[2019] 2 IBJ (Art.) 43

Insights

Allottees under Real Estate Project – Unsecured Financial Creditors

In this article, the author makes an attempt to analyse whether 'Home Buyers' fall within the definition of 'Secured Creditor' along with the legal framework under the Insolvency and Bankruptcy Code, 2016 and other relevant laws.

– Kahnav Mahajan, Lawyer

Background

In the matter of *Nikhil Mehta & Sons* v. *AMR Infrastructure Ltd*[1]., the NCLAT for the first time considered the issue relating to the status of allottees under real estate projects ('**home-buyers**'), under the Insolvency and Bankruptcy Code, 2016 ('Code') and observed that the home buyers are Financial Creditors under the provisions of the Code. However, the observation made in this case was, in my humble submission, very case specific and did not have any universal applicability.

Due to pendency of several cases in the Supreme Court regarding the status of home-buyers, the issue was further considered by the Insolvency Law Commission and based on its report, the home-buyers were given the status of Financial Creditors under the Code by way of an explanatory amendment[2]. Thus, it is of no doubt that the home-buyers were given the status of financial creditor under the Code from its inception.

The categories of creditors under the Code, i.e., Financial Creditor and Operational Creditor are a creation under the Code for the purpose of insolvency resolution process and rather the traditional classification, i.e., secured and unsecured creditor, is used for the purpose of repayment under the waterfall mechanism as provided under section 53 of the Code. In the matter like *Jaypee Infratech Ltd.*[3], the home-buyers have been given a seat at the creditor's committee table, but does it give them the same rights as secured creditors under the waterfall mechanism in case of liquidation?

In the matter of *Chitra Sharma* v. *UOI*[4], the Supreme Court while dealing with the issue of home-buyers, left the issue open as to whether the home-buyers fall under the category of 'secured creditor' or 'unsecured creditor' for the purpose of distribution of funds under the Code and observed that the disbursement of Rs. 750 crore to home-buyers would be discriminatory and would cause gross injustice to the secured creditors as it would amount to preferential payment.

Legal Framework

The term 'Financial Creditor' means "any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to."[5] The term 'Financial Debt' means "a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money and includes –

1. *[2017] 1 IBJ (JP) 111 (NCLAT)*
2. *Insolvency and Bankruptcy Code (Second Amendment) Act.*
3. *[2018] 1 IBJ (JP) 489 (SC)*
4. *Ibid.*
5. *Section 5(7) of the Code*

(*a*) money borrowed against the payment of interest ;

(*b*) any amount raised by acceptance under any acceptance credit facility or its dematerialised equivalent ;

(*c*) any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument ;

(*d*) the amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed ;

(*e*) receivables sold or discounted other than any receivables sold on non-recourse basis ;

(*f*) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing.

Explanation. – For the purposes of this sub-clause, –

(*i*) 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 ; and

(*ii*) the expressions, "allottee" and "real estate project" shall have the meanings respectively assigned to them in clauses (d) and (zn) of section 2 of the Real Estate (Regulation and Development) Act, 2016.[6]

The Code defines the term 'Secured Creditor' to mean "a creditor in favour of whom security interest is created.[7]"

Further, the term 'Security Interest' means "right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement securing payment or performance of any obligation of any person. Provided that security interest shall not include a performance guarantee."[8]

Priority of Rights

Where a person purports to create by transfer at different times rights in or over the same immovable property, and such rights cannot all exist or be exercised to their full extent together, each later created right shall, in the absence of a special contract or reservation binding the earlier transferees, be subject to the rights previously created.[9] Regulation 21 of IBBI (Liquidation Process) Regulations, 2016 is as follows :

"The existence of a security interest may be proved by a secured creditor on the basis of –

(*a*) the records available in an information utility, if any;

(*b*) certificate of registration of charge issued by the Registrar of Companies; or

(*c*) proof of registration of charge with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India."

Analysis of Legal framework of Code

The reason behind providing home-buyer the status of financial creditor is that the developer/seller use the home-buyer's money to fund the project in addition to the loan amount received from the financial institutes. To avail the loan facility from the financial institutes the developer/seller is required to provide a guarantee or create a security interest in favour of the financial institutes. However, no such secured interest is created in favour of the home-buyers while entering into the agreement to sell.

