regulations 2016, reg 35A.
[6] *Tata Steel BSL Ltd v Venus Recruiter (P) Ltd* [2023] 172 CLA 239.

turn raises questions as to who shall pursue the Avoidance Applications after CIRP and who shall be the beneficiary of any proceeds, *inter alia* – questions that the IBC did not specifically address. The Delhi High Court has held that in the absence of a provision in the approved resolution plan prescribing the treatment of pending Avoidance Applications, the RP shall continue to pursue such litigations, and any proceeds would accrue to the benefit of the creditors.[7]

Now, Regulation 38(2)(d) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (**CIRP Regulations**) has been introduced, making it mandatory for resolution applicants to provide for the treatment of pending Avoidance Applications in their resolution plan. The CIRP Regulations are not prescriptive in requiring a particular form or manner of treatment, thus allowing discretion to the creditors and the resolution applicants in determining distribution of proceeds arising out of the Avoidance Applications. The authors have come across instances where NCLTs have approved resolution plans providing for assignment of pending Avoidance Applications in favour of the resolution applicant/s for a consideration and with proceeds of such applications, if any, accruing to the resolution applicant.[8]

C. Treatment of Avoidance Applications during liquidation process

[7] Ibid.
[8] *Kapil Wadhwanv Piramal Capital and Housing Finance Limited* CA (AT)(Ins) No. 437 of 2023;*Vinay Kumar Sandal &Ors v Malhotra Group PLC &Ors*IA-3415/2022 in Company Petition No. IB-1466/(ND)/2019 (NCLT Delhi order dated May 24, 2023).

Similarly, even on the commencement of liquidation process, the liquidator is required to continue to pursue the Avoidance Applications and file new Avoidance Applications, if required.

Notably, Regulation 37A of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 (**Liquidation Regulations**) permits the liquidator (in consultation with the Stakeholders Consultation Committee) to assign or transfer any 'not readily realisable assets' (**NRRA**) such as contingent/disputed assets or assets underlying avoidable transactions. The NRRA may be assigned or transferred to any person who is eligible to submit a resolution plan under the IBC, through a transparent process. The regulation however does not clarify whether the pending Avoidance Applications themselves are/may be classified as NRRAs and/or assigned to any third-party.

III. ISSUES IN REALISING VALUE FROM AVOIDANCE APPLICATIONS UNDER IBC

While the IBC has, no doubt, introduced a more comprehensive framework for pursuing action against avoidable transactions. However, almost seven (7) years into the new legal regime, Avoidance Applications have accrued little value to stakeholders. Data shows that as of June 2023, Avoidance Applications have a meagre one point seven percent (1.7%) recovery rate.[9]

[9] IBBI, 'The Quarterly Newsletter of Insolvency and Bankruptcy Board of India April-June, 2023' (IBBI 2023) 1 <https://ibbi.gov.in/uploads/publication/0d26415640ac24dab79ebdcbc11a64a8.pdf> accessed 30 August 2023.

The reasons attributable to the lack of value realisation from Avoidance Applications are broadly as follows:

A. Judicial delays

Data published by the Insolvency and Bankruptcy Board of India (**IBBI**) shows that as of June 2023, 947 Avoidance Applications have been filed by RPs and liquidators, with claims amounting to almost INR three lakh crores (INR 3,00,000 crores) and only two hundred (200) applications have been disposed by courts, with RPs and liquidators managing to claw back only INR five thousand two hundred and sixteen crores (INR 5,216 crores).[10]

The NCLTs are overburdened with cases and understaffed with members, which has made it difficult to achieve speedy adjudication of cases. In addition, parties often look to appeal the lower court decision. Further, in the case of Avoidance Applications, examination of evidence and arguments are a lengthy process and are often subject to tactical litigation by promoters and the erstwhile management of the CD, who look to derail the process.

B. Lack of resources available for RPs and liquidators

The IBC imposes a host of duties on the RP and liquidator to manage the operations of the CD and prevent value deterioration. Given that time and speed are of essence in insolvency, the RPs and liquidators are often

[10] Ibid.

required to prioritise duties. In terms of tracing avoidable transactions, the market practice is for the RP to appoint an independent auditor to conduct a 'transaction audit review'. The auditor scrutinises the past transactions and prepares a report flagging transactions that are seemingly suspect transactions. The RP then forms an opinion whether these suspect transactions fall within any of the categories of avoidable transactions under IBC, and thereafter files Avoidance Applications before the NCLT.

