NATIONAL JUDICIAL ACADEMY

REFRESHER COURSE FOR COMMERCIAL COURTS

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CONSTRUCTION AND INFRASTRUCTURE CONTRACTS

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OUTLINE FOR DISCUSSION

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- Importance of Infrastructure for India's Growth
- Concept of Project Finance
- Guidance from Supreme Court
- PPP Contracts
  - Key Aspects; and
  - Key Legal Issues in Dispute
- EPC- Key Legal Issues in Dispute
- Conclusion

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- *India has the potential to become a* ***USD 10 trillion economy****, one of the biggest growth pockets in the world"-* ***Dominic Barton, Chairman of McKinsey & Company.***

- India's GDP can be **4 times** current GDP in 15 years.

- ***Building infrastructure*** *is one of the vital factors for economic growth and development.*

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Oxfam Report

1980-2016 World

- Bottom 50% .... Grew by 12%
- Top 1% .... Grew by 27%

India: 2017

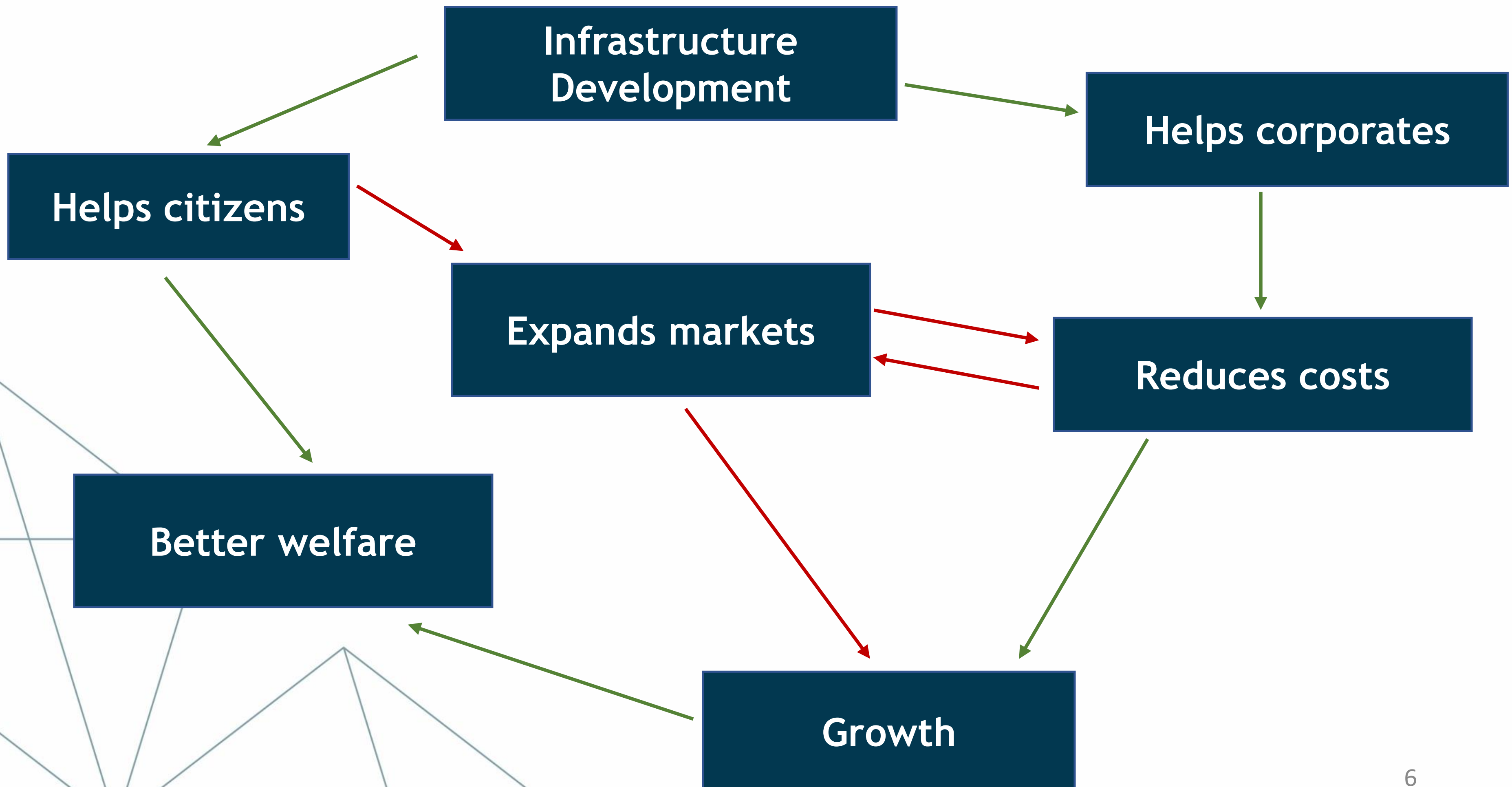
- Top 1% .... Grew by 39%
- Bottom 50% .... Grew by 3%
- Current estimate- 200 million people in India make less than US$ 1/day.

