

## Insolvency Code & Status of Home-buyers: A Conundrum

### 1. Introduction

The Insolvency and Bankruptcy Code, 2016 (“**IBC**”) was passed with the objective of balancing interests of all stakeholders in a corporate entity’s insolvency resolution process. In furtherance of this objective, the government passed the IBC (Amendment) Ordinance, 2018<sup>1</sup> (“**Ordinance**”) on June 6, 2018. The Ordinance amends IBC to promote insolvency resolution over liquidation and streamlining provisions regarding eligibility for insolvency resolution, with specific focus on protecting interests of home-buyers<sup>2</sup> and MSMEs. It seeks to include amounts raised from home-buyers in a real estate project (“**Allotment Debt**”) within the ambit of “financial debt”, in order to enable their claims as financial creditors. Financial debt is a debt disbursed against the consideration for the time value of money and includes transactions having the commercial effect of a borrowing.<sup>3</sup> With inclusion of Allotment Debts as financial debts; it is widely perceived that the Ordinance shall protect the interests of home-buyers, and assist in formalizing the real estate sector by eliminating ‘fly by night’ real estate developers. However, the actual impact created will have to be tested with time.

This newsletter aims to lay out the existing conflict around status of home-buyers and to critically analyse the Ordinance *vis-à-vis* the rights of home-buyers as creditors in an insolvency resolution process.

### 2. Overview of insolvency resolution process

Under IBC, where a company fails to repay an admitted debt of a minimum of INR 100 thousand (USD 1.4 thousand)<sup>4</sup>, an insolvency resolution process can be initiated against the company by financial creditors, operational creditors or the company itself. Once such process is initiated the company’s management vests in an interim resolution professional, who collates claims against the company and formulates a Committee of Creditors (“**CoC**”). The CoC exclusively comprises of the company’s financial creditors with the complete exclusion of operational creditors. This enables financial creditors to singularly decide the course of action *vis-à-vis* the insolvent company. Through the CoC, financial creditors can either accept a resolution plan for the company’s revival or liquidate the company. In the event that CoC opts for liquidation, the scheme of distribution of realized assets under IBC applies,<sup>5</sup> wherein secured creditors are prioritised over unsecured ones. Therefore, the distinction between financial creditors and operational creditors is immaterial during liquidation.

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<sup>1</sup>Ordinance, [http://ibbi.gov.in/webadmin/pdf/legalframework/2018/Jun/186195\\_2018-06-06%2021:08:49.pdf](http://ibbi.gov.in/webadmin/pdf/legalframework/2018/Jun/186195_2018-06-06%2021:08:49.pdf), (last accessed on June 17, 2018)

<sup>2</sup> Legal construction of the term “home-buyers” is to be derived from “Allottees” under Section 2(d) of Real Estate (Regulation and Development) Act, 2016

<sup>3</sup> Section 5(8) of IBC

<sup>4</sup> USD 1 = about INR 68

<sup>5</sup> Section 53 of IBC

### 3. Position of home-buyers as creditors before the Ordinance

Prior to the Ordinance, there was no clarity regarding home-buyers' rights, either as financial or operational creditors under IBC. Thus, home-buyers were unable to assert their rights for initiating an insolvency resolution process and participate in CoC. This ambiguity enabled real estate developers to sideline the claims of home-buyers. For example, in an on-going dispute before the Supreme Court, *Chitra Sharma vs. Union of India*,<sup>6</sup> home-buyers raised claims for refund of INR 100 billion (USD 1.5 billion) against Jaypee Infratech Limited ("JIL") due to non-allotment of 24,125 apartments. Herein, the aggregated claim value of home-buyers was almost equivalent to that of the financial creditors. Yet due to lack of safeguards under IBC, the Supreme Court had to exercise its inherent powers to order interim protective measures against JIL.<sup>7</sup> Further, the Supreme Court required home-buyers' inclusion in CoC and mandated JIL to deposit security worth INR 20 Billion (USD 295 million).

Hence, it becomes relevant to analyze the Pre-Ordinance status of home-buyers to gather a realistic and legal interpretation of the Ordinance's amendments *vis-à-vis* home-buyers' rights.

