

TREATING HOMEBUYERS AS FINANCIAL CREDITORS: An Enduring Solution or Not?

Kunjali Jawaria and Meha Dad*

INTRODUCTION

Earlier, there were multiple overlapping laws and adjudicating forums dealing with financial failure and insolvency of companies and individuals in India. The Companies Act, 2013 did not aid lenders in effective and timely recovery or restructuring of defaulted assets and caused undue strain on the Indian credit system. Recognizing that, reforms in the bankruptcy and insolvency regime were critical for improving the business environment and alleviating distressed credit markets, the Government introduced the Insolvency and Bankruptcy Code Bill in November 2015, drafted by a specially constituted 'Bankruptcy Law Reforms Committee' (BLRC) under the Ministry of Finance. Trilegal worked with the BLRC to assist with the drafting of the bill. After a public consultation process and recommendations from a joint committee of Parliament, both houses of Parliament passed the Insolvency and Bankruptcy Code, 2016 (Code).¹The Insolvency & Bankruptcy Code, 2016 consolidates and amends the laws relating to insolvency of companies, partnership firms, and limited liability partnership into a single legislation. It aims to provide time bound resolution and empowers the creditors to initiate the insolvency resolution process if default occurs.

MEANING OF FINANCIAL AND OPERATIONAL CREDITOR

The following definitions would provide us the linkage which is prescribed under Insolvency and Bankruptcy Code, 2016 between 'Creditors' and 'Debt' and then from 'financial debt' to 'financial creditors'

Section 3(10) defines: "creditor" means any person to whom a debt is owed and includes a financial creditor, an operational creditor, a secured creditor, an unsecured creditor and a decree-holder.

Section 3(11) defines: "debt" means a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt;

According to the code, creditors are necessarily of two types: financial and operational. Financial creditors [Section 5(7)] are those who have disbursed monies to the corporate debtor 'against consideration for the time value of money' and include a range of parties, such as those who have lent money to the debtor against the payment of interest. On the other hand, operational creditors [Section 5 (20)] are those who have established certain types of relationship with the debtor company, such as the provision of goods or services, employment or for government dues. In several cases that arose before adjudicating authorities, homebuyers were meted out an orphaned treatment: they were considered to be neither financial creditors nor operational creditors. Although the Insolvency and Bankruptcy Board of India whipped up a temporary solution by creating a residual third class of creditors, it provides limited benefit to homebuyers.²

THE NEED FOR AMENDMENT

* 2nd year student, BBA-LL.B Hons. (Corporate Law)

¹Chambers and Partners. (2018). The Insolvency and Bankruptcy Code, 2016 - Key Highlights | Trilegal | Article | Chambers and Partners. [online] Available at: <https://www.chambersandpartners.com/article/903/the-insolvency-and-bankruptcy-code-2016---key-highlights> [Accessed 14 Jun. 2018].

²Bloomberg Quint. (2018). Homebuyers As Financial Creditors: An Inelegant Solution?. [online] Available at: <https://www.bloomberquint.com/insolvency/2018/06/07/homebuyers-as-financial-creditors-an-inelegant-solution> [Accessed 17 Jun. 2018].

The high profile insolvencies of several real estate and housing development companies have tested the mettle of the Insolvency and Bankruptcy Code, 2016. Thousands of homebuyers were left in the lurch as they remained bereft of recourse in insolvency proceedings against these companies in distress. Homebuyers in various Jaypee Infratech projects, who had no option but to forget all about their investment, moved court against IDBI Bank taking the developer to the National Company Law Tribunal (NCLT) to start insolvency proceedings. Several moved the Supreme Court, saying the start of insolvency proceedings against the developer in the NCLT would thwart their right to justice. Chitra Sharma, who had moved the apex court on behalf of about 32,000 affected buyers against Jaypee going insolvent, said in her plea that under the Insolvency and Bankruptcy Code of 2016, flat buyers did not fall in the category of secured creditors and hence they could get back their money only if something was left after repaying the secured and operational creditors. Keeping in mind the interests of buyers, the SC on September 4 last year stayed the insolvency proceedings against the real estate firm.

Similar fears drove homebuyers of various projects of Amrapali Group to move the apex court when Bank of Baroda moved the NCLT against the developer. The Amrapali Silicon City Flat Owners Welfare Society moved the SC against an order of the NCLT that admitted the bank's insolvency petition against Amrapali's Silicon City project in Noida in Uttar Pradesh. The number of affected buyers, in this case, is estimated to be 41,000. The SC recently asked the developer to devise a plan to deliver homes to buyers. In reply, Amrapali told the apex court that it would use outside help to accomplish the task.

