

In this short read, we lay down the status of Homebuyers in a resolution under IBC and practical implications for real estate investors.

Background

In May 2016, The Insolvency and Bankruptcy Code (IBC or the Code) was notified with an objective to consolidate and amend laws relating to re-organization and insolvency of corporates. This is turning out to be a game-changer for creditors and is facilitating much higher recovery in a time bound manner which prior legal frameworks for bankruptcy resolution in India had failed to achieve.

Approximately 3,911 companies have so far been admitted for resolution under the IBC, of which 250 have been resolved through resolution plans, 218 have been withdrawn (through bilateral settlement) and 955 went for liquidation. Creditors have recovered INR1.9trillion / US\$25Bn+, which is 184% of the liquidation value of assets of 250 companies rescued till June 2020 and a recovery rate of ~45% of the creditors' outstanding¹. In addition to above ~14,369 applications (2,789 by financial creditors and 11,581 by operational creditors) with combined dues of INR3.6trillion / US\$49Bn were withdrawn before admittance, suggesting significant recovery / settlement by just application and before actual proceedings under IBC.

Real Estate Context

Of the total cases admitted, ~20% are from real estate, hospitality and construction sectors. Within the real estate sector, in addition to lenders (banks, non-bank financial institutions and bondholders) and operational creditors, there is another major class of creditors – home buyers. In residential development projects (~70%+ of the real estate sector in India) advances from home buyers, depending on pre-sales level and stage of construction can be significant and sometimes more than the exposure of secured lenders. Under the Code, home buyers have been classified as unsecured financial creditors and have a say in approval of any resolution plan. This status and the relative size of the class make them an important stakeholder and decision maker in the overall resolution process.

While the Code is a net positive, the existence of a unique class of creditors (Homebuyers) in residential development projects has several practical implications on transaction underwriting, structuring and diligence. In this short note, we examine some of the key principles of the Code (with respect to Homebuyers) and give our thoughts on its practical implications.

1. Insolvency & Bankruptcy newsletter, June 2020

Bankruptcy Resolution Process under the Code

Resolution Process Under IBC

Addmittance to IBC by NCLT

Application by a secured lender, group of Homebuyers, other unsecured financial creditors and / or operational creditors

Appointment of Interim Resolution Professional ("IRP")

Admittance of all creditor claims by IRP

Constitution of Committee of Creditors ("CoC")

Secured and unsecured financial creditors (incl. Homebuyers)

Appointment of Valuers

To provide a) Going Concern Valuation b) Liquidation Value

Invitation of Bids (Resolution Plan) on a going concern basis

Specifying the value and its distribution among creditors

Voting on Bids by the CoC

66% by value of creditors to approve any Resolution Plan; Creditors may choose to desert

Implementation of approved Resolution Plan

Proceeds to be distributed as provided in the winning bid; Dissenting creditors to receive at least their share based on Liquidation Value

Liquidation (if no plan is approved or no bids are received)

Proceeds distributed based on Liquidation waterfall; Within a specific class based on seniority and inter se arrangements

Some Key Points to Note

1. Can Homebuyers initiate proceedings under the IBC?

As unsecured financial creditors a group comprising at least 10% or 100 Homebuyers (whichever is lesser) can initiate insolvency proceedings against the Company.

2. Do Homebuyers form part of the CoC? What is their vote share? How do they exercise their vote?

Homebuyers form part of the CoC. Their vote share is the ratio of the amounts paid by the homebuyers (along with accrued interest on delays) to the total admitted claims of all CoC members. Homebuyers vote at the CoC through an appointed representative