Since recovery is the main concern for stakeholders of an insolvent company, the COC may not be very forthcoming in approving additional funding, as the Avoidance Applications may not result in a speedy realisation of money. Consequently, RPs and liquidators are forced to operate under a tight budget and limited resources.

C. Inconsistent interpretations by courts

The IBC is a fairly new legislation which was framed keeping in mind broad principles of insolvency and value maximisation. Certain positions of law are still unclear despite amendments. In certain cases, courts have been observed to take inconsistent views. For instance, in the context of Avoidance Applications, there have been conflicting judgements by the NCLT on the permissibility of assigning the right to pursue pending Avoidance Applications to third-parties during the liquidation process.[11]

[11] *Macquarie Bank Ltd v Shilpi Cable Technologies Ltd* (IB)-64(PB)/2017; *M/s Inquest Fintech Private Limited v Maya Gupta* Interlocutory Application (I.B.C) 35(PB)/2022.

IV. LITIGATION FINANCING FOR REALISING VALUE FROM AVOIDABLE TRANSACTIONS

A. What is Litigation Financing?

Simply put, litigation financing refers to a mechanism whereby a third-party to a litigation, also known as the 'financier', funds the cost of the legal proceedings of a claimant to facilitate recovery of the claims in return for a share of any proceeds recovered (**Litigation Financing**).[12] This may cover the costs of filing and pursuing the claim, such as costs of attorneys, expert witnesses and documentation. Litigation Financing may extend to purchasing the claim, resulting in the substitution of the claimant with the financier.

Litigation Financing structures are flexible and based on the agreement between the financier and the claimant; these are generally structured as:

- The financier financing the litigation on a recourse or non-recourse basis, without exerting any control or decision making over the litigation; or
- The financier purchases the claim from the claimant for a fixed consideration.[13]

[12] Debajyoti Ray Chaudhuri and Radhika Agarwal, 'Litigation Funding: A Breakthrough for Avoidance Proceedings under IBC' (Quinquennial of Insolvency and Bankruptcy Code 2016, IBBI October 2021), <https://ibbi.gov.in/en/resources/articles> accessed on 28 August 2023.
[13] Sam Eastwood, 'Litigation Funding: A changing Market' (2008) 1 Corporate Rescue and Insolvency Journal 30.

Litigation Financing is a growing industry in many common law jurisdictions.[14] For instance, the assets of financiers in the United Kingdom (**UK**) amounted to GBP two billion two hundred million (GBP 2.2 billion) as of 2021, which was an eleven percent (11%) increase year-on-year.[15] India however is still nascent in the development of a robust Litigation Financing market.

Before weighing the benefits of Litigation Financing in the Indian insolvency context, it is necessary to evaluate the legality of Litigation Financing in India.

B. Permissibility of Litigation Financing under Indian law

Litigation Financing in India traces its way back to the pre-Independence period, wherein the Privy Council approved a third-party funding arrangement for litigation.[16] The Privy Council held that such arrangement would be invalid only if it were demonstrably unconscionable, extortionate, entered for an improper object or to pursue litigation that is unrighteous. However, the Supreme Court has clarified that the English law rules of champerty and maintenance are not applicable in India.[17]

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[14] Jasminka Kalajdzic and others, 'Justice for Profit: A Comparative Analysis of Australian Canadian and US Third Party Litigation Funding' (2013) 61(1) The American Journal of Comparative Law 93.
[15] Reynolds Porter Chamberlain, 'Litigation funders backing class action lawsuits as they put £2.2bn "war chests" to work' (*Reynolds Porter Chamberlain UK*, 20 June 2021) <https://www.rpc.co.uk/press-and-media/litigation-funders-backing-class-action-lawsuits-as-they-put-22bn-war-chests-to-work> accessed on August 28, 2023.
[16] *Ram Coomar Coondoo v Chunder Canto Mookerjee*, [1876] 2 Cal 233.
[17] *In Re: Mr. 'G', a Senior Advocate of Supreme Court*, [1955] 1 SCR 490.

