

Insolvency and Bankruptcy Hotline

September 29, 2017

SUPREME COURT CLAWS INTO JAIPRAKASH ASSOCIATES TO PROTECT HOME BUYERS

- The Court orders upfront deposit of INR 2000 Crores to protect the interest of home buyers.
- Home buyers are allowed to participate in the Insolvency proceedings.
- IRP ordered to submit Insolvency Resolution Plan within 45 days and make provisions for home buyers

In a move to protect the interest of home buyers, the Supreme Court (“**Court**”) has recently passed an interim order directing Jaiprakash Associates Limited (“**JAL**”) to deposit INR 2,000 Crores with the Court in relation to the insolvency proceedings pending against its subsidiary, Jaypee Infra-tech Limited (“**JIL**”) (“**Interim Order**”).¹ The Court *inter-alia*, also directed that the directors and managing director (both at the time of institution of insolvency proceedings as well as presently holding office) of JAL and JIL shall not leave the country without prior approval of the Court. The Court also directed certain lawyers of home buyers to participate in the meetings of committee of creditors to espouse their cause and protect their interest.

The order has come in the wake of controversies surrounding the status of home buyers in the insolvency proceedings initiated against JIL under the Insolvency and Bankruptcy Code, 2016 (“**Code**”).

BRIEF BACKGROUND

The National Company Law Tribunal (“**NCLT**”) admitted the application of a financial creditor, IDBI Bank, against JIL² under Section 7³ of the Code (“**Insolvency Order**”). Pursuant to the Insolvency Order, the NCLT appointed an Interim Resolution Professional (“**IRP**”) to take control of the company and carry out its functions. The NCLT also ordered a moratorium on all proceedings against the company until the completion of corporate insolvency resolution process or until a resolution plan is approved by NCLT.

Apart from defaulting on the loan of INR 526.11 Crores from IDBI Bank, JIL also failed to deliver homes to about 32,000 home buyers, who had purchased the flats offered by the company. A controversy arose as to which category of creditors, if at all, do such home buyers belong under the Code and whether their interests are adequately protected. To seek clarity on the legal issues and protection of their interest, the home buyers approached the Hon’ble Supreme Court which has passed the Interim Order. The final verdict of the Court is now awaited.

DILEMMA OF HOME BUYERS

Many real estate developers have accepted money from buyers for sale of homes but have failed to deliver possession of the property. In such situations, home buyers are left with few, if any, remedies against the developers. With the promulgation of the Code, the home buyers started exploring the option of initiating insolvency proceedings against builder companies under the Code. However, NCLT, dismissed the applications of home buyers holding that they can neither be categorized as a *financial* nor as an *operational* creditor of the debtor company.⁴

The Code broadly envisages two types of Creditors who can initiate a corporate insolvency resolution process (“**CIRP**”) against a corporate debtor being (1) Financial Creditor; and (2) Operational Creditor.

A “*financial creditor*” means any person to whom a “*financial debt*” is owed, being a debt along with interest, if any, which is disbursed against the consideration for time value of money. The code also provides certain cases of financial debt.⁵ A Financial Creditor can either be a *secured* or an *unsecured* creditor. On the other hand, an “*operational creditor*” means any person to whom an “*operational debt*” is owed, being a debt in respect of the provision of goods and services including employment or dues payable to central/state government or any local authority under law. An Operational Creditor is an unsecured creditor of the debtor company.

The NCLT was of the view that it is not possible to construe the Code so widely as to include within its scope the cases where monies are paid to the developer on account of advance towards purchase of flat or a commercial site. Amongst other issues, this position troubled the home buyers on four fronts:

1. inability to initiate CIRP against a defaulting debtor company;
2. inability to participate in the CIRP; and
3. uncertainty over their status as a creditor, whether secured or unsecured, at the time of liquidation.
4. inability to continue with civil remedies for recovery of their dues after initiation of CIRP

INABILITY TO INITIATE CORPORATE INSOLVENCY RESOLUTION PROCESS

Under the Code, only a financial creditor or operational creditor (as defined thereunder) can initiate a CIRP against the debtor company. The Code does not provide for any other category of creditors which can initiate the CIRP against the debtor company. Hence, home buyers, being neither financial nor operational creditors, do not have the ability to initiate insolvency proceedings against a defaulting company under the Code. Where the number of home

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buyers are large, as in the case of JIL, they may constitute a substantial portion of the claim, possibly even running into thousands of crores of rupees. It is therefore, important that their interests too are protected under the Code like other financial or operational creditors. The Supreme Court may provide further clarity on this aspect in the present JIL case as it develops.

