Real Estate Insolvency and the IBC

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Insolvency of Real Estate corporate entities poses particular problems under the Insolvency and Bankruptcy Code, 2016 (IBC) regime. This is on account of the peculiar nature of the business of these entities.

In any usual case of insolvency of a corporate entity, which in the IBC regime is referred to as the 'corporate debtor' (CD), there are stakeholders in the form of creditors, employees, management, etc. The creditors can be financial or operational depending upon the nature of the transaction between the creditor and the corporate debtor.

The IBC regime is unique in the sense that it classifies financial and operational creditors and allocates differential rights to both of them. For instance, the financial creditors (FCs) get to sit on the Committee of Creditors (CoC) and get voting rights in proportion to the debt they are owed. The operational creditors (OCs) do not get a seat on the CoC and they are consequently disenfranchised from voting as well. The FCs are banks, financial institutions, etc. The OCs are the creditors who have become creditors by virtue of the CD's business operations. These include trade creditors, employees of the CD, and the government dues like taxes.

The CoC is the principal body in the IBC regime which not only has control of the CD during the resolution process but also decides on the fate of the CD by approving a resolution plan if it deems fit or can also decide to liquidate the CD. Naturally, being denied the right to sit on the CoC poses significant disadvantages to the OCs.

The policy to exclude OCs was justified on account of two primary reasons. First is the absence of financial knowledge in the OCs, which FCs, being financial institutions, will have and, therefore, can make a better decision for the CD. OCs are trade creditors who may not have the same level of knowledge as FCs. The second reason is that the FCs have the capacity to restructure the debt they are owed as they have broader financial capacity. OCs, on the other hand, have very limited capacity to take a haircut. Thus, FCs may not make the decision to liquidate the CD; instead, they may take a haircut and restructure the debt to recover it in the future. It was assumed that OCs would want to recover their debt even if it came at the cost of liquidating the CD. Thus, it was argued that there may be a stronger 'liquidation bias' in the OCs when compared to the FCs. For the same reasons, the OCs have a tougher process to trigger the CIRP under the IBC, and the FCs have a relatively easier process.

In the cases that involve the insolvency of real estate corporations, the identification of stakeholders itself becomes complex. A real estate developer has access to two major finance sources. First is the banks, and the other is taking partial payments in advance from the homebuyers, which is usually linked to the construction progress of the project. Thus, the homebuyers themselves finance the construction project, at least in part, if not in full. If the concerned real estate developer is admitted into the Corporate Insolvency Resolution Process (CIRP) under the IBC, then what should be the status of homebuyers has been an issue of significant debate.

This issue reached the Supreme Court for the first time in the case of *Chitra Sharma v Union of India*. In this case, the Court realized that the IBC does not address the complexity of the insolvency of the real estate companies because it was difficult to ascertain the status of the homebuyers, who have supplied finance to the CD yet the question before the Court that can they be classified as the creditors of the CD. Moreover, since it is itself not certain that they are creditors, classifying them further as FCs or OCs posed further challenges to the Court. Yet, disenfranchising all the homebuyers from the process seemed unfair to the Court.

During the pendency of the case before the Supreme Court, an ordinance was passed by the Union Government in June 2018. This ordinance amended the IBC, which now provided that the homebuyers were to be treated as FCs. The Court, in this case, decided to invoke its constitutional powers to allow the benefit of the amendment to the homebuyers. Subsequently, in all cases, the homebuyers have been acknowledged as FCs.

The policy outlined in the ordinance, which was followed by an amendment, can be sustained by agreeing to two propositions. First was that the IBC is an economic legislation, and economic policy should be left in the domain of the legislature and the executive, courts, thus, shouldn't interfere in such matters. The second is the nature of the transactions between the homebuyers and the CD, and that in principle means that the homebuyers indeed lent finance to the CD, and hence, should be classified as FCs.

This leads to another contradiction in the scheme of the IBC. The homebuyers do not at all satisfy the conditions precedent in the policy for classifying FCs and OCs as two separate classes, for a variety of reasons.