In *Bar Council of India v A.K. Balaji*,[18] the Supreme Court, as an *obiter,* expressed that there is no explicit restriction for third-party litigation funding arrangements in India and that the only restriction that appears to exist is for the advocate to fund their client's case. More recently, the Delhi High Court upheld the validity of a non-recourse-based Litigation Financing arrangement for an arbitration.[19]

Some States such as Maharashtra and Uttar Pradesh have amended the Code of Civil Procedure, 1908 to introduce the concept of 'financier' of a civil suit and provisions pertaining to impleading the financier as a party and demanding security from the financier in certain cases.[20] However, there is no comprehensive legislation governing Litigation Financing, the eligible financiers, or permissible structures for Litigation Financing.

As a result, Litigation Financing in the country is by-and-large contract-driven, and is subject to the restrictions imposed by courts as highlighted above. Litigation Financing is also subject to restrictions under the Indian Contract Act, 1872, such as the requirement that the arrangements should not be contrary to public policy.[21] Thus, Litigation Financing agreements with extortionate terms, or the existence of undue

[18] *Bar Council of India v AK Balaji*, AIR [2018] SC 1382.
[19] *Tomorrow Sales Agency Private Limited v SBS Holdings Inc*, AIR [2023] (NOC 669) 266.
[20] The Code of Civil Procedure 1908, order XXV r3 (added by Bombay High Court notification dated 01 September 1983);The Code of Civil Procedure 1908, order XXV r1 (amended by Allahabad High Court notification dated 05 February, 1983); Rajat Jariwal and others, 'Litigation Funding' (Lexology GTDT, 2021) <https://woodsford.com/wp-content/uploads/2022/01/2022-Litigation-Funding-India.pdf> accessed 22 August 2023.
[21] The Indian Contract Act 1872, s 23.

influence in executing the agreement are grounds for the agreement to be declared as void by courts.[22]

Further, where Litigation Financing involves the financier purchasing the claim, it would be by way of an assignment or transfer. The requirements under the Transfer of Property Act, 1882 (**TPA**) may apply based on the subject-matter of the Litigation Financing arrangement. Section 130 of the TPA permits assignment or transfer of an 'actionable claim' by an instrument in writing.[23] Notably, a mere right to sue is not an actionable claim. This position has been clarified by the courts to mean that even though a bare right to sue or claim damages cannot be assigned, a right of action which is incidental to a property or contract can be assigned along with the transfer of such property or assignment of such contract.[24]

C. Benefits of Litigation Financing for detecting avoidable transactions and pursuing Avoidance Applications

IBBI data reflects a potential for high recoveries from Avoidance Applications.[25] The Delhi High Court observed that "[t]hird-party funding is essential to ensure access to justice. In absence of third-party

[22] *Lala Ram Sarup v Court of Wards*, [1949] 42 Bom LR 307.
[23] The Transfer of Property Act 1882, s130.
[24] *Murulidhar Agarwalla v Rupendra Mitter*, AIR 1953 Cal 321; *Benumetcha Gangarajuv Veluri Gopala Krishnamurthi*, AIR 1957 AP 190; *Union of India v Sri Sara Mills Ltd*, [1973] SCR (2) 484.
[25] IBBI (n 9).

funding, a person having a valid claim would be unable to pursue the same for recovery of amounts that may be legitimately due."[26]

Litigation Financing can help where the CD's corpus is insufficient to adequately pursue Avoidance Applications.[27] Scrutiny of past transactions and formulating an opinion to file Avoidance Applications requires the RP or liquidator to spend considerable effort and time. Financiers may also offer professional services in addition to meeting the funding requirements, which will serve as a one-stop solution for the RPs or liquidators facing difficulties in tracing avoidable transactions or pursuing various Avoidance Applications.

V. LITIGATION FINANCING STRUCTURES FOR AVOIDANCE APPLICATIONS UNDER THE IBC

The Indian legal framework is not very descriptive when it comes to Litigation Financing. To weigh whether Litigation Financing may resolve issues relating to avoidable transactions requires an analysis of whether Litigation Financing fits in the extant scheme of the IBC. In this regard, the authors have once again placed reliance on the milestone events under the IBC, i.e., (i) from commencement of CIRP till approval of a successful resolution plan by the NCLT; (ii) under a resolution plan; and (iii) during liquidation.

