

Insolvency and Bankruptcy Code, 2016

Implications for Real Estate Sector

Brief Background

Real estate for long has been considered the most beneficial and sought-after avenue for investors in India. After having witnessed ex-potential growth over the past couple of decades, the market trends indicate that investment in the real estate has stagnated. Homebuyers were dissuaded from investing in real estate given the heavily delayed and terminally sick housing projects hemorrhaging their investments.

The recourses available to distressed home buyers were to either file a consumer complaint before the Consumer Disputes Redressal Forum or before Real Estate Regulatory Authority (RERA), wherein the relief although effective, would have taken years to receive. With growing popularity of Insolvency and Bankruptcy Code speedy relief given by the National Company Law Tribunal (“NCLT”), home buyers decided to approach the NCLT, forcing the tribunal to decide whether a home buyer would qualify as an ‘operational creditor’ or ‘financial creditor’.

The National Company Law Appellate Tribunal (NCLAT) held that home buyers were to be classified as ‘financial creditors’ due to the **assured return scheme in the contract**, in which there was an arrangement wherein it was agreed that the seller of the apartments would pay ‘assured returns’ to the home buyers till possession of property was given. It held that such a transaction was in the nature of a loan and constituted a ‘financial debt’ within the Code. Interestingly, the home buyers who had an assured returns clause in their agreement could file an insolvency petition and others could not. However, after initiation of insolvency process the other home buyers could submit their claim to the resolution professional.

This conundrum was addressed by the Government by introducing the amendment no. 26 of 2018 vide The Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 on August 17, 2018, granting homebuyers also referred to as the ‘Real Estate Allottee’ (allottee) a status of “Financial creditor”. This amendment was a suggestion made by the Insolvency Law Committee in its report in March 2018. An explanation was added to Section 5(8)(f) of the Code, clarifying that allottees are to be treated as financial creditors so that they can trigger the insolvency process under Section 7 of the IBC.

Rights of Home Buyers under the Code and RERA

An allottee in a real estate project, including a home buyer having attained the status of a Financial Creditor under the Code, has following rights in a CIRP:

- I.** He shall be at par with the banks and the financial institutions as Financial Creditor.
- II.** He shall have a right of representation in the Committee of Creditors (CoC) on its own or through an Authorized Representative in a class of creditors.
- III.** By becoming a Financial Creditor, a home buyer would have priority over Government and Operational Creditors.
- IV.** He can also initiate a CIRP proceeding against defaulting promoters by filing an application with the NCLT under Section 7 of Code on the occurrence of a default, as a Financial Creditor

‘Default’ has not been amended in the Code. For initiating insolvency proceedings by home buyers, default might be either non-delivery of home or not refunding the amount with interest. As per Section 18 of the RERA, if the promoter fails to complete or is unable to give possession of an apartment, plot or building, –

- a.** in accordance with the terms of the agreement for sale or, as the case may be, duly completed by the date specified therein; or
- b.** due to discontinuance of his business as a developer on account of suspension or revocation of the registration under the Act or for any other reason,

he shall be liable on demand to the allottees, in case the allottee wishes to withdraw from the project, without prejudice to any other remedy available, to return the amount received by him in respect of that apartment, plot, building, as the case may be, with interest at such rate as may be prescribed in this behalf including compensation in the manner as provided under the Act. Provided that where an allottee does not intend to withdraw from the project, he shall be paid, by the promoter, interest for every month of delay, till the handing over of the possession, at such rate as may be prescribed. Section 19(4) of the RERA stipulates that the allottee shall be entitled to claim the refund of amount paid along with interest at such rate as may be prescribed and compensation in the manner as provided under the Act, from the promoter, if the promoter fails to comply or is unable to give possession of the apartment, plot or building, as the case may be, in accordance with the terms of agreement for sale or due to discontinuance of

his business as a developer on account of suspension or revocation of his registration under the provisions of the Act or the rules or regulations made there under.

Constraints and Issues pertaining to Home Buyers

Following are the constraints and hindrances in the ultimate benefits to the home buyers and certain issues which may take shape with the passage of time:

- I.** In the meeting of CoC, the voting powers of home buyers might be very less compared to the voting rights of the banks and financial institutions as Financial Creditors. Hence, they might have little say in the CoC.
- II.** The ultimate aim of the home buyer is get his house for which he has been making payments to the builder for years or to get back his money in case of extreme circumstances. In case of insolvency resolution, the project might be delayed, there might be some haircut in the form of quality or specifications or return of money with some hair cut, etc.
- III.** The home buyers as Financial Creditor shall be represented in the CoC through an Authorized Representative appointed by the Insolvency Resolution Professional ('IRP'). He has to choose one among the three representatives recommended by the IRP. The stand of the homebuyers therefore might not be represented well as per their requirement. Moreover, the home buyers do not have any power for change of Authorized Representative, if required.

Are Homebuyers Secured Financial Creditors or Unsecured Financial Creditors under IBC?