Firstly, the homebuyers do not have the financial knowledge that is there with FCs. Secondly, they also do not have the capacity to restructure the debt which they are owed. The homebuyers, in most cases, have themselves borrowed money from the banks to purchase the homes. Thirdly, they cannot be expected to take a haircut on these loans. Therefore, it can be safe to assume that the 'liquidation bias' in the case of homebuyers will be more than financial institutions, and it might not be a great idea to put them on the same footing. In fact, it can be argued that the liquidation bias in cases of homebuyers may actually be more than the OCs as well because OCs have a business relationship with the CD, and it can be in their interest that the CD survives the CIRP and is not liquidated so that they can continue to do business with

it. Denying a CoC seat to the OCs and allowing the same to the homebuyers is arguably not fair. The homebuyers could also now easily trigger the IBC process against the real estate developers.

This legal position was also disadvantageous to both financial institutions and real estate developers. For the financial institutions, their voting power in the CoC was diluted because of the presence of a significant number of homebuyers. The real estate developer can now be taken to the NCLT even by a single homebuyer whose home may not be able to be completed because of a variety of reasons.

To rectify the first position and to address the issue of the financial institutions, the parliament, when it converted the ordinance into a law in August 2018, tried to blunt the effect of the ordinance. Thus, though it still acknowledged the homebuyers as FCs, it added one qualifier. Now, though the homebuyers get a seat on the CoC they will have to necessarily be represented in a class through an authorized representative. This, in effect, means that all the votes of the homebuyers will be cast one way or the other. Regardless of their individual opinions, the view of the majority will be representative of each and every homebuyer.

This qualifier does address the issues of non-homebuyer FCs to some extent but not entirely. The homebuyers now can't directly scuttle the process in the CoC as they are represented through an authorized representative and can only vote one way as a group. Still, this does not resolve the problem of dilution of the vote share of the non-homebuyer FCs. In various cases, the non-homebuyer FCs will possibly be reduced to a minority, whereas earlier, they were the only ones in the CoC.

The IBC was again amended in 2020 and a second qualifier was introduced. This rule now provided that a single real estate project allottee cannot trigger the CIRP under the IBC; instead, it should be a minimum of 10% of all the allottees or 100, whichever is less.

The second qualifier is more efficient and significantly limits the ability of homebuyers to misuse the IBC process to their advantage. A single allottee not being able to get the delivery of their home may not be a solvency issue at all. However, 10% or 100 allottees not being able to get their homes delivered does raise a solvency question. It can be argued that in such cases, the financial health of the real estate developer is not good enough.

The 2018 Amendment was challenged before the Supreme Court in *Pioneer Urban v Union of India*. All the parties were unhappy with this amendment. The real estate developers were unhappy with it because the homebuyers were being treated as FCs. The homebuyers were unhappy because they couldn't directly represent themselves in the CoC. The Court did not interfere again by putting forward the two propositions which have been discussed earlier, no judicial intervention in policy matters, and the nature of the transaction makes the homebuyers FCs.

The 2020 Amendment was challenged in *Manish Kumar v Union of India*, and the second qualifier came under judicial scrutiny. The Court again had put two arguments to sustain the amendment. First was again the economic policy argument. The second, however, became contentious because it can't be argued that homebuyers are essentially FCs by virtue of the nature of the transactions they have undertaken, and yet they won't be allowed to not trigger the IBC process on their own. To sustain the rule in this amendment, the Court had to contradict itself and justify the amendment by analyzing the economic policy and arriving at a different conclusion than what it did in Pioneer to say that homebuyers are not equivalent to financial institutions.

It can be seen that there is significant ambiguity in the policy as well as adjudication of the insolvency of real estate corporations. It is submitted that the IBC process is a generic process that may not suit a sectoral issue of homebuyers. Amending the IBC for sectoral problems and issues is also not the proper thing to do, because stakeholders in other sectors may as well demand sectoral changes and concessions. Thus, in the interest of justice and business efficiency, the government must notify a separate framework for the resolution of real estate insolvency.