- **Infrastructure development** has direct bearing on economic growth of poor and the nation.

- Better quality and quantity of infrastructure directly raises the **productivity of human and physical capital** and hence growth.

- There is enough empirical date to show this co-relation.

- An illustration of how infrastructure contributes to growth:



ECONOMIC SURVEY

- In **1980**, **India's per capita income** was **more** than **the per capita income of China.**

- Per capita income in 2017:
  - India: USD 1700
  - China: USD 8200

- One of the **key drivers** for per capita income growth in China has been infrastructure development in the last 20 years.

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*Around **US$ 4.5 trillion** worth of investments is required by India till **2040** to develop infrastructure to improve economic growth and community wellbeing, which is approximately **2** times our current GDP.*

WHERE WILL US$ 4.5 TRILLION COME FROM?

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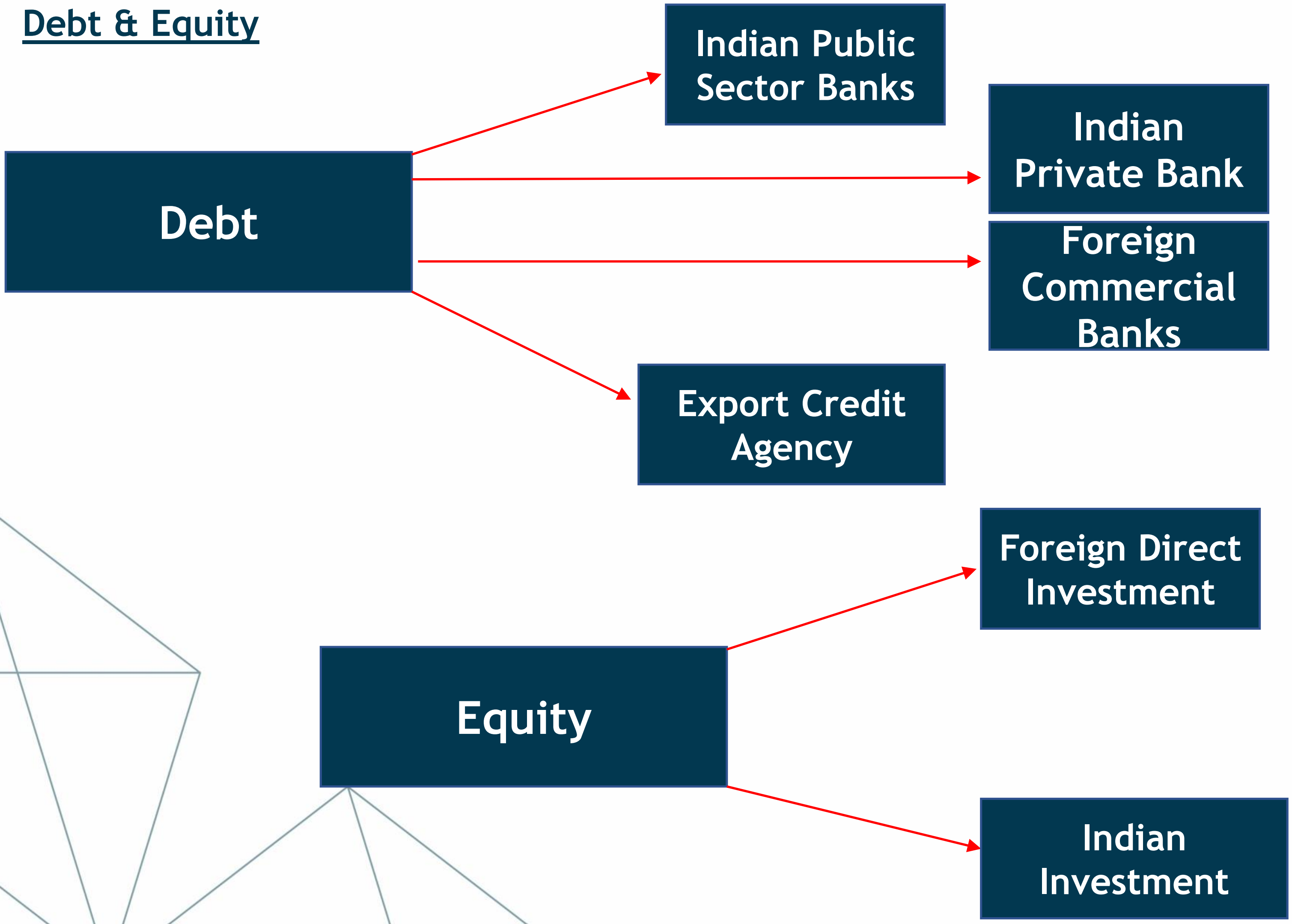
Debt & Equity