The agreement to sell entered between the buyer and the seller is in relation to a property which does

6. *Section 5 (8) of the Code*
7. *Section 3(30) of the Code*
8. *Section 3 (32) of the Code*
9. *Section 48 of the Transfer of Property Act, 1882*

not exist at the time of the signing the agreement. The nature of the agreement between the buyer and the seller is very simple. The primary obligations of the parties under the agreement is that the buyer will provide the monies for construction and delivery of the house and the seller/developer's primary obligation is to deliver the property.

The definition of 'Security Interest' as provided under the Code states "right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation....", the reference to the term 'transaction' in the definition identifies the purpose of such transaction i.e. creating a secured interest in favour of the secured creditor, and such transaction can take place by way of "mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement". Such transaction has to be a separate transaction from the primary obligation of the parties in order to result in a security interest in favour of the creditor as the purpose of the such transaction is to "securing payment or performance of any obligation of any person". In the case of home-buyers, there is no mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement in place in order to create right, title or interest or a claim to property by a transaction to secure payment or performance of the obligation. The only interest the home-buyers have is created under the agreement to sell and that does not form part of the transaction which secure payment or performance of an obligation. The obligations under the agreement are the primary obligations of the parties and therefore, the same can not be considered to be a transaction creating secured interest. Furthermore, in the case of liquidation a secured creditor has to prove its security interest and in order to do so he must fulfill one of the following requirement:

- Records available in an information utility, if any;
- Certificate of registration of charge issued by the Registrar of Companies; or
- Proof of registration of charge with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India."[10]

A home-buyer whose property has not yet been created can not prove his secured interest as there exist no provision under the Code to prove a non-existing security.

Real Estate (Regulation and Development) Act, 2016 (RERA)

It is pertinent to analyse the rights of the allottees under real estate project in terms of how the rights of the allottees are treated and protected under the special law created to protect their interest. The RERA was enacted to protect the interest of the consumers i.e., home-buyers. As per section 19(4) of the RERA, the right provided to the home-buyers RERA is as follows :

> "(4) 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 this 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 this Act or the rules or regulations made thereunder."

Sub-section (4) makes it clear that in case the developer/seller fails to comply or is unable to give the possession, the home-buyer is entitled to get the refund of amount along with interest rate. There is no right in favor of the home-buyer, whereby, the home-buyer can enforce the security against the developer/seller as there exist no security interest in favor of the home-buyer under the terms of the agreement to sell.

10. Regulation 21 of IBBI (Liquidation Process) Regulations, 2016

Exception

One can put forward the argument that the home-buyers may be given share, proportional to the value of the property under the agreement, in order to secure their interest and elevate them to the level of secured creditors. However, it is to be noted that the financial lender who provided the monies to fund the project has first charge over the property and thereby making the home-buyers a second charge holder, if a proportional share of land is secured in their interest. This will result in a chaotic scenario as firstly, it is important for the corporate debtor to first get a no-objection certificate from the first charge holder in order to create a second charge over the same asset, which as per the standard business practice does not happen. Secondly, the charge created in favor of the home-buyers will be exercised subject to the previously created charge[11], *i.e.*, the home-buyers shall only be paid when the principal lender has been paid in full, as the right of the first charge holder prevails over the successive charge holders. This however raises another grey area in the Code as to what will happen in a situation where the CD has not defaulted towards primary lender but has defaulted against the sub-ordinate charge holder.

Conclusion

There is no doubt that the amount given by the home-buyer to the developer/seller is a financial debt, thereby, making the home-buyer a financial creditor of the developer/seller. Since, the definition of secured creditor provided under the Code does not include allottee under real estate project, they fall under the category of unsecured creditor as per the provisions of the Code. The same is also supported by the provisions of the special law i.e. Real Estate (Regulation and Development) Act, 2016. Home-buyers do not have any security under the terms of the agreement and therefore all they can seek is refund of their amount along with interest and the same can not be enforced by way of realizing the security due to lack of any secured interest.

In light of the above, it can be concluded that the status of the home-buyers, even after their inclusion in the category of the financial creditor, remains that of the unsecured creditor and as per the waterfall mechanism provided under section 53 of the Code will rank below unpaid dues to employees[12]. Interpreting the provisions of the Code otherwise would be equal to forcing an interpretation against the intent of the Legislature.