In the present day scenario, homebuyers have been given acknowledgment of their rights as defined in Real Estate (Regulation & Development) Act, 2016 (RERA) and the Insolvency and Bankruptcy Code, 2016 (IBC). Wherein RERA provides a short term solution to the problems, IBC eliminates the problem by undertaking the default and delay caused by the Builder. The Insolvency & Bankruptcy Code, 2016 was amended through the Insolvency and Bankruptcy Code (Amendment) Ordinance of 2018, following which the home buyers and allottees, got the status of financial creditors under Section 5(8)(f) of IBC.

The ordinance has brought a sense of security and protection to the homebuyers and has enabled the homebuyers and other allottees to be able to invoke Section 7 of IBC, which allows financial creditor(s) to file an application before the National Company Law

Tribunal (NCLT) for initiating **corporate insolvency resolution process against a defaulting company/developer/builder**. Interestingly, there are two kinds of financial creditors and the confusion lies as to, in which category the homebuyers fall.

A FINANCIAL CREDITOR, u/s 5(7) of IBC, is a person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred. Whereas, a SECURED CREDITOR is any creditor or lender who is associated with an investment in an asset or issuance of that asset, which is backed by collateral. If a borrower defaults, the secured creditors have a legal right to the asset used as collateral, which can be seized and sold to pay off the obligations. On the other hand an UNSECURED CREDITOR is an individual or institution that lends money without obtaining specified assets as collateral. This poses a risk to the creditor because it will have nothing to fall back on if the borrower defaults.

Under IBC, the **difference between secured financial creditors and unsecured financial creditors** mostly has an implication on the priority of payments upon liquidation of the company. One of the interpretations with regard to homebuyers being unsecured creditor is that, while the homebuyers credit the money to the developer without obtaining a collateral, their right on asset is only ensured when the asset is transferred to them by the developer. This makes them an unsecured creditor to the developer.

However, until now there has been no further clarification as to whether the home buyers are secured financial creditors or unsecured financial creditors, but in consideration of the recent developments, one thing is sure that the result will be in the interest of homebuyers only. The Government has left no stone unturned to bring justice to the cause of the aggrieved homebuyers and the same can be felt vide the amendment brought in IBC.

Insolvency and Bankruptcy Code, 2016 (“IBC”) Amendment ‘Financial debt’ under Section 5(8) of the IBC to provide that *any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing*. The term ‘allottee’ and ‘real estate project’ had their meaning assigned through the Real Estate (Regulations and Development) Act, 2016. (As amended under 2018)

Opening of flood gates

The amendment opened the flood gates and a number of petitions were filed across the country by home buyers. One interesting aspect of the IBC law is that there must be a 'default'. Section 3(12) of the IBC defined 'default' to mean *non-payment of debt when whole or any part or installment of the amount of debt has become due and payable and is not paid by the debtor or the corporate debtor as the case may be*. Where a homebuyer has paid money under an agreement to purchase an apartment and when there is a delay in completion or delivery, can it be said that there is a default

Constitutional challenge

The constitutional validity of the amendment was challenged before the Supreme Court by many developers and the batch of writ petitions were disposed of by the Hon'ble Supreme Court

The Writ Petitioners before the Hon'ble Supreme Court assailed the amendment on the ground that it affected the fundamental right under Article 19(1)(g), and the deeming fiction introduced through the explanation was inconsistent with the object of the IBC. Further, it was also argued that when there was a specific legislation viz. RERA which would address all these issues and was a sector specific legislation, the enactment of 'a sledgehammer to kill a gnat' would render the impugned amendment excessive, disproportionate and violative of Article 14 and 19(1)(g). It was also contended that there was no 'debt' or 'borrowing'.

Decision of the Supreme Court in Pioneer Urban Land case

The Hon'ble Supreme Court upheld the constitutional validity of the amendments introduced to IBC with reference to home buyers and held that

- (i) The Insolvency Law Committee has found as a matter of fact that delay in completion of flats / apartments has become a common phenomenon and the amounts raised from home buyers contribute significantly to the construction of such flats / apartments. It was important therefore to clarify that home-buyers are treated as 'financial creditors' so that they can trigger the Code and have their rightful place in the committee of creditors.
- (ii) It was difficult to accept the argument that RERA is a special enactment which deals with real estate development project and must therefore be given precedence over the Code which is only a general enactment. At the time of

introduction of the explanation to Section 5(8)(f) of the IBC, Parliament was aware of RERA and applied some of the definition provisions to the Code.