STATE OF AFFAIRS: INDIAN BANKS

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- Large lenders have been saddled with and are grappling with **NPAs** on their bank.

  For example:

  - ICICI Bank
  - State Bank of India
  - Canara Bank
  - IDBI Bank
  - Punjab National Bank
  - Bank of India

STATE OF AFFAIRS: INDIAN DEVELOPERS

- Infrastructure developers in India are very stressed and lack ability to develop a project:
  - IL&FS Group
  - Tata Power
  - GMR group
  - GVK group
  - Reliance Infrastructure
  - Jaypee Infratech (Matter pending before the Supreme Court)
  - Lanco Infratech (CoC deciding on resolution plan submitted by Thriveni Earthmovers)

STATE OF AFFAIRS: INTERNATIONAL PLAYERS

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- International Players : Almost absent
  - Foreign Commercial Banks
  - Export Credit Agency
  - Foreign Developer except in Solar & Wind Power

TIME FOR SOME INTROSPECTION

- What went wrong:
  - Infrastructure **risk allocation** between different stakeholders;
  - **Faulty** implementation of projects;
  - Disputes relating to **interpretation** of project contracts;
  - **Enforcement** of project contracts;
  - **Delay in payment**;
  - **Cancellation** of contract.

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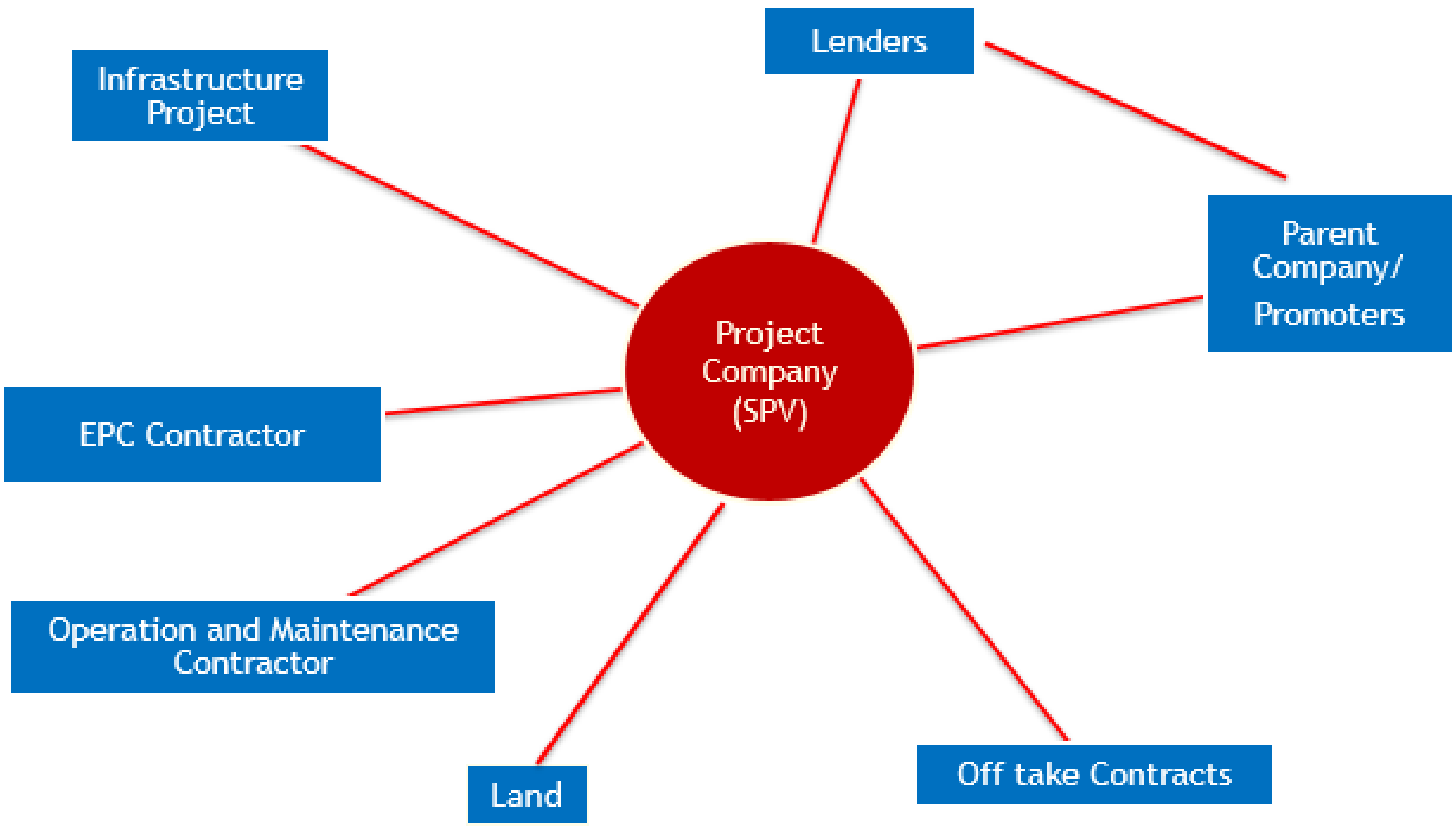
World Bank report (May, 2018)

- Enforcing Contracts, India ranked **163** in the world (out of 190 countries)
- On an average it takes 4 years for each claim
- Costs incurred are **31% of the claim value.**

Corporate Finance v/s Project Finance

- India **does not have balance sheet** to support raising of US$ 4.5 million.
- Premise of project finance – lenders lend money for the development of a project solely based on the **specific project's risk** and **future cash flows**.
- Under project finance mechanism – lenders to the project have **limited recourse to the parent company** that develops or sponsors the project.