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[26] *Tomorrow Sales Agency Private Limited v SBS Holdings Inc*, AIR [2023] (NOC 669) 266.

[27] Amrit Mahal, 'Third-party litigation funding for avoidance actions: The key to trapped recoveries for creditors' (*International Insolvency Institute*, 2022) <https://www.iiiglobal.org/file.cfm/12/docs/gold% 20amrit%20mahal%20-%20tplf%20for%20avoidance%20actions.pdf> accessed 28 August 2023.

A. Litigation Financing during CIRP

a. Litigation Financing *via* interim finance

Interim finance under the IBC refers to any 'financial debt' raised by the RP during CIRP or such other debt as permitted by the government.[28] The RP is permitted to raise funds by interim finance to "protect and preserve the value of the assets of the corporate debtor", subject to COC approval.[29] By nature, Avoidance Applications are filed to reverse the effects of the avoidable transactions that have deteriorated the assets of the CD. Therefore, detecting avoidable transactions and pursuing Avoidance Applications is a legitimate object for the RP to raise interim finance.

The RP may thus avail Litigation Financing by way of interim finance for meeting costs associated with detecting avoidable transactions, filing and pursuing Avoidance Applications. In this route, the financier provides Litigation Financing generally by way of a term loan to the CD.[30] The ambit of interim finance is wide enough to cover any debt falling with the ambit of a 'financial debt' under the IBC.

[28] The Insolvency and Bankruptcy Code 2016, s 5(15).
[29] ibid [s 25(2)(c)].
[30] Shipra Singh, 'How litigation finance works as an alternate investment' (*Mint*, 13 February 2022) <https://www.livemint.com/money/personal-finance/how-litigation-financing-works-as-an-alternate-investment-11644772908327.html> accessed 25 August 2023.

In terms of repayment, interim finance forms part of the CIRP costs,[31] and is thereby provided super-priority during the distribution of resolution proceeds. Therefore, the financier would stand to be repaid before any other creditor. The return on investment for the financier would be by way of interest or coupon on the monies disbursed. Given the Litigation Financing is structured as a debt and the super-priority in repayment, the financier is almost assured a return on their investment. Further, the CD has an obligation to repay as per the contractual terms and the financier's recovery is not contingent on the success of the Avoidance Applications. Notably, this route has been availed by the RPs in the past, with Litigation Financing being availed *via* short term loans of twelve (12) to eighteen (18) months.[32]

The main problem is that this approach does not reallocate risk/rewards from Avoidance Applications instead, this creates super senior debt on the books of the CD against the potential benefit from Avoidance Applications.

b. Litigation Financing on non-recourse basis

Litigation Financing on a non-recourse basis entails the financier disbursing funds in compensation for a share from any recoveries made in relation to the claim.[33] In the event of a non-successful claim, the claimant is not under any obligation to repay the financier.

[31] The Insolvency and Bankruptcy Code 2016, s 5(13).
[32] Singh (n 30).
[33] Woodsford, 'What is non-recourse Litigation Funding?' (*Woodsford*) <https://woodsford.com/us/faq-what-is-non-recourse-litigation-

It is uncertain whether a non-recourse Litigation Financing structure where the obligation to pay arises only on the success of the Avoidance Application can fall within the contours of transactions which are expressly permitted under the IBC. "Interim financing" (which by its definition covers "financial debt" and would arguably not cover non-recourse financing) is the only type of financing during CIRP which is expressly contemplated under the IBC. Litigation Financing on non-recourse basis is largely indeterminate on the chance as well as the quantum of recovery. The financier will foresee an economic benefit or profit in the transaction, but it is unclear whether Litigation Financing on non-recourse basis would be a contingent claim at best or if it would satisfy the tests of a financial debt under the IBC. As a result, it is also unclear whether Litigation Financing on a non-recourse basis may be availed by the RP under the extant framework.

