



# HOMEBUYERS AS FINANCIAL CREDITORS

June 22, 2018

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## Introduction

The initiation of corporate insolvency resolution process (“**CIRP**”) against Jaypee Infratech Limited (“**Jaypee**”) brought to fore the issue of treatment of home buyers under the Insolvency and Bankruptcy Code, 2016 (“**IBC**”). Immediately after the insolvency petition was admitted against Jaypee by the National Company Law Tribunal (“**NCLT**”), Allahabad<sup>1</sup>, a public interest writ petition was filed before the Supreme Court seeking relief for the home buyers. The Supreme Court initially granted a stay on the order of the NCLT<sup>2</sup> and subsequently, while lifting the stay, directed that the resolution plan should contain necessary provisions to protect the interests of the home buyers and also directed Jai Prakash Associates Limited (holding company of Jaypee) to deposit Rs. 2,000 crore with the court<sup>3</sup>.

The ambiguity on classification of homebuyers as ‘financial creditors’ or ‘operational creditors’ pointed out in the Jaypee case, prompted the Insolvency and Bankruptcy Board of India (“**IBBI**”) to amend the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (“**CIRP Regulations**”) to introduce the concept of ‘other creditors’, i.e. a class of creditors other than financial creditors or operational creditors.<sup>4</sup> Such ‘other creditors’ are not entitled to initiate CIRP against a corporate debtor, however, they can file their claims against a corporate debtor.

In November 2017, the Insolvency Law Committee (“**Committee**”) was constituted with the mandate of making recommendations on issues arising from the implementation of the IBC. One of the key recommendations of the Committee was that, in order to enable home buyers to participate equitably in the CIRP under the IBC, they should be treated as financial creditors owing to the unique nature of financing in real estate projects.<sup>5</sup>

Thereafter, on June 6, 2018, the President gave his assent to promulgate the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 (“**Ordinance**”) to amend the IBC. Pursuant to the Ordinance, amounts raised from home buyers have been brought within the purview of ‘financial debt’.

This note discusses the evolution of the position of home buyers under the IBC and a few implications of classifying home buyers as financial creditors.

## Judicial pronouncements in connection with evolution of the position of home buyers

Prior to the promulgation of the Ordinance, the treatment of home buyers under the IBC was a grey area and was subject to judicial interpretation on various occasions.

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<sup>1</sup> *IDBI Bank Limited v. Jaypee Infratech Limited*, NCLT, Allahabad, CP No. (IB) 77/ALD/2017, order dated August 9, 2017.

<sup>2</sup> *Chitra Sharma v. Union of India*, [2017]143 SCL 680 (SC).

<sup>3</sup> *Chitra Sharma v. Union of India*, [2017]144 SCL 1 (SC).

<sup>4</sup> Pursuant to the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations 2017, regulation 9A was introduced in the CIRP Regulations to provide for claims by ‘other creditors’.

<sup>5</sup> Report of the Insolvency Law Committee dated March 26, 2018.

### **Home buyers as operational creditors**

The NCLT, Principal Bench in *Col. Vinod Awasthy v. AMR Infrastructure Limited*<sup>6</sup>, while considering whether the applicant home buyer would be an ‘operational creditor’<sup>7</sup> of the respondent company, observed that ‘operational debt’<sup>8</sup> may arise out of provision of goods or services or dues arising out of employment or dues arising under any law and payable to the Central/ State Government. In this case, an ‘assured return’ was payable every month by the respondent to the applicant till the date of possession of the flat, which the respondent failed to pay. The NCLT observed that in the instant case the debt had not arisen out of any of the aforesaid four categories and that the amount sought to be recovered by the home buyer was necessarily associated with the delivery of possession of immovable property which had been delayed. In view of the above, it was held that the applicant home buyer would not be classified as an ‘operational creditor’<sup>9</sup>.

In this regard, it may be noted that ‘operational debt’ is defined as “*a claim in respect of the provision of goods or services ...*”. Since the phrase used in the definition is “in respect of” as opposed to “for”, it can be interpreted to mean that the claim can be either by a provider of goods or services or by a receiver of goods or services.