#### 3.1 Home-buyers not operational creditors

An operational creditor is a person to whom operational debt is owed. Operational debt is a debt in respect of provision of goods or services.<sup>8</sup> Based on the definition of operational debt, it will not be absurd to consider Allotment Debt as a debt arising in respect of supply of real estate development services to home-buyers,<sup>9</sup> and accordingly, regard home-buyers as operational creditors. However, in various cases concerning home-buyers, National Company Law Appellate Tribunal ("NCLAT")<sup>10</sup> misinterpreted the definition of "operational debt" and held that since home-buyers themselves do not supply any goods or services to a company, they cannot be considered as operational creditors. To arrive at such interpretation, the NCLAT narrowly construed the illustrations of operational creditors as provided in the committee report that originally proposed IBC,<sup>11</sup> and observed that operational debt can arise only on account of supply made to the company and not *vice-versa*. Further, the NCLAT refused to widely interpret the definition of operational debt by stating that timelines of IBC would get affected if home-buyers are allowed to raise claims against real estate companies in the capacity of operational creditors.<sup>12</sup> Such interpretation is bound to be faulty due to three key reasons as elucidated below:

- *Firstly*, the definition of operational debt does not stipulate who should be the supplier of goods or services. It only provides the nature of debt which must be "in respect of provision of goods or services". Interestingly, the committee report relied by NCLAT itself

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<sup>6</sup> Writ Petition (Civil) No(s). 744/207 (Supreme Court)

<sup>7</sup> Article 141 of the Constitution of India

<sup>8</sup> Section 5(21) of IBC

<sup>9</sup> Real Estate Development is included within the definition of "Service" under the Consumer Protection Act, 1988; *Narne Construction vs. Union of India*, AIR 2012 SC 2369 following *Lucknow Development Authority vs. MK Gupta*, AIR 1994 SC 787

<sup>10</sup> *Pawan Dubey and Anr. vs. J.B.K. Developers Private Limited, C.A. (AT) (Insolvency) No. 40 of 2017 NCLAT Delhi*; following *Vinod Awasthy vs. AMR Infrastructure*, [2017] 141 SCL 70 at Paragraph 9; *Sanjeev Kanwar vs. AMR Infrastructure C.P. No. (ISB)- 03 (PB)/2017*

<sup>11</sup> Banking Law Reforms Committee Report at Paragraph 5.2.1

<sup>12</sup> *Vinod Awasthy vs. AMR Infrastructure*, [2017] 141 SCL 70 at Paragraph 10

defined operational creditors as “creditors on account of transactions on operations”.<sup>13</sup> In effect, NCLAT invented a restriction on the scope of operational debt and consequently, on the class of operational creditors which was not included in IBC.

- *Secondly*, as operational creditors do not form a part of CoC and cannot participate in its decision making process, NCLAT’s assessment that inclusion of home-buyers as operational creditors will delay IBC’s timelines is without any basis in law.
- *Thirdly*, in light of IBC’s objective of balancing the interests of all stakeholders in the insolvency resolution process, the definition of operational creditor ought to have included home-buyers who are vital stakeholders in real estate companies.

### 3.2 Inclusion of home-buyers as financial creditors in certain situations

Financial debt includes money borrowed against payment of interest, amounts raised under a credit facility and any other transaction having the commercial effect of a borrowing. For a debt to qualify as financial debt, it must have the following components:<sup>14</sup>

- there must be a liability or an obligation in respect of a claim which is due from any person;
- the debt must be disbursed against consideration for time value of money; and
- it must be included in the illustrative list of financial debts, or must arise from a transaction having the commercial effect of a borrowing.

As a general rule NCLAT has held that transactions wherein amounts are disbursed for sale of real estate in the future do not have the commercial effect of a borrowing and thus, are not financial debts.<sup>15</sup> However, in certain circumstances, the NCLAT has included home-buyers as financial creditors.

In *Nikhil Mehta vs. AMR Infrastructure Ltd*,<sup>16</sup> the petitioner had provided almost the entire consideration for an apartment to the respondent pursuant to a “commitment plan”. The commitment plan was akin to a collective investment scheme,<sup>17</sup> wherein the respondent was obligated to provide assured monthly returns until handing over the apartment. This monthly repayment was the incentive for upfront payment of entire apartment consideration, which in turn was used to raise finance for the respondent’s real estate development activities. Nonetheless, the respondent defaulted on monthly re-payments and delayed handing over the apartment. The question before the NCLAT was whether the upfront amount paid under the commitment plan contained all the components of a “financial debt”, so as to classify the petitioner as a financial creditor.