Additionally, non-recourse-based Litigation Financing comes with its share of practical issues in an insolvency scenario. It may cause complications where the recoveries from Avoidance Applications are not in the form of money. For instance, the court may order restoration of assets transferred by the erstwhile management of the CD as part of the avoidable transaction. This would raise concerns on how such recoveries shall be distributed to the financier. Further, non-recourse Litigation Financing creates uncertainty in recovery, which may in turn cause issues for the resolution applicant in assigning value for the pending Avoidance Applications that have been funded by non-recourse-based

funding/#:~:text=Non%2Drecourse%20litigation%20funding%20involves,of%20the%20dispute(s)> accessed 27 August 2023.

Litigation Financing and providing adequate treatment for the same under their resolution plan.

c. Litigation Financing by assignment or transfer of Avoidance Applications during CIRP

Litigation Financing by assignment involves the claimant assigning or transferring their right to pursue the claim, along with the right over any recoveries to the financier for a consideration.[34] The IBC places a duty on the RP or liquidator to institute proceedings for Avoidance Applications,[35] but is silent on whether Avoidance Applications may be assigned to third-parties, such as financiers during the CIRP period.

One interpretation of the extant provisions on avoidable transactions may suggest that the IBC only instructs the eligible persons who may institute proceedings, but not who may pursue them – thereby permitting valid assignees/transferees to pursue the Avoidance Applications that have been filed by the RP. However, the RP has the duty to take control and custody over and preserve the assets of the CD,[36] as well as exercise rights for the benefit of the CD in judicial proceedings.[37] Therefore, it may be argued that assignment or transfer of Avoidance Applications by the RP during CIRP is contrary to their mandate under the IBC. There may also be concerns that Avoidance Applications would

[34] Gian Marco Solas, 'Third Party Funding: Law, Economics and Policy' (2019) 84(3) CUP 118.
[35] The Insolvency and Bankruptcy Code 2016, s 25(2)(j).
[36] Ibid [ss 18(f) and 25(1)].
[37] Ibid [s 25(2) (b)].

lose their colour and convert to simple recovery proceedings if assigned to a third-party during pendency of CIRP.

Further, where the Avoidance Application has an underlying claim to an unsecured debt or any beneficial interest in movable property, the assignment of that Avoidance Application would need to be compliant with the TPA. As highlighted above, the mere right to sue is not an actionable claim. Certain claims are personal in nature or arise by virtue of a person's office and can therefore not be assigned to a third-party. It may be argued that the right to institute and pursue Avoidance Applications is a right and a corresponding duty vested only on the RP or the liquidator by virtue of their office,[38] and therefore the right to pursue Avoidance Applications is not assignable.

In absence of express legislative approval, it is not clear if Litigation Financing by assignment of Avoidance Applications is permissible during CIRP. It is pertinent to note that other common law jurisdictions explicitly permit assignment of the right to pursue claims against avoidable transactions during the insolvency process. For instance, in the UK, Section 246ZD of the Insolvency Act, 1986 explicitly permits the administrator or liquidator of the insolvent company to assign the right of action, including the proceeds of an action, in relation to avoidable transactions.[39] The same is also permitted by administrators and

[38] Except in case where the RP or liquidator has failed to institute proceedings relating to an undervalued transaction, wherein any creditor, member or partner of the CD may institute the Avoidance Application under Section 47 of the IBC.
[39] The Insolvency Act 1986, s 246ZD.

liquidators of insolvent companies in Australia by virtue of the 2016 amendment to the Corporations Act, 2001 (Australia).[40]

B. Litigation Financing by assignment or transfer under a resolution plan

The CIRP Regulations require a resolution plan to mandatorily provide for the treatment of pending Avoidance Applications.[41] This language is wide and not descriptive on the manner of treatment that may be provided by the resolution applicant. As highlighted above, courts have approved resolution plans that have provided for the right to pursue pending Avoidance Applications being assigned to a resolution applicant for a consideration.[42] Therefore, it may be argued that the IBC permits persons other than the RP to pursue pending Avoidance Applications where the same has been provided for in a resolution plan. Once the resolution plan is approved by the NCLT, the assignment or transfer of Avoidance Applications would occur by operation of law. Financiers may explore this structure by tie-ups with resolution applicants, wherein the resolution plan may contain a clause that the pending Avoidance Applications would stand assigned to the financier for a consideration that is mentioned in the plan.