In *Nupower Renewables Private Ltd. v. Cape Infrastructure Private Ltd.*<sup>10</sup>, the Chennai Bench of NCLT observed that the term ‘operational debt’ should be given a purposive and contextual interpretation. In this case, the corporate debtor had received an advance from the petitioner for rendering services in respect of setting up of a wind power project but had failed to perform the services and agreed to refund the advance amount. The NCLT observed that the petitioner had advanced money to the corporate debtor for providing services and held that the petitioner falls within the meaning of ‘operational creditor’.

If the term ‘operational debt’ is interpreted as aforesaid, home buyers who have claims for refund of amounts paid towards an under construction unit<sup>11</sup> can be said to be ‘operational creditors’.

Another argument which was not made in the aforesaid cases was that such flats would be treated as stock-in-trade in the books of the builder and thus amounts payable in respect of the same may be treated as operational debt.

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<sup>6</sup> *Col. Vinod Awasthy v. AMR Infrastructure Limited*, Principal Bench, New Delhi, C.P. No. (IB)-10(PB)/2017, order dated February 20, 2017.

<sup>7</sup> Section 5(20) of the IBC provides as follows:

*“operational creditor” means a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.*

<sup>8</sup> Section 5(21) of the IBC provides as follows:

*“operational debt” means a claim in respect of the provision of goods or services including employment or a debt in respect of the repayment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority.*

<sup>9</sup> Relied on by the NCLAT in *Pawan Dubey v. J.B.K. Developers Private Limited*, NCLAT, Company Appeal (AT) (Insolvency) No. 40 of 2017, order dated August 3, 2017.

<sup>10</sup> *Nupower Renewables Private Ltd. v. Cape Infrastructure Private Ltd.*, NCLT, Chennai, TCP/3(IB)/CB/2017, order dated July 7, 2017.

<sup>11</sup> Housing construction has been held to be a ‘service’ for the purposes of the Consumer Protection Act, 1986 in *Lucknow Development Authority v. M.K. Gupta*, AIR 1994 SC 787, and was included within the meaning of ‘service’ under the Consumer Protection Act, 1986 by an amendment in 1993.

### **Home buyers as financial creditors**

In cases<sup>12</sup> where the contract between the home buyer and the developer provided for payment of 'assured returns' to the home buyer until handing over of possession of the unit, it has been held that the amount disbursed by the home buyer was "against the consideration for the time value of the money" and that the corporate debtor had raised the amount by way of sale-purchase agreement, "having a commercial effect of a borrowing"<sup>13</sup>. In some of these cases, in the annual returns filed by the corporate debtor, the amounts so raised from the home buyers were shown as 'financial cost'. In these cases, the home buyer was held to be a 'financial creditor'.

On the other hand, in cases<sup>14</sup> where the home buyer was not entitled to any 'assured return' but was merely seeking a refund on account of failure to deliver possession of the unit, it has been observed that the disbursement made in such cases was not against the consideration for time value of money. In view of this, it was held that the claim in these cases cannot be termed to be a 'financial debt'.

## **Amendments introduced by the Ordinance**

Pursuant to the Ordinance a deeming provision has been added as an explanation to section 5(8)(f)<sup>15</sup> of the IBC which provides that any amount raised from an allottee<sup>16</sup> under a real estate project<sup>17</sup> shall be deemed to be an amount having the commercial effect of a borrowing.

It is interesting to note that while the rulings on this issue sought to make a distinction between contracts with home buyers where an assured return was payable and contracts where no such assured return was payable and only a refund in case of cancellation was provided for, the Ordinance provides for a blanket inclusion of all allottees (irrespective of

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<sup>12</sup> *Nikhil Mehta v. AMR Infrastructure*, NCLAT, Company Appeal (AT) (Insolvency) No. 07/2017, order dated July 21, 2017; *Anil Mahindroo v. Earth Iconic Infrastructures (P) Ltd.*, NCLAT, Company Appeal (AT) (Insolvency) No. 74/2017, order dated August 2, 2017.