PROJECT CONTRACTUAL FRAMEWORK



CONTRACTUAL FRAMEWORK CRITICAL

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Key Principles

- Risk to be borne by the entity **best suited to manage the risk**;
- Interface/**back-to back risk coverage**;
- **Uninterrupted cash flow** for project;
- Ring fencing of the cash flows **(TRA mechanism)**;
- **Lenders control over assets** (through creation of security);
- No surprises.

GUIDANCE FROM SUPREME COURT

- Reliance Airport Developers Private Limited v. Airports Authority of India and Others

<u>Challenges</u>:

- **Defects in the bidding process**; and
- **Annul selection of GMR Infrastructures Limited as the successful bidder.**

<u>Held</u>:

- **Urgency - 2010 Commonwealth Games**
- **Slow to interfere….**administrative **functions** unless decision is tainted….<u>illegality, irrationality and procedural impropriety</u>.
- **Mere assertion** in that regard would not be sufficient…. This needs to be established.

GUIDANCE FROM SUPREME COURT

While determining the extent/scope of judicial review of administrative decisions, the Supreme Court relied on some earlier decisions, relevantly,

> *….Therefore, to arrive at a decision on '**reasonableness' the Court** has to find out…. Whether the decision has been **a bona fide one**. The decision could be **one of many choices open to the authority** but it was for that **authority to decide upon the choice** and **not for the Court** to substitute its view.*
>
> ….Therefore, though the **principle of judicial review cannot be denied** so far as exercise of contractual powers of government bodies are concerned, but it is intended to **prevent arbitrariness or favouritism** and it is exercised in the **larger public interest** or if it is brought to the notice of the court that in the matter of award of a contract power has been exercised for any collateral purpose....