For implementing such a structure, the financier will have to find a willing resolution applicant and also negotiate the terms of assignment with the COC. To the knowledge of the authors, this structure has not

[40] The Corporations Act 2001 (Australia), s 100-5.
[41] IBBI (Insolvency Resolution Process for Corporate Persons) Regulations 2016, reg 38(2)(d).
[42] Piramal (n 8).

been implemented in any resolution plan submitted for a CIRP in India yet.

C. Litigation Financing during liquidation process

The liquidator is not conferred the power to raise interim finance during the liquidation process. However, the Liquidation Regulations permit assignment or transfer of NRRA of the CD to third-party by following a transparent process. The judicial precedents on whether Avoidance Applications may be considered to be NRRA are not clear. The NCLT Delhi in *Macquarie Bank Ltd. v Shilpi Cable Technologies Ltd.*,[43] has permitted the assignment of the right to pursue pending Avoidance Applications during liquidation process. In another case, the NCLT Delhi has held to the contrary stating that only Avoidance Applications that have been crystallised by a favourable order and pending execution may be assigned as NRRA to third-parties.[44] Notably, the IBBI in its recent discussion paper dated 20 October 2023 sought comments from the public on amending Regulation 37A of the Liquidation Regulations to clarify that the assets underlying avoidable transactions may be transferred by the liquidator "*even before the adjudication of such proceedings*" by the NCLT.[45] Therefore, at what stage an Avoidance Application becomes eligible to be monetised by the liquidator by way of assignment is unclear, clarifications to the language of Regulation 37A of the Liquidation Regulations.

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[43] Shilpi (n 11).
[44] Maya (n 11).
[45] IBBI, 'Discussion Paper on Strengthening the Liquidation Process', (IBBI 2023) 9, 15 <https://ibbi.gov.in/uploads/whatsnew/b3f9d9e4145dee5cb50dc46b8efe3b00.pdf>accessed 03 November 2023.

As highlighted above, other common law jurisdictions permit assignment of avoidable transaction applications to third-parties. In the view of the authors, permitting pending Avoidance Applications to be assigned or transferred, as opposed to waiting till the final order from the NCLT is a pro-creditor approach, as it permits faster access to funds for the CD's creditors, and more value for Financiers who need an incentive to finance the deal.

VI. LITIGATION FINANCING BY FOREIGN FINANCIERS

India is a foreign exchange-controlled country. Transactions between persons resident outside India and persons resident in India will require compliance with the Foreign Exchange Management Act, 1999 (**FEMA**) and the Reserve Bank of India (**RBI**) guidelines. Litigation Financing *per se* is not an explicitly recognised and regulated transfer under FEMA. The authors have also analysed the various requirements and restrictions based on the structure of Litigation Financing. As a thumb rule, financiers from certain countries, such as countries sharing border with India,[46] are subject to additional restrictions while engaging in any transactions involving persons resident in India.

A. Litigation Financing by interim finance

Where Litigation Financing is provided by way of interim finance, it is a lending arrangement which shall require compliance with the Foreign

[46] Foreign Exchange Management (Non-Debt Instruments) Rules 2019.

Exchange Management (Borrowing and Lending) Regulations, 2018 (**Borrowing and Lending Regulations**). A person resident in India may borrow in Indian rupees or foreign exchange *via* an arrangement not specifically provided for under the Borrowing and Lending Regulations, only with the prior approval of the RBI.[47] Typically, Litigation Financing by way of interim finance, on a recourse or non-recourse basis, is expected to have a maturity of one (1) to two (2) years; whereas the extant foreign exchange regulations prescribe a minimum maturity of at least five (5) or ten (10) years, depending on the lender, for borrowing in foreign currency. So, foreign currency denominated Litigation Financing, which is not falling within a specified route under Regulation 4B of the Borrowing and Lending Regulations, would require RBI approval. The process of seeking and procuring RBI approval is a time and cost consuming affair, which may not be prudent in an insolvency scenario that is a time-bound process, where the RP would be looking for quick access to funds.