INABILITY TO PARTICIPATE IN THE INSOLVENCY RESOLUTION PROCESS

Insolvency proceedings can primarily be divided into 2 stages. The first stage is insolvency resolution process, which focuses on the possible revival of the corporate debtor. This stage commences as soon as an application of Insolvency is admitted by NCLT. Upon its commencement, an Interim Resolution Professional (“**IRP**”) is appointed, which takes control of the corporate debtor. The IRP then invites proof of claims from all creditors and forms the Committee of Creditors (“**COC**”), which is comprised of Financial Creditors and in their absence of Operational Creditors. The COC is responsible for approving a resolution plan. If the COC does not approve a plan within a stipulated time or if it is of the opinion that the company cannot be revived, the company will go into liquidation.

Only the Financial Creditors have a right to vote in the COC on a resolution plan. The Operational Creditors can vote on a resolution plan only if there are no Financial Creditors in the debtor company. The Code however, specifically provides for and protects the interest of Operational Creditors. It imposes a duty on the COC, and also the NCLT at the time of approving an insolvency resolution plan, to ensure that the interest of Operational Creditors are adequately protected in the resolution plan. An Operational Creditor is also entitled to appeal a resolution plan if it does not adequately protect the interest of such creditors.

The above position raises a three-pronged concern for the home buyers being that (1) they have no other legal recourse against the developer once NCLT admits the application under the Code and orders a moratorium on all legal proceedings; (2) they have absolutely no right of participation in the CIRP and any possible subsequent liquidation; and (3) they are left at the whims and fancies of the COC.

The Insolvency and Bankruptcy Board of India (“**IBBI**”) sought to ameliorate the situation of home buyers by inserting Regulation 9A in the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.⁶ As per Regulation 9A, home buyers can also file their proof of claims with the IRP under a separate category of “*other creditors*”. However, the rights and entitlements of this new category of creditors as well as its role in the insolvency resolution process, especially the interplay with the exiting provisions of the Code, is not clear.

Further, considering that unlike operational creditors, there are no safe guards built into the Code for the newly inserted category of “*other creditors*”, home buyers who do not have any voting / participating rights in the COC, will be left at the mercy of Financial Creditors without any recourse to remedial actions in case their interest is not adequately represented by Financial Creditors.

STATUS OF HOME BUYERS

The second stage of insolvency proceedings in relation to a company is liquidation. The process of liquidation commences with the order of NCLT whereby it appoints a liquidator. Upon its appointment, the liquidator takes control of the assets of the company and starts liquidating them. Once the monies are realized, they are distributed to various stakeholders in the order of preference as mentioned in the Code⁷.

There is ambiguity on whether the home buyers would constitute secured creditors or unsecured creditors at the time of liquidation. The plea of home buyers in the present case was to be treated as secured creditors which would place them on par with other secured / financial creditors. If they are treated as unsecured creditors, their position in the liquidation waterfall would place them after secured / financial creditors and on par with operational creditors. The secured / financial creditors will therefore take away a substantial portion of the liquidation proceeds, thereby possibly leaving the home buyers high and dry with no money from the liquidation proceeds and no sight of the home which they have purchased. It is pertinent to note that many home buyers are still paying EMIs of the loans they took to buy the property and/or are still incurring expenses towards renting their current place of dwelling.

Given that the amounts obtained by the developer from the potential home owners may sometimes be significantly larger than the amounts obtained from financial and/or operational creditors, this is a significant concern.

REMEDIES FOR HOME BUYERS

While there is lack of adequate clarity for home buyers, the picture is not entirely grim. The fact that a developer is under insolvency proceedings does not compulsorily mean that it will go into liquidation. There are chances of the developer's revival under the insolvency resolution process.