- To support the economic growth and infrastructure development.
- The main intent - to do away with the discretion of courts to grant specific performance and to **make specific performance of contract a general rule rather than exception subject to certain limited grounds**.
- In addition - provides for **substituted performance of contracts** where a contract is broken (at the **cost and expense of defaulting party**).
- Importantly, for infrastructure project contracts a new Section 20A has been included. This section provides that the **courts shall not grant injunction in any suit**, where it appears to it that granting injunction would cause **impediment or delay in the progress or completion of such infrastructure project**.

SPECIFIC RELIEF ACT, 1963

- Other relevant amendments proposed are:

  - Special courts- The State Government, in consultation with the Chief Justice of the High Court, shall designate, by notification published in the Official Gazette, one or more Civil Courts as **Special Courts**, within the local limits of the area to exercise jurisdiction and **to try a suit under the Specific Relief Act in respect of contracts relating to infrastructure projects.**

  - Expeditious disposal- Notwithstanding anything contained in the Code of Civil Procedure, 1908, a suit filed under the provisions of the Specific Relief Act shall be disposed of by the court **within a period of 12 months** from the date of service of summons to the defendant. The said period may be extended for a further period not exceeding **6 months** in aggregate after **recording reasons in writing for such extension** by the court.

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- The 15 October, 2018 order of NCLAT regarding the insolvency issue of IL&FS and its group companies and **granting stay on the action of creditors** against this gigantic group has **generated a fear** that **each of the SPVs** under the IL&FS umbrella which own its own projects and project financing are to be treated **as a group** and the **resolution** (if any) to be ascertained on a **consolidated basis.**

- **Against-**

  - ❖ Principle of **SPV** and **Project Finance.**
  - ❖ Principle of **Separate Legal Personality.**

PPP CONTRACTS

PUBLIC PRIVATE PARTNERSHIP (PPP)

- The Department of Economic Affairs, Government of India defines PPP as:

  - *An arrangement between a **government** or statutory entity or government owned entity on one side and a **private sector entity** on the other*

  - *For the provision of **public assets** and/or related services for public benefit*

  - *Substantial risk sharing with private sector*

KEY ASPECTS- PPP CONTRACTS

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- PPPs make this possible because they allow access to:
  - **substantial financial resources of the private sector,** and
  - Enable the public sector to benefit from:
    - **Technical expertise;**
    - **Experience; and**
    - **Efficiency,**

  of the private sector

KEY ASPECTS- PPP CONTRACTS

- The **payments** are usually based on **performance standards** set out in the contract.

- Private sector's **costs** may be **recovered** in **whole** or in **part**, from:

  - **Charges related to the use of the services** provided by the project; and

  - Some **portion** from the **public sector**.

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Regulatory Framework

- In India while there **is no central statute pertaining to grant of PPP projects**, the Government has a policy framework for the development of PPP projects specifically in the road sector, metro rail etc., where the government has issued guidelines and model concession agreements for such projects.

- The PPP Projects are also subject to **sector specific legislations** such as the Electricity Act 2003; National Highways Act 1956; Airports Authority of India Act 1994; Major Port Trusts Act, 1963; Urban Development Authorities Act etc.

PPP- REGULATORY FRAMEWORK

- In addition, some **State** governments have enacted **specific legislations** to govern PPP Projects such as:
  - Andhra Pradesh- The Andhra Pradesh Infrastructure Development Enabling Act, 2001;
  - Gujarat- Gujrat Infrastructure Development Act, 1999;
  - Bihar- Bihar Infrastructure Development Enabling Act, 2006;
  - Goa- Goa Policy on Public Private Partnership;
  - Punjab- Punjab Infrastructure Development and Regulation Act, 2002.

PPP MODELS

- The preferred mode of PPP projects in India is the concession route. Some of models adopted for this concession regime are:

  - **<u>Build-Operate- Transfer (BOT)</u>**- Most common form of concession in India. The private partner is responsible for the financing, construction, operation and maintenance of a facility over the concession period before finally transferring the fully operational facility to the government at no cost.

  - **<u>Build-Own-Operate-Transfer (BOOT)</u>**- The private partner undertakes to complete a large project, for which concession is granted. The public partner provides limited funding or other benefits such as tax exemption.