Alternatively, Indian companies are permitted to raise money from a foreign portfolio investor (**FPI**) through issuance of eligible debt instruments, such as non-convertible debentures and bonds.[48] Investment by FPIs in such instruments is also subject to end-use restrictions (such as restrictions on investment in real estate businesses and purchase of land), minimum residual maturity requirement (three (3) years in case of non-convertible debentures and one (1) year in case of eligible corporate bonds) and concentration limits imposed by the RBI

[47] Foreign Exchange Management (Borrowing and Lending) Regulations 2018, reg 3.
[48] Foreign Exchange Management (Debt Instruments) Regulations 2019, sch 1, para 1(A)(b).

from time-to-time.[49] The authors believe the FPI route may be explored for Litigation Financing *via* interim finance, as well as by the resolution applicant under their resolution plan. However, in the context of availing Litigation Financing for pursuing Avoidance Applications, satisfaction of the various conditions and restrictions would need to be evaluated on a per case basis. *Prima facie*, the minimum maturity and lock-in requirements, especially in the case of investments under the voluntary retention route (**VRR**) may pose as a concern for raising debt *via* the FPI route.

Where Litigation Financing is sought to be availed on a non-recourse basis, there may be also issues with the characterisation of the transaction. There have been views taken in the market that issuance of non-convertible debentures on a non-recourse basis lacks the obligation to repay – a key component of any debt financing arrangement, and may thereby be categorised as a derivative transaction, which entails significant additional compliances and consequences.

B. Litigation Financing by assignment

Capital account transactions alter the assets and liabilities and are subject to stricter regulation as opposed to current account transactions. Pending Avoidance Applications and the underlying assets are treated as contingent assets of the CD and are reflected on the balance sheet of the CD based prevailing accounting standards – which require contingent assets to be recognised as an asset in the balance sheet only where the

[49] Reserve Bank of India, Investment by Foreign Portfolio Investors (FPI) in Debt – Review dated June 15, 2018 (A.P. (DIR Series) Circular No.31).

probability of inflows is *virtually certain*.[50] On the other hand, where the Avoidance Applications are not recorded as assets in the CD's books of accounts, their assignment in favour of a foreign Financier as part of a Litigation Financing could be treated as a current account transaction.

Additional restrictions may apply based on the underlying rights/assets forming part of the Avoidance Application that is assigned to the financier. For instance, the financier seeks to acquire an Avoidance Application pertaining to restoration of land parcels that were transferred by the CD on a preferential basis – the financier would likely require prior RBI approval for the assignment of Avoidance Application, due to the restrictions imposed on persons resident outside India for acquiring immoveable property in India.[51]

C. Other services provided by the financier

Where the foreign financier provides other professional services to the RP, such as assistance in scrutiny of past transactions of the CD, or litigation strategy, it would be deemed import of services under FEMA.[52]

As a result, such services will have to be availed in compliance with the RBI Master Direction – Import of Goods and Services dated 01 January 2016 (**Import Directions**). The RP will be required to remit monies for services availed from the foreign Financier through the CD's authorised dealer bank. The Import Directions also prescribe a time-limit of six (6)

[50] MCA, 'Indian Accounting Standard 37' (*Ministry of Corporate Affairs*, 16 February 2015) [35].
[51] Foreign Exchange Management (Non-Debt Instruments) Rules 2019, r 30.
[52] Foreign Exchange Management Act 1999, ss 2(p) and 2(zb).

months for making remittances, and any extension in the time-period will require the approval of the CD's authorised dealer bank or the RBI as the case may be. This requirement would likely cause issues in an insolvency scenario, since financiers would be paid out only at the stage of distribution of resolution proceeds, or during liquidation of the CD's assets in case of liquidation.