While the home buyers do not have the option to initiate any legal proceedings against the builder company during the moratorium period, the home buyers do have the option of approaching the IRP and submitting their respective claims. The moratorium runs from the commencement of insolvency proceedings till 180 days thereafter or till the approval of insolvency resolution plan. Once the moratorium is over, the home buyers can approach various legal forums like consumer courts, civil courts, etc. for redressal of their grievances.

Home buyers can also submit their own resolution plans to the IRP for seeking approval from the COC. However, such resolution plan may not necessarily be approved by the COC which comprises only the financial creditors.

CONCLUSION

Like any other new law which comes into force, the Code has also thrown up certain operational challenges. The Supreme Court to an extent has sought to iron out these teething issues that have cropped up in the short time since the commencement of the Code. For example the Court has clarified what constitutes “*dispute*” under Section 8 of the Code⁸ and exercised its inherent powers to dismiss insolvency proceedings in a case where an applicant creditor had no claim left after admission of an Insolvency Petition.⁹ The Court is now actively seized of the case of home buyers in relation to insolvency proceedings of JIL. While holding that one has to read the Code strictly¹⁰, the Court still passed the above mentioned Order to protect the interest of a large pool of home buyers. In the same case, the Court has also directed the IRP to submit the resolution plan within 45 days. It is pertinent to note that the Court may have ventured outside the Code to pass such orders as there is no requirement under the Code for:

1. IRP to submit Resolution Plans. The IRP can only receive Resolution Plans from Resolution Applicants, which will then have to be placed before the COC for approval; or

2. the parent entity i.e. JAL to provide security for its subsidiary entity JIL, with respect to the claim of home buyers.
3. "Other Creditors" or their representatives to participate in the meetings of committee of creditors.

While it is commendable to see the NCLT, National Company Law Appellate Tribunal and other courts working in tandem to strictly implement the Code, the process of ironing out issues in law cannot entirely be left to the courts. The government will have to move fast to plug the loopholes in the Code and ensure that its benefits accrue to all kinds of creditors. We now await to see the list of next set of proposed amendments to the Code and hope that the issues that have cropped so far are sufficiently addressed.

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You can direct your queries or comments to the authors

¹ Order dated September 11, 2017 in *Chitra Shama v. Union of India*, Writ Petition (Civil) No(s). 744/207 (Supreme Court)

² by Order dated August 9, 2017 in *IDBI Bank v. Jaypee Infratech Limited*, CP(IB) 77/ALD/2017

³ Section 7. "(1) A financial creditor either by itself or jointly with other financial creditors may file an application for initiating corporate insolvency resolution process against a corporate debtor before the Adjudicating Authority when a default has occurred.

...
(5) Where the Adjudicating Authority is satisfied that (a) a default has occurred and the application under sub-section (2) is complete, and there is no disciplinary proceedings pending against the proposed resolution professional, it may, by order, admit such application..."

⁴ *Satish Mittal v. Ozone Builders & Developers Pvt. Ltd.*, CP NO. (IB)-66(PB)/2017; *Col. Vinod Awasthy, v. AMR Infrastructure Ltd.*, CP NO. (IB)-10(PB)/2017; *Mukesh Kumar & Anr. v. AMR Infrastructure Ltd.*, CP NO.(IB)-30(PB)/2017.

⁵ Section 5(8) of the Code. For Example: "(a) money borrowed against the payment of interest;
(b) any amount raised by acceptance under any acceptance credit facility or its de-materialised equivalent;
(c) any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument; etc."
...

⁶ Notification No. IBBI/2017-18/GN/REG013 dated August 16, 2017

⁷ Section 53 of the Code

⁸ *Mobilox Innovations Private Limited v. Kirusa Software Pvt. Ltd.*, Civil Appeal No. 9405 of 2017 (Supreme Court)

⁹ *Lokhandwala Kataria Construction Private Limited v. Nisus Finance and Investment Managers LLP*, Civil Appeal No. 9279 of 2017 (Supreme Court); *Mothers Pride Dairy India Private Limited v. Portrait Advertising and Marketing Private Limited*, Civil Appeal No. 9286 of 2017 (Supreme Court).

¹⁰ *Lokhandwala Kataria Case*, refer to footnote 9.

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