  - **<u>Build-Transfer-Operate (BTO)</u>**- Under a BTO contract, private partner will be given the right to operate an infrastructure facility within a certain period of time after transferring the built infrastructure facility to the State.

PPP MODELS

- **Build-Own-Operate (BOO)**- Private partner designs, finances, constructs, owns, manages and maintains the asset. The asset ownership is with the private sector and the service/facility provision responsibility also rests with the private sector.

- **Design-Construct-Manage-Finance (DCMF)**- The private partner designs, constructs, manages and finances the asset. Project cash flows result from public partner's payment of rent in the form of periodical payment or direct payment from the user to the private partner.

- **Design-Build-Finance-Operate (DBFO)**- Private partner designs, constructs, finances and operates the asset. In consideration for performing its obligations, the private partner may be paid by the public partner (in the form of availability payments) or from fees collected from the project's end users.

- In addition to the Roads and Ports sector, Government has recently introduced new PPP models in the following sectors:

  - **Affordable housing** under the Pradhan Manthri Awas Yojna (PMAY);

  - **Hospital** based clinical services.

PPP CONTRACT- KEY LEGAL ISSUES IN DISPUTE

- **Tendering Process:**
  - **Disputes** - Unsuccessful bidders challenge the bidding process

- **Impact of delay in achieving satisfaction of Conditions Precedent, mainly:**
  - Land acquisition/ Right of Way;
  - Obtaining all permits for project development;
  - Financial close.
  - As the impact of any such **delay** could have a **huge financial impact on the developer and project *per se*.**

PPP CONTRACT- KEY LEGAL ISSUES IN DISPUTE

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- **Compliance of the obligations of Concessioning authority/Government:**

  - Number of disputes centered around **developers claim that it could not perform its obligations under the contract** as the **pre-requisites** to be performed by the concessioning authority were not performed in time.

  - Who pays for cost overrun?

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- **Invocation of Bank Guarantees (for delay and performance):**
  - Unconditional and irrevocable bank guarantee.
  - The law on grant of stay by courts on enforcement of bank guarantee is well established; and generally the courts grant a stay on invocation on grounds:
    - Of it being against the terms of bank guarantee;
    - Of it being fraudulent; or
    - The same would result in irreparable loss to the other party.

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- **Change Orders:**
  - The dispute in this regard is usually if a **particular scope of work** is part of the originally envisaged scope or something **additional** the concessioning authority requires the developer to do.
  - In such cases, the **variation clause** in the agreement needs to be examined to ascertain if a particular scope was a variation and if factually parties had agreed to additional cost, etc.
  - **Impact on time and cost of achieving COD due** to such a variation and if the developer is entitled to such relief under the contract.
  - Even in case of dispute, courts need to facilitate payment of the **undisputed amount.**

PPP CONTRACT- KEY LEGAL ISSUES IN DISPUTE

- **Force Majeure:**

  - Civil law concept- Common law contract

  - Frustration of contract- Impossibility to perform

  - For disputes on this issue it needs to be examined by courts:

    - **What events qualify** to be a force majeure event;
    - **Impact of delay** occurring on account of a force majeure event;
    - Does the agreement grant an **extension of time** to achieve COD to the concessionaire;
    - Is there a **provision for payment of additional cost** to the concessionaire in case of occurrence of force majeure event. Usually costs in case of a political force majeure event and certain indirect political force majeure event to be borne by concessioning authority.

  - Also would be useful to consider if any **insurances** have been obtained by parties for the force majeure event in consideration.

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- **Change in Law:**
  - **Sovereign right** to change in law.
  - Definition- **Post execution of the contract.**
  - **Who bears** the impact of such a change.
  - Usually the concessioning agreement provides a **financial threshold** beyond which the relief for a change in law is granted to the developer.

PPP CONTRACT- KEY LEGAL ISSUES IN DISPUTE

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- **Termination Payouts:**

  - **Government Event of Default**.. Debt + Equity

  - **Company Event of Default**.. Debt

  - This issue is critical as it has a cascading effect on the **banking industry** (in addition to the project not getting developed as envisaged originally basis which the developer had deployed equity).