The NCLAT observed that the respondent had borrowed the amount for the commercial purpose of financing its real estate development activities and equated the Allotment Debt with a

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<sup>13</sup> Supra Note 11

<sup>14</sup> B.V.S. Lakshmi vs. Geometrix Laser Solution Private Limited, [2018] 142 CLA 321

<sup>15</sup> Nikhil Mehta & Sons vs. AMR Infrastructure, [2017] 143 SCL 278

<sup>16</sup> Ibid; Anil Mahindroo and Ors vs. Earth Iconic Infrastructure (P) Ltd., IV (2017) BC 128

<sup>17</sup> A scheme where contributions of investors are pooled and utilized for the purpose of the scheme with a view to return profit to the investors

loan which arose out of a transaction having the commercial effect of borrowing. Further, the NCLAT assessed whether the Allotment Debt had been “disbursed against the consideration for time value of money”. The forum observed that the aforementioned condition is satisfied when there is (i) a distance between inflow and outflow of money, and (ii) compensation is paid for the time between deposit of consideration and realization of investment.<sup>18</sup>

The NCLAT held that the Allotment Debt satisfied the credentials for time value of money, as there was time lapse between inflow of Allotment Debt and handing over of apartment, combined with compensation in form of assured monthly repayments. Since the cardinal conditions for financial debt were fulfilled, the NCLAT held that the Allotment Debt was a financial debt and the petitioner was a financial creditor. Additionally, NCLAT upheld that forward sale real estate contracts where money is paid by home-buyers for future transfer of property shall not be considered as financial debts. As observed, in certain circumstances, Allotment Debt can qualify as financial debt and home-buyers as financial creditors. However, in cases of simple real estate buy-purchase contracts where there is no repayment or consideration for time value of money, it cannot be the case. Hence, Nikhil Mehta decision cannot be beneficial for all kinds of home-buyer claims against real estate corporates’ without similarity in facts.

#### 4. Position of home-buyers as creditors after the Ordinance

The Ordinance acknowledges Allotment Debts as debts arising from transactions having the commercial effect of borrowing. Nevertheless, the amendment in a sweeping generalization includes all kinds of Allotment Debt as financial debt, and such approach may fall short of settling the status of home-buyers as financial or operational creditors. Claiming home-buyers must still satisfy the requirement that Allotment Debt is “disbursed against the consideration for time value of money” to be categorized as financial debts. Allotment debts which do not provide any compensation as consideration for the time value of money and where there is no time lapse between deposit and final realization of investment, cannot be clubbed within the scope of financial debts. Accordingly, such home-buyers may not necessarily qualify as financial creditors.

Further, the rationale of inclusion of all Allotment Debts as arising from transactions “having the commercial effect of borrowing” is questionable. The Insolvency Law Committee that proposed the Ordinance observed that common contractual terms between real estate developers and home-buyers suggest that most Allotment Debts are sought as financing means for development of real estate projects; and therefore, all Allotment Debts should be deemed to have commercial effect of borrowing.<sup>19</sup> Such observation is in disregard of NCLAT’s position in Nikhil Mehta case that ordinary forward sale contracts of real estate do not have the commercial effect of a borrowing. In light of this, scepticism of how home-buyer claims will be treated in insolvency resolution process continues. It is likely that the Ordinance lost the opportunity to settle the status of home-buyers’ and in further disputes adversaries may be inclined to reopen the pre-Ordinance confusion all over again.

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<sup>18</sup> Supra Note 15

<sup>19</sup> ILC Report at Paragraph 1.5

## 5. Conclusion

The Ordinance could have classified the status of home-buyers, and it would have been valid to classify them as operational creditors as discussed in para 3.1. The Ordinance fails to address the concerns faced by courts in safeguarding home-buyers right to participate in CoC meetings in a meaningful way. While the deeming provision may create the impression that any and all home-buyers have a say in insolvency resolution process, the ideal is far from reality unless home-buyers' status is determined with absolute certainty.

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