<sup>13</sup> Section 5(8) of the IBC provides as follows:

*"financial debt" means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes –*

*...*

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

<sup>14</sup> *Rajendra Kumar Saxena v. Earth Gracia Buildcon Pvt Ltd.*, Principal Bench, New Delhi, C.P. No. (IB)-448(PB)/2017, order dated March 5, 2018.

<sup>15</sup> Pursuant to the Ordinance, in section 5(8)(f) the following explanation has been inserted:

*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.*

<sup>16</sup> Section 2(d) of RERA provides as follows:

*"allottee" in relation to a real estate project, means the person to whom a plot, apartment or buildings, as the case may be, has been allotted, sold (whether as freehold or leasehold) or otherwise transferred by the promoter, and includes the person who subsequently acquires the said allotment through sale, transfer or otherwise but does not include a person to whom such plot, apartment or buildings, as the case may be, is given on rent.*

<sup>17</sup> Section 2(zn) of RERA provides as follows:

*"real estate project" means the development of a building or a building consisting of apartments, or converting an existing building or a part thereof into apartments, or the development of land into plots or apartment, as the case may be, for the purpose of selling all or some of the said apartments or plots or building, as the case may be, and includes the common areas, the development works, all improvements and structures thereon, and all easement, rights and appurtenance belonging thereto.*

the terms of the contract) as aforesaid within the definition of 'financial creditor'. The rationale for inclusion of home buyers as financial creditors provided by the Committee was that amounts raised by the builders from home buyers are used as a means of financing the real estate project and are thus in effect a tool for raising finance.<sup>18</sup>

### **Rights of home buyers**

Home buyers will now be entitled to initiate a CIRP against a corporate debtor under section 7 of the IBC and will also form part of the committee of creditors ("CoC").

Further, home buyers who vote against a resolution plan or abstain from voting for a resolution plan which is approved by the CoC will have to be paid the liquidation value due to them before any recovery is made by the assenting financial creditors pursuant to the resolution plan.<sup>19</sup>

### **Representation of home buyers in the CoC**

The newly introduced sub-section 6A to section 21 provides that where a financial debt is owed to a class of creditors exceeding a specified number (except where a trustee or agent is appointed under the terms of the financial debt), the interim resolution professional will make an application to the Adjudicating Authority with the name of an insolvency resolution professional, other than the interim resolution professional, to act as the authorised representative of such class of creditors. Such authorised representative will be appointed by the Adjudicating Authority prior to the first meeting of the CoC.

The authorised representative will attend the meetings of the CoC, and vote on behalf of each financial creditor to the extent of his voting share. Assuming the number of home buyers in a project exceed the specified number, they would be represented by an authorised representative as aforesaid.

### **Manner of voting**

The Ordinance provides that the manner of voting and the determination of the voting share in respect of such financial debts may be specified by the IBBI.<sup>20</sup> On the other hand, section 25A which has been introduced by the Ordinance provides that if the authorised representative represents several financial creditors, then he shall cast his vote in respect of each financial creditor in accordance with instructions received from each financial creditor, to the extent of his voting share. However, if any financial creditor does not give prior instructions, the authorised representative will abstain from voting on behalf of such creditor.

### **Submission of financial information**

Another consequence of home buyers being categorised as financial creditors is that they would be required to submit financial information, including records of the debt and instances of default, with the information utilities in the specified manner.<sup>21</sup>

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<sup>18</sup> Report of the Insolvency Law Committee dated March 26, 2018.

<sup>19</sup> Regulation 38(1)(c) of the CIRP Regulations.

<sup>20</sup> Section 21(7) of the IBC.

<sup>21</sup> Section 215(2) of the IBC.

## Few implications of the amendments

### Initiation of CIRP by home buyers

The IBC lays down different procedures for initiation of CIRP by financial creditors and operational creditors.