VII. RECOMMENDATIONS

The extant IBC framework is not adequate for providing legislative permission for Financiers to develop a Litigation Financing market for Avoidance Applications. Additionally, the RBI regulations may have the effect of prescribing onerous compliance requirements and restrictions, which may dissuade the RP from seeking Litigation Financing from financier. In light thereof, the authors make the following recommendations:

1. *Statutory recognition for assignment of Avoidance Applications*: Other common law jurisdictions recognise the assignment of the right to pursue Avoidance Applications. Given the benefits associated with permitting such assignment, it is recommended that the IBC be amended to provide for a specific provision enabling the RP or liquidator to assign the right to pursue Avoidance Applications in favour of permitted assignees (as detailed below). The IBC is a special statute and providing recognition to assignment under the IBC may also serve as a comfort in overriding the restrictions on assignment or transfer of claims under the TPA that may apply to the assignment of Avoidance Applications.

2. *Recognition of financiers as 'permitted assignees'*: Pursuing Avoidance Applications requires significant cost and effort. Avoidance Applications also serve the public policy purpose of holding wrongdoers to task. It would therefore be prudent to consider recognition of the class of persons as the eligible assignees, such as financiers who have the professional expertise and know-how to pursue the Avoidance Applications. Given the assignment of Avoidance Applications is a commercial decision, the 'permitted assignee' must be an entity approved by the CoC.

3. *Clarify the language in Regulation 37A of the Liquidation Regulations:* NRRA is defined under Section 37A to include "*contingent or disputed assets and assets underlying proceedings for preferential, undervalued, extortionate credit and fraudulent transactions referred to in sections 43 to 51 and section 66 of the Code*". While the definition includes the assignment of the underlying assets forming part of the Avoidance Applications, it does not explicitly include the assignment of the right to pursue the Avoidance Applications. It is recommended that the definition of NRRA be amended as follows:

"*…contingent or disputed assets, the right to pursue proceedings for preferential, undervalued, extortionate credit and fraudulent transactions referred to in sections 43 to 51 and section 66 of the Code, including the assets underlying such proceedings ~~for preferential, undervalued, extortionate credit and fraudulent~~*

~~*transactions referred to in sections 43 to 51 and section 66 of the Code.*~~*"*

4. *Code of conduct for financiers:* Litigation Financing as a business is crucially intertwined with access to justice. It is important to therefore create a fine balance between profit-motives of financiers and the claimants' needs. For this purpose, financiers in jurisdictions with developed Litigation Financing markets such as the UK have instituted self-regulation codes for the conduct of their business.[53] In the Indian context, the Indian Association for Litigation Financing was incorporated in 2021 by a group of practitioners, Financiers and law firms to self-regulate Litigation Financing in India.[54] While this is a welcome effort in creating a sound base for a Litigation Financing market, the authors understand from information available on public sources that there has not been much headway in this initiative. It is also recommended that the IBBI, as the regulator overseeing the insolvency regime in the country, publish a best-practices manual for Litigation Financing in the IBC context – given the opportunities in this market.

5. *Enable rescue financing by foreign lenders and investors*: There are only a few players in the Indian Litigation Financing market, despite the abundance in opportunities. The RBI may consider permitting a special window for financiers resident outside India to provide interim finance to the CDs, given interim finance is raised for short-

[53] Rachel Mulheron, 'England's Unique Approach to The Self-Regulation Of Third Party Funding: A Critical Analysis Of Recent Developments', (2014) 73 (3) CLJ 570.
[54] Agarwal (n 12).

term requirements and on a time-sensitive basis. In the context of FPI route, certain exemptions from the minimum residual maturity and investor limits have been provided for debt instruments issued by a CD pursuant to a resolution plan approved by the NCLT. It is recommended that extending similar exemptions for interim finance availed by issuing debt instruments to FPIs would further incentivise participation in the secondary debt market and increase avenues for rescue financing.

VIII. CONCLUSION

It is important to ensure that the Litigation Financing structures and conduct of financiers are aligned with furthering the objects of the IBC. The authors believe the IBBI would serve as the ideal watchdog in this regard in providing necessary guidance and regulating conduct.

The Indian Litigation Financing market is nascent compared to other countries, despite the multitude of investment opportunities. This would provide commercial incentive for foreign financiers to penetrate the market. However, the FEMA and the RBI regulations impose various restrictions and compliance requirements, making the commercial incentives not so appetising for foreign financiers. In this regard, the authors believe making necessary changes in the foreign exchange control regime to allow rescue financing by foreign financiers will improve the Litigation Financing market and widen the options available to the RP to access funding during CIRP.