It was the corporate ministry itself which recommended Unitech, the real estate giant whose Managing Director Sanjay Chandra is in Tihar jail in a criminal case lodged against him in 2015 by 158 homebuyers of the company's two projects in Gurgaon, be declared insolvent. Once again, buyers knocked at the doors of the top court seeking protection. The number of affected buyers, in this case, is estimated to be 19,000. The SC has stayed the insolvency proceedings against Unitech.

In the recent past, there have been numerous cases petitioned by the homebuyers against real estate companies before the National Consumer Disputes Redressal Commission ("NCDRC") for deficient services. In the peculiar cases of Jaypee Infratech and Amrapali Group (supra), aggrieved homebuyers claimed deficiency in service on the part of developers post payment of full consideration. However, the developers thereafter filed insolvency applications before the NCLT. Once the insolvency applications were admitted, the moratorium period was declared and the homebuyers' suits/ complaints were abated. This meant that the developer companies could proceed with the resolution plan under IBC while the homebuyers were left remedy-less.³

The need for homebuyers to approach the SC was felt owing to the fact that the Insolvency and Bankruptcy Code (IBC), 2016, placed consumers right at the end of the queue when it comes to distribution of assets if a company is liquidated.⁴ Such a lacuna in the law attracted considerable backlash given that several home builders entered insolvency after having collected significant amounts of money from homebuyers who had to face inordinate delays in obtaining possession of the homes they had substantially paid for. Sufficient momentum was garnered to provide appropriate protection to this vulnerable constituency. Accordingly, the Insolvency Law Committee, in its report released in March 2018, recommended that homebuyers be treated as financial creditors so that they can take recourse to the protection conferred under the Code. Recent reforms have sought to address the concerns of homebuyers by treating them as 'financial creditors' for the purposes of the Code. While these efforts certainly provide the much-needed succor to homebuyers, their precise treatment as financial creditors raises more questions than it answers, thereby beckoning an alternative approach.

With President Ram Nath Kovind giving his assent to promulgate the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018, on June 6, the homebuyers will now be classified as 'financial creditors'

³Bloomberg Quint. (2018). Homebuyers As Financial Creditors: An Inelegant Solution?. [online] Available at: <https://www.bloomberquint.com/insolvency/2018/06/07/homebuyers-as-financial-creditors-an-inelegant-solution> [Accessed 17 Jun. 2018].

⁴Bloomberg Quint. (2018). Homebuyers As Financial Creditors: An Inelegant Solution?. [online] Available at: <https://www.bloomberquint.com/insolvency/2018/06/07/homebuyers-as-financial-creditors-an-inelegant-solution> [Accessed 17 Jun. 2018].

for the purposes of the Corporate Insolvency Resolution Process (“CIRP”). The intent behind such classification is to enable homebuyers to participate in the insolvency resolution process in a constructive and egalitarian manner. The much needed reforms also seek to put to rest the homebuyers’ ambiguous statuses, which arose in Jaypee Infratech and Amrapali Group cases.

MAJOR CHANGES

1. The IBC Ordinance has amended the definition of financial debt under Section 5(8)(f) by adding another ‘Explanation’, which states: “An amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing.” Thus, an amount paid by a homebuyer in a real estate project would now amount to financial debt under the IBC.⁵
2. Under the existing code, there were eight levels of distribution, in case a builder goes bankrupt and his assets are liquidated to compensate the stakeholders.
 - First to be compensated would be resolution professionals and administrators
 - The second in line are financial creditors
 - Third parties to be compensated would be the workmen.
 - Following them at number four would be employees who are not workmen.
 - Fifth in line are unsecured financial creditors.
 - The government will get its dues after that, at number sixth.
 - The remaining money would be used to compensate equity shareholders.
 - At number eight, homebuyers would be compensated from what is left.

Now, the homebuyers will move up some notches and come in the category of financial creditors this means they would be treated on a par with banks. With that, buyers will also get a right to participate in the insolvency proceedings, become part of the panel of creditors and get voting rights.⁶

3. They are now empowered as (a) applicants eligible to initiate CIRP under Section 7 of the IBC, (b) represent themselves in the CoC, and (c) have a better chance at receiving re-payment of their investment because they would be third in the ranks of receivers (post payment of secured creditors and employees’ dues) in the hierarchy of distribution of proceeds of the liquidation sale. The IBC Ordinance has thus positively enabled homebuyers to initiate the insolvency process against an erring defaulting company, and even seek the benefits of the resolution plan or liquidation proceeds as the case may be.⁷
4. The IBC Ordinance has added Sub-Section 6A in Section 21, which provides that a class of creditors, who exceed a specified number, would be represented by a resolution professional in the meetings of CoC. It also provides that the said Class is empowered to appoint the resolution professional themselves to protect their interests and voice their concerns. Further, Sub-Section 7 has now been modified and it provides that it will be the Insolvency and Bankruptcy Board of India (“Board”), which will decide the manner of voting and voting share for each of the consortium/ class of creditors.