Where a financial creditor files an application for initiating CIRP against a corporate debtor, once the Adjudicating Authority is satisfied as to the existence of the default and has ensured that the application is complete and no disciplinary proceedings are pending against the proposed resolution professional, it is required to admit the application.<sup>22</sup> The Adjudicating Authority is not required to look into any other criteria for admission of the application.<sup>23</sup>

On the other hand, in case of a default in payment of an operational debt, the operational creditor is first required to deliver a demand notice to the corporate debtor.<sup>24</sup> In case the operational creditor does not receive its payment or a notice of the existence of a dispute within the specified period, it is then entitled to file an application for initiating CIRP against the corporate debtor.<sup>25</sup>

The rationale for specifying different procedures for financial creditors and operational creditors was two-fold. Firstly, operational debts tend to be small amounts (in comparison to financial debts) or are recurring in nature and may not be accurately reflected on the records of information utilities at all times and, secondly, the possibility of disputed debts in relation to operational creditors is higher in comparison to financial creditors such as banks and financial institutions.<sup>26</sup>

In case of builder-buyer agreements as well, there is a high possibility of a dispute between the builder and the home buyer in case of delay in completion of the project on account of force majeure or forfeiture of booking amount in case of cancellation by the buyer etc.

As against a simpliciter loan agreement where the only obligation of the borrower is to pay the outstanding, in a transaction between an allottee and a builder the primary obligation of the builder is to construct the units and only in certain events the builder has an obligation to pay the allottees. Consequently, the possibility of a genuine *bona fide* dispute between the builder and the allottee cannot be ruled out. Despite the nature of the contracts between builders and home buyers being more akin to operational debt than financial debt, the latter are now entitled to initiate CIRP against a corporate debtor even for a disputed debt.

### Participation of home buyers in the CoC

At the time of designing the IBC, one of the aspects which was considered for determining the composition of the CoC was that the members of the CoC have to be creditors, both with the capability to assess viability as well as to be willing to modify terms of existing liabilities in negotiations.<sup>27</sup>

Since operational creditors are typically not able to decide on matters relating to commercial viability of the corporate debtor, nor are they typically willing to take the risk of restructuring

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<sup>22</sup> Section 7 of the IBC.

<sup>23</sup> Notes on Clauses annexed to the bill in respect of the IBC.

<sup>24</sup> Section 8 of the IBC.

<sup>25</sup> Section 9 of the IBC.

<sup>26</sup> Notes on Clauses annexed to the bill in respect of the IBC.

<sup>27</sup> Report of the Bankruptcy Law Reforms Committee: Volume I, dated November 4, 2015.

their debts in order to make the corporate debtor a going concern, it was decided that the CoC would comprise only of financial creditors except in cases where the corporate debtor does not have any financial creditor.

Home buyers would also usually not be competent to assess the commercial viability of the corporate debtor or be willing to restructure their dues. The interest of lenders in a CIRP would be typically aligned in as much as all of them would want speedy and better recovery. Home buyers, on the other hand, may either want a refund or want their homes.

Having a disparate group of creditors as members of the CoC would inevitably lead to inefficiencies in the decision making process. This would defeat the objective of time bound resolution and maximisation of value of assets of the corporate debtor.

### **Interplay between the IBC and RERA**

Another piece of legislation which was recently enacted to protect the interest of the home buyers is the Real Estate (Regulation and Development) Act, 2016 (“**RERA**”).<sup>28</sup> RERA provides for various compliances to be made in respect of real estate projects. If the promoter fails to complete or is unable to give possession of a unit in accordance with the terms of the agreement for sale, it is liable to return the amount received by it in respect of that unit along with interest to allottees who wish to withdraw from the project.<sup>29</sup>

In case of any violation of the provisions of RERA, the Authority has the power to revoke the registration granted to a real estate project and facilitate the remaining development works to be carried out in the specified manner.

Once an insolvency resolution process has been initiated, whilst there will be a moratorium on institution of suits and proceedings against the corporate debtor<sup>30</sup>, the issue which arises for consideration is whether the RERA Authority will still be empowered to revoke the registration of a project of such a corporate debtor.