Even if the home-buyer is given proportional share of the property, his interest might not be secured as his secured interest amounts to second charge on the property and the Code is not yet clear regarding the status and relationship between the first charge holder and the second charge holder under resolution process and liquidation. Much clarity is required on the same issue.

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11. Section 48 of Transfer of Property Act, 1882

12. Section 53(d) of the Code

[2019] 2 IBJ (Art.) 47

Going Concern Liquidation – Make the 'Deal' Happen

The primary objective of the going concern sale is to facilitate the turnaround of the corporate debtor as a going concern and not merely as a sale of assets and distribution of funds amongst the stakeholders. In this article, the author has discussed key proposals for going concern sale stated in the Discussion paper besides need therefor and challenges therein. He believes that going concern sale of corporate debtor is undoubtedly a better approach that the piecemeal sale of assets.

– Neetika Ahuja, Associate Partner, Clasis Law

– Dinesh Gupta, Senior Associate, Clasis Law

Introduction

The Insolvency and Bankruptcy Code, 2016 **('Code')** has resulted in several merger and acquisition (**'M&A'**) deals in the past two and a half years. Some of the prominent M&A deals include acquisition of Bhushan Steel Ltd. by Tata Steel Ltd., Electrosteel Steels Ltd. by Vedanta Ltd. and Monnet Ispat & Energy Ltd. by JSW Steel Ltd. While these acquisitions have helped the lenders recover a substantial amount of their outstanding debt, the acquirers have also used this as an opportunity to acquire some lucrative facilities.

As per an estimate, the resolution plans under the Code have yielded about 200 per cent of liquidation value for the creditors and they are on an average realising 43 per cent of their claims through resolution plans. However, there are various instances where the corporate insolvency resolution process **('CIRP')** has concluded with the order for liquidation of the corporate debtor. As per the data available on the website of the Insolvency and Bankruptcy Board of India **('IBBI')**, as on 31st March 2019, 378 corporates are facing liquidation under the Code due to failure of the CIRP.

In terms of section 33 of the Code, the Adjudicating Authority has the authority to pass an order for liquidation of the corporate debtor if *(a)* the Adjudicating Authority rejects the resolution plan under section 31 for the non-compliance of the requirements specified therein, or *(b)* no resolution plan is received by the adjudicating authority before the expiry of maximum period permitted for completion of CIRP, or *(c)* the committee of creditors **('CoC')** with the approval of not less than 66 per cent of the voting share decides to liquidate the corporate debtor at any time during the CIRP.

Need for Going Concern Liquidation

The primary objective of the Code is resolution of the corporate debtor. The preamble to the Code does not mention anything about liquidation of the corporate debtor. In the matter of *Binani Cement Ltd.* [2018] 1 IBJ (JP) 665, the National Company Law Appellate Tribunal **('NCLAT')** said that liquidation would bring the life of a corporate

debtor to an end and that the Code does not allow liquidation of a corporate debtor directly but only on failure of the CIRP. The Supreme Court, in its order in *Swiss Ribbons*[1], held that the Code is first and foremost a Code for reorganization and insolvency resolution of corporate debtors and that the liquidation should be availed of as a last resort only if there is no resolution plan or the resolution plans submitted are not up to the mark. Further, in *Arcelor Mittal India Pvt. Ltd. v. Satish Kumar Gupta*[2], the Supreme Court opined that the corporate debtor consists of several employees and workmen whose daily bread is dependent on the outcome of the CIRP. If there is a resolution applicant who can continue to run the corporate debtor as a going concern, every effort must be made to try and see that this is made possible. The Hon'ble Supreme Court also observed that even in liquidation, the liquidator can sell the business of the corporate debtor as a going concern. In view of these judgments, the NCLAT and the adjudicating authority have, in several cases including *Bharati Defence & Infrastructure Ltd.* and *Reid & Taylor (India) Ltd.* directed the liquidators to make efforts to sell the corporate debtor as a going concern before selling the assets of the corporate debtor on a piecemeal basis.