- (iii) The fact that RERA is in addition to and not in derogation of other laws (Section 88) makes it clear that remedies under RERA to allottees were intended to be additional and not exclusive remedies;
- (iv) The Hon'ble Supreme Court in *KSL Industries Ltd. Vs. Arihant Threads Ltd. (2015) 1 SCC 166* has held that Sick Industries (Special Provisions) Act, 1985 would prevail over the Recovery of Debts Due to Banks and Financial Institutions Act, 1993;
- (v) By the process of harmonious construction, RERA and Code must be held to co-exist and in the event of a clash, RERA must give way to the Code. RERA therefore cannot be held to be a special statute which in the case of a conflict, would override the general statute viz. the Code;
- (vi) The Code is meant to a proceeding in *rem* which after being triggered goes completely outside the control of the allottee who triggers it. Thus, any allottee / home buyer who prefers and application under Section 7 of the Code takes the risks of his apartment not being completed in the near future in the event of there being a breach on the part of the developer;
- (vii) If the Petition is admitted under the Code the allottee may never get refund of the entire principle let alone the interest on account of an elaborate insolvency resolution process. On the other hand, if such allottee were to approach under RERA it is more than likely that the project would be completed early and / or full amount of refund and interest with compensation and penalty would be awarded;
- (viii) Only an allottee who has completely lost faith in the management of the real estate developer would come before the NCLT under the Code;
- (ix) When a person supplies goods and services such a person is a creditor and the person who has to pay for the goods and services is the debtor. In the case of real estate developer, the developer who is the supplier of the apartment is the debtor inasmuch as the homebuyer / allottee funds his own apartment by paying amounts in advance;

- (x) In a real estate project, money raised from the allottee is being raised as consideration for the time value of money. The fact that the allottee makes such payment in installments which are co-terminus with phases of completion of the real estate project does not any the less make such payments as payments involving 'exchange', i.e. advances paid only in order to obtain a flat / apartment;
- (xi) Based on the fundamental differences between the real estate developer and the supplier of goods and services, the legislature has focused upon and included real estate developers as financial creditors;
- (xii) Home buyers/ allottees can be assimilated with other individual creditors like debenture holders and fixed deposit holders who have advanced certain amounts to the corporate debtor;
- (xiii) Given the fact that the allottee may be entitled to claim of compensation in the event of a breach of agreements with the developer, the allottee gets a right to have seat on the committee of the creditors;
- (xiv) The information published in the website under RERA can be the basis for 'a default' relating to the amount due from the developer;
- (xv) It is also open to a developer to point out that the allottee is a speculative investor and not a person who is genuinely interested in purchasing the apartment. The contention that a wholly one sided and futile hearing would take place before the NCLT and would ignite the process of removal of management and lead to the death of the corporate debtor cannot be accepted;
- (xvi) The expression 'disburse' would refer to the payment of instalment by the allottee to the real estate developer for the particular purpose of funding the real estate project. The allottee 'disburses' money in form of advance payments made towards construction of the real estate project. Section 5(8)(f) would subsume amounts raised under transactions which are necessarily loan transactions so long as they have the commercial effect of borrowing&
- (xvii) The allottees and homebuyers were included in the main provision i.e. Section 5(8)(f) with effect from the inception of the Code and the 2018 explanation merely clarifies doubts that had arisen.

New Questions to Answer

The homebuyer is now in a quandary. There could be a set of allottees who may want the apartment where there could be others who may trigger the IBC which would bring in all other creditors into the scene and from a claim perspective there could be much serious and bigger debts compared to what is due to the allottee. The developer is also in trouble since the IBC window may have the effect of affecting a business which is otherwise healthy but in trouble due to market conditions.

The three-member Bench decision of the Hon'ble Supreme Court upholding the constitutional validity of the 2018 amendment and holding that the allottee/ homebuyer is a 'financial creditor' from inception of IBC is likely to open up completely new concerns of significance.

- (i) The Supreme Court has recognized the principle that the Parliament is very much aware of the existence of RERA and had still chosen to clarify that *any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing*. If that be the case, the Parliament is equally aware of the existence of the Central Goods and Services Tax Act, 2017 which seeks to treat construction of complex as a service. Now that the allottee is to be considered as a financial creditor, can it be said that a real estate developer is engaged in providing construction services to a consumer?
- (ii) The Supreme Court in Para 40 has held that in operational debts when a person supplies goods and services, such person is the creditor and the person who has to pay is the debtor but in the case of real estate developers, the developer is the debtor since the allottee is funding his own apartment by paying amounts in advance. By classifying the allottee as a creditor and as a financial creditor, can it now be said that the transaction is akin to borrowing and hence there is no service rendered by the developer for levy of GST?
- (iii) If real estate developers are considered as only financial debtors and not operational debtors, what would be the character of monies in the hands of the developers?
- (iv) The Supreme Court in Para 61 observes that the allottee 'disburses' the money in the form of advance payments towards construction of the real estate project and therefore it is a debt. If the Court had held that an allottee is an operational creditor, the nature of the construction as a service could have survived but declaration as a

financial creditor would open up new vistas of debate as to whether there is a supplier or recipient or service equation in real estate development.

- (v) None of the decisions in the context of tax laws relevant to construction seem to have been cited. The developer had undertaken to build for the flat purchaser and so long as there was no termination of the contract the construction is for and on behalf of the purchaser and it remains a works contract.

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