In the case of *State Bank of India v. Electrosteel Steels Limited*<sup>31</sup>, the Director of Mines, Odisha did not grant permission to the corporate debtor to procure, store and transport coking coal and iron ore from its jurisdiction since the consent to operate (“**CTO**”) issued by the Jharkhand State Pollution Control Board, a requirement under the Orissa Minerals (Prevention of Theft, Smuggling & Illegal Mining and Regulation of Possession, Storage, Trading and Transportation) Rules (“**OMPTS Rules**”), had expired. In this case, the NCLT, Kolkata Bench held that since the CTO had expired after the declaration of moratorium, the status of the CTO would continue as on the date of declaration of the moratorium. The NCLT also observed that section 20(1) of the IBC requires the interim resolution professional to make every endeavor to protect the operations of the corporate debtor as a going concern. Referring to section 238 of the IBC<sup>32</sup>, the NCLT held that the IBC would take precedence over the OMPTS Rules.

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<sup>28</sup> The provisions of RERA were first published in the Official Gazette on May 26, 2016 and were made effective with effect from May 1, 2017.

<sup>29</sup> Section 18 of RERA.

<sup>30</sup> Section 14(a) of the IBC provides as follows:

*Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:*

*(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority...*

<sup>31</sup> *State Bank of India v. Electrosteel Steels Limited*, NCLT, Kolkata, CA (IB) No. 173/KB/2018, order dated March 9, 2018.

<sup>32</sup> Section 238 of the IBC provides as follows:

Similarly, in *State Bank of India v. Orissa Manganese and Minerals Limited*<sup>33</sup>, the Deputy Director Mines, District Sundargarh issued a notice to the corporate debtor for stoppage of mining operations on account of non-payment of compensation in pursuance of the order of the Supreme Court. In this case also the NCLT, Kolkata Bench held that any legal proceedings or legal actions in respect of any debt due from the corporate debtor shall be deemed to have been stayed till the CIRP period ends. Further, the NCLT held that stoppage of the mining operations while the moratorium was in force was illegal and inoperative.

The moratorium on initiation and continuation of legal proceedings was stipulated in the IBC to ensure a stand-still period during which creditors cannot resort to individual enforcement action which may frustrate the object of the CIRP.<sup>34</sup> Another motivation behind stipulating the moratorium was that continuation of operations of the corporate debtor would lead to value maximisation and there would be no additional stress on the business.<sup>35</sup>

In this regard, the issue which requires consideration is whether a regulatory action (not being in the nature of a recovery action) such as revocation of registration by the RERA Authority on account of non-compliance, can be initiated against the corporate debtor during the moratorium.

The interplay between the IBC and RERA would be relevant even in cases where the registration is revoked by the RERA Authority prior to declaration of a moratorium. Upon revocation of the registration, the RERA Authority can (in consultation with the appropriate Government) take such action as it may deem fit, including the carrying out of the remaining development works in the manner determined by the RERA Authority. On the other hand, the resolution plan formulated pursuant to the IBC is required to provide for the management of the affairs of the corporate debtor and obtaining necessary approvals from regulatory authorities.

In such a case, the proposed course of action to be adopted by the RERA Authority for carrying on the project may not be in line with the proposed resolution plan for the corporate debtor. Any ambiguity in the prospects of the project may discourage prospective bidders from submitting a resolution plan for the corporate debtor.

It will be interesting to see how this plays out considering that, in real estate projects, the amounts raised from buyers as well as lenders may each be more than 34%, thus giving both the ability to block a resolution plan.<sup>36</sup> The practical implications of a diverse group such as home buyers participating in the CoC is also something which would need to be looked into.

*This note has been prepared by Aastha (Partner), Debopam Dutta (Managing Associate), Abhay Jain and Vaibhav Ailawadi (Associates).*

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*The provisions of this Code shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.*

<sup>33</sup> *State Bank of India v. Orissa Manganese and Minerals Limited*, NCLT, Kolkata, CA (IB) No. 134/KB/2018, order dated March 8, 2018.

<sup>34</sup> Notes on Clauses annexed to the bill in respect of the IBC.

<sup>35</sup> Report of the Bankruptcy Law Reforms Committee: Volume I, dated November 4, 2015.

<sup>36</sup> Pursuant to section 30(4) of the IBC, a resolution plan is required to be approved by a vote of not less than 66% of voting share of the financial creditors.

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