Regulation 32 of the IBBI (Liquidation Process) Regulations, 2016 **('Liquidation Regulations')** which specifies the options for sale of assets of the corporate debtor was amended on 27th March, 2018, to provide for sale of the corporate debtor as a going concern as one of the modes for sale of assets of the corporate debtor undergoing liquidation.

The sale of a corporate debtor in liquidation as a going concern **('Going Concern Sale'**) is expected to help in realisation of a higher value, value preservation and rescuing a viable business. The going concern sale may also offer some lucrative opportunities for the M&A deals. However, at present, there is a lack of clarity under the Code and the Liquidation Regulations on the implementation aspects of the proposal for sale of a corporate debtor as a going concern. To address this concern and to provide guidelines for implementation of the going concern sale proposals, the IBBI has issued a discussion paper along with draft regulations on 27thApril 2019 **('Discussion Paper').**

Key Proposals in the Discussion Paper Concerning Going Concern Sale

The Discussion Paper proposes that in case no resolution plan is received by the CoC or if the CoC does not approve any resolution plan, the CoC may, at the time of passing a resolution for liquidation of the corporate debtor, recommend the going concern sale of the corporate debtor. In case of failure to achieve the going concern sale within a period of ninety days, the liquidator may proceed with other modes of liquidation. If there is no recommendation from the CoC, the liquidator shall explore all options of sale simultaneously keeping in view with the market practice in the line of business of the corporate debtor.

In terms of section 35(1)(e) of the Code, the liquidator can carry on the business of the corporate debtor for its beneficial liquidation. It has been proposed that in the going concern sale option, the corporate debtor along with the business, assets and liabilities will be transferred to the acquirer. Also, the employees of the corporate debtor will be transferred to the acquirer, hence, the employees will not be discharged on passing of the liquidation order by the adjudicating authority. Once the corporate debtor is sold as a going concern, the liquidator shall make an application to the adjudicating authority for the closure of the liquidation process of the corporate debtor and not for the dissolution of the corporate debtor.

Section 35(2) of the Code enables the liquidator to consult any of the stakeholders entitled to the distribution of proceeds under section 53 of the Code subject to the condition that such consultation shall not be binding on the liquidator. In line with the

1. Swiss Ribbons Pvt. Ltd. v. Union of India [2019] 2 IBJ (JP) 73 (SC)

2. [2018] 1 IBJ (JP) 563 (SC)

said provision of section 35(2), the Discussion Paper has proposed constitution of an advisory committee called stakeholders consultation committee **('Consultation Committee')** to advise the liquidator on matters related to liquidation of the corporate debtor. The Consultation Committee shall comprise of representatives of financial creditors, employees, workmen, operational creditors, representatives of the Government and shareholders, wherever relevant. The advice of the Consultation Committee shall not be binding on the liquidator. However, the liquidator shall record the reasons in writing where the liquidator takes a decision against the advice of not less than 66 per cent of the members of the Consultation Committee.

As regards the consideration to be paid by the acquirer for the going concern sale, the Discussion Paper provides that the total consideration to be paid by the acquirer shall be bifurcated into share capital and liabilities at the option of the acquirer. The fresh shares shall be issued to the acquirer against the share capital part of the total consideration. The existing shares of the corporate debtor would be cancelled and extinguished and the existing shareholders would become claimants from the liquidation proceeds under Section 53 of the Code which provides for a waterfall mechanism.

Challenges in the Going Concern Sale

The acquisition of corporate debtor under the going concern sale would be like any other M&A deal and may face certain regulatory challenges which are faced in such M&A deals. It is pertinent to note that the regulatory authorities have amended several regulations and relaxed various regulatory requirements to facilitate the acquisition of the corporate debtors pursuant to the resolution plan under the Code. However, similar relaxations are not available to the proposal of acquisition of the corporate debtor pursuant to the going concern sale as of now.

For instance, the Reserve Bank of India **('RBI')** has amended the regulations governing external commercial borrowings **('ECB')** and has allowed the resolution applicants to raise loans under the approval route from foreign entities for repayment of the rupee term loans of the corporate debtor being acquired pursuant to the resolution plan under the Code. An acquirer proposing to acquire the corporate debtor under the going concern sale would also need funds to discharge the debt owed by the corporate debtor to the lenders. However, the ECB regulations, at present, do not permit the acquirer to raise foreign loans for repayment of the rupee term loans of the corporate debtor being acquired through the going concern sale.