DRAWBACKS

1. The only reason they were excluded as operational creditors is that the Code refers to the provision of “goods and services” and does not contemplate immoveable property. This can be more easily addressed by expanding the scope of the definition of “operational debt”. On the other hand, the concept of financial debt is more remote from the relationship that homebuyers bear with sellers. This is hardly a relationship of financial nature. It may be true, as the Insolvency Law Committee has unduly emphasized, that the money paid by the homebuyers ultimately go towards financing the business of the debtor companies. The utility

⁵Live Law. (2018). Homebuyers Triggering IBC – Mischief Managed? | Live Law. [online] Available at: <http://www.livelaw.in/homebuyers-triggering-ibc-mischief-managed/> [Accessed 18 Jun. 2018].

⁶<https://www.proptiger.com/guide/post/buyers-to-get-a-say-in-insolvency-proceedings-against-builders>

⁷<http://www.livelaw.in/homebuyers-triggering-ibc-mischief-managed/> [Accessed 18 Jun. 2018].

- of the funds is by itself insufficient to define the relationship between the parties. For that matter, a seller of goods or services may also utilize an advance received from a customer towards financing its business.
2. The IBC was created with the vision to achieve efficient and time-bound redressal for distressed companies. One of the ways in which time-bound resolution has been achieved so far is because the CoC consists of financial creditors, mostly banks, which have the professional expertise to pass swift resolutions and even waive a percentage of their re-payment, owing to the larger scheme of issues being resolved. However, the homebuyers are not expected to waive hefty amounts of their savings/ investments, thus, creating a greater possibility for deadlocks and delay in passing of resolution plans. Therefore, the concern that arises is whether the homebuyers, who have been allowed to participate in the CoC have the necessary expertise to productively contribute to the resolution exercise or not, in line with the purpose and intent of IBC.
 3. The Indian real estate market never really had the extravagance of a regulatory body beforehand the Real Estate Regulatory Authority (RERA) was put in place. After 2016, one can claim that he or she has the advantage of heading towards a regulatory body that could enforce certain property-related laws. However, these recent developments have shaken the foundation of RERA.

CONCLUSION

It now has to be seen how the IBC Ordinance will be applied practically, which, to a considerable extent depends upon the Board's regulations that will define the voting share and consequently the parameters of the homebuyers' participation. The Board while ensuring that the creditors are represented proportionally, will have to balance the interests of the corporate debtors and banking institutions as well, all while keeping in mind the ethos, aims, objectives and vision of the IBC. There also appears to be a looming threat to this amendment, in the form of a constitutional challenge, on the ground that the homebuyers have been given a special status as receivers of services; while no other services are covered by the IBC. It is thus, left to be seen whether the builders/ developers welcome this sword of Damocles over their head or challenge it, like many other provisions of the IBC pending challenge before the Hon'ble Supreme Court.⁸

To conclude, the efforts to rectify the prevalent anomaly that deprives homebuyers of benefits in insolvency are indeed beneficial. However, the proposed manner of addressing the concern simply by treating them as financial creditors is an inelegant solution. While it may help assuage the growing numbers of affected homebuyers, it is sure to inflict collateral damage on the philosophical framework of the Code. The change could end up increasing debt financing costs for Indian developers. Banks may charge more for loans if their recovery rates in the event of insolvency are going to be lower. That would be the case if homebuyers' cash advances are also treated as senior claims against developers' assets.

Also, this could negatively influence the lenders as the recovery proceeds will now have another layer of distribution, which was not factored in at the time of origination of loan to the developer. This would effectually upturn the realized haircuts for the financiers. In other words, without changes in probability of default, loss given default (LGD) could rise for the financiers. On the contrary, home buyers could recover some share of their charges in case the builder defaults as against the current scenario where buyers have to depend on the residual value after financial creditors are paid, which entails higher hair-cuts. Ind-Ra is of view that end-users' susceptibility to start case under the IBC would be much lower than investors', considering the end-use and emotional attachment with the assets for the former.

Conferring to the ratings agency, with the dilution of lenders' right in liquidation proceeds, financiers have to start re-pricing lending yields. As a consequence, borrowing rates could harden for developers relative to their credit profiles. However, it also rely on through-the-cycle probabilities of default and LGDs are yet to be recognized for financiers, considering most players

⁸<http://www.livelaw.in/homebuyers-triggering-ibc-mischief-managed/> [Accessed 18 Jun. 2018].

are yet to see a full cycle apart from the extensive refinancing prevalent in the developer financing space.⁹

⁹The Economic Times. (2018). Home buyers treatment as financial creditors may impact realty sector asymmetrically: Report. [online] Available at: <https://economictimes.indiatimes.com/wealth/personal-finance-news/home-buyers-treatment-as-financial-creditors-may-impact-realty-sector-asymmetrically-report/articleshow/64291463.cms> [Accessed 18 Jun. 2018].