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EPC CONTRACTS

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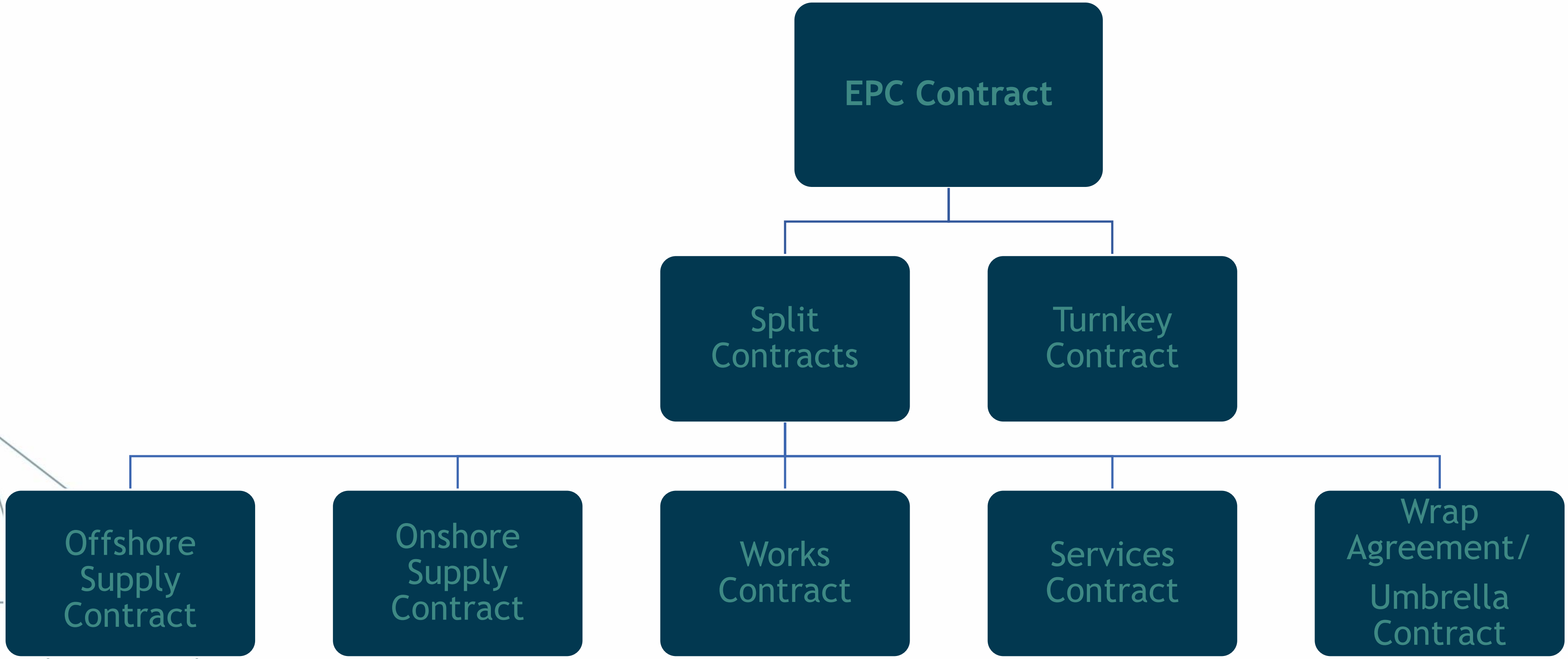
Introduction to EPC:

- EPC contracts are the most common form of contract used to undertake construction works on large-scale and complex infrastructure projects.
- Fixed Price Fixed Term Turnkey EPC Contract
- Failure to comply with any requirements will usually result in the contractor incurring monetary liabilities.

EPC CONTRACT STRUCTURING



EPC CONTRACT- KEY LEGAL ISSUES IN DISPUTE

We discuss below some of the issues/dispute seen under EPC contracts:

- **EPC contract structuring**- As EPC contract structuring is **tax driven**, the disputes seen on this are often tax related.

  By way of background, we set out below the rationale for splitting of EPC contracts:

  - EPC contracts may be "turnkey" i.e., a Project developer awards a **single consolidated contract** to a Contractor or "split" i.e., separate contracts by separate entities for supply, erection and commissioning and civil works

  - Before the introduction of GST (Goods and Services Tax), for tax purposes (to avoid overlapping taxes/tax clauses), EPC contracts were usually split into: onshore supply, offshore supply, service contract and civil works contract, as a turnkey contract was not considered ideal from a tax prospective.

EPC CONTRACT- KEY LEGAL ISSUES IN DISPUTE

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- In order to arrive at single point responsibility from the owner's perspective, despite the split contracts, a wrap agreement was entered into amongst the owner and all the contractors.

- With the **GST regime** coming into effect, the relevance of split contracts needs to be examined on a case by case basis.

- As works contracts are now treated as a service so both provisions of services and works is taxed at the same rate; however, **supply of equipment** (another component of EPC contracts) is taxed **at different rates** (depending on the type of equipment etc.); and thus, some parties still prefer to split the EPC contracts into supply and service components.

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- Scope of work and Variation–

  - The **scope of work clause and the variation clause** have to be **examined** in its entirety as to determine if the contractor is entitled to additional payment for extra work.

  - Difficulty arises as usually a number of **EPC contracts do not have well defined change order clauses** to set out the complete process as to how a variation could be requested and then process for agreeing **revised scope, price and impact of such variation** order on timelines and/or performance standards.

  - In such cases, the **courts will need to rely on other clauses** of the contract – scope of work, the contract being a fixed fee contract, documentary evidence that the change order was requested by a party and the additional price agreed thereto.

EPC CONTRACT- KEY LEGAL ISSUES IN DISPUTE

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- **Fixed time contracts-** EPC contracts are fixed time contracts wherein the contractor is to achieve **COD by a prescribed date**. Accordingly, the main disputes that arise on this aspect are:

  - Whether **delay is on account of contractor's default** or for reasons **outside its control**;

  - While EPC contracts provide a **"time is of the essence clause"** and in addition provide for **payment of LDs** for delay the enforceability of such a clause is questionable.

  - What are the consequences of such delay – **payment of liquidated damages (LDs)** by the contractor and/or **termination right** of the owner.

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- **Performance parameters-**

  - In this case, compliance of **performance parameters and related LD clause** needs examination.

  - Related to this aspect is the **limitation of liability** of the contractor under the EPC contract – to cover this aspect EPC contracts usually include a limitation of liability of the contractor which peg the total liability of the contractor (either including or excluding the LD amounts) at 10% to 20% of the contract price.

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- **Claim for LDs (delay or performance)-**

  - By way of catena of judgments, the Hon'ble Supreme Court has laid down the law for payment of damages.

  - As per the law laid down, damages **cannot be awarded by way of penalty**. If **damages are pre-estimated**, only **reasonable compensation** can be granted. Also, damage or loss caused is a *sine qua non* for the applicability of pre-estimated damages.

- **Handover provisions/testing mechanism-**

  - Disputes are also seen with respect to what all works must be completed by the contractor before the developer would take over the facility; and the standard of work performed by the contractor.

  - In this regard the **performance parameters, testing provisions and handover provisions** of the contract require intensive analysis to ascertain if the claim of the developer/contractor has backing under the contract;

  - Ideally, detailed handover provisions and testing provisions to be included in the contract.

  - In the absence of these provisions, courts need to interpret other clauses such as scope, performance parameters, purpose of the facility etc. to establish at what stage handover/takeover is to be completed.

- **Warranties and defect liability period-**

  - Disputes are seen between a developer and a contractor on quality issues – where the developer claims that the contractor has not met the prescribed standards and there are defects in the facility.

  - In such issues, courts need to interpret the warranty and defect liability period clauses in the EPC contract to ascertain *inter alia:*

    - If a particular equipment is covered under **warranty period.**

    - What are the **contractor's obligations during the warranty period-** repair, replacement of the equipment which are defective;

    - What is the **duration** of this warranty obligation of the contractor.

CONCLUSION

- Adjudicating **dispute** relating to **infrastructure contract** is **not merely a contractual dispute.**
- **Delay in adjudicating disputes** can deprive 200 million people who make less than US$ 1 per day **- opportunity** for **growth** & **upliftment.**
- For **Social Cost Benefit Analysis** – **No injunction .... No stay ....**
- **Specific performance** as a **rule not exception**, **monetary compensation cannot help** millions of family who **need infrastructure project** for **improving their productivity.**
- **Risk** needs to be **on the party** which is **best suited** to manage such risk.
- **Any time there is a delay in making payment to the project company.... Project company gets close to Bankruptcy!!**

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