In case of a resolution plan for the listed corporate debtors, the Securities and Exchange Board of India **('SEBI')** has made various amendments in the regulations with the objective of easier implementation of the resolution plans. A proposal for the acquisition of equity shares beyond the stipulated threshold and/or control of a listed corporate debtor pursuant to the resolution plan enjoys absolute exemption from the applicability of open offer requirement under the takeover regulations. The allotment of equity shares of corporate debtor pursuant to the resolution plan does not attract the preferential issue guidelines prescribed by the SEBI. The SEBI had also amended the delisting regulations consequent to which delisting of corporate debtors pursuant to the resolution plan does not require compliance with the delisting regulations if the resolution plan sets out any specific procedure to complete the delisting or provides an exit option to the existing public shareholders at a price specified in the resolution plan. In addition to the above, the re-classification of promoters of listed corporate debtors pursuant to the resolution plan does not require any approval of the stock exchange(s) under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. The provisions relating to minimum public shareholding were also amended for the listed corporate debtors which are not delisted but continue to be listed on stock exchange(s) after the approval of the resolution plan.

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It has been noticed that, in the event an order for liquidation of a corporate debtor has been passed under the Code, though the stock exchange(s) suspends the trading in shares of the corporate debtor, the corporate debtor continues to be listed on the stock exchange(s). Therefore, it can be argued that any proposal to acquire a listed corporate debtor through the going concern sale mechanism may attract the regulations framed by the SEBI including preferential issue guidelines, takeover regulations etc., in the absence of specific provisions/exemptions in this regard.

As proposed in the Discussion Paper, the existing equity shares of the corporate debtor will not be transferred but will be extinguished in the going concern sale. It is, however, unclear if such extinguishment of existing share capital of corporate debtor needs to comply with section 66 of the Companies Act, 2013, considering that no requirement of approval by the adjudicating authority is contemplated for the actions as may be involved in implementation of the going concern sale.

The acquisition of the corporate debtor pursuant to the going concern sale may also attract the requirement of obtaining certain regulatory approvals including the approval of Competition Commission of India **('CCI')** under the provisions of the Competition Act, 2002, depending on case to case basis. While the Code has specific provision for obtaining approval of the CCI and other regulatory authorities in case of the resolution plan, there needs to be some clarity on whether the acquirer would be required to obtain such approvals to implement the going concern sale proposal and if yes, at which stage.

This is on account of the fact that in view of the Discussion Paper, the liquidator would make an application to the adjudicating authority for closure of liquidation proceedings upon completion of the going concern sale and is not supposed to seek approval of the adjudicating authority in relation to the actions required to implement the proposal. Though, in terms of section 35(1)*(n)* of the Code, the liquidator can apply to the adjudicating authority for necessary orders or directions in relation to the liquidation process, this is not clear if the adjudicating authority can grant relief from the above mentioned regulatory requirements to implement the going concern sale.

Another important aspect in the going concern sale is related to the selection of the preferred bidder/ acquirer by the liquidator. In the CIRP, the resolution applicants are shortlisted basis the evaluation matrix to be decided by the CoC. However, neither the Code nor the Liquidation Regulations presently stipulate the selection criteria for the potential bidders in the going concern sale. This remains unclear whether the preferred bidder/acquirer will be selected at the discretion of the liquidator or the scope of 'advice' to be given by the Consultation Committee would also include evaluating the feasibility and viability of the proposal submitted by the potential bidders. This becomes important in view of the fact that the primary objective of the going concern sale is to facilitate the turnaround of the corporate debtor as a going concern and not merely as a sale of assets and distribution of funds amongst the stakeholders.

Conclusion

The going concern sale of the corporate debtors is undoubtedly a better approach than the piecemeal sale of assets of the corporate debtor. This is a win-win option for the creditors and the employees of the corporate debtors. While the creditors may realise a higher value, the going concern sale would save the employment of many workers and employees whose daily bread is dependent on the corporate debtor. However, to make a 'deal' happen under the going concern sale mechanism, the regulatory authorities should bring a clear and unambiguous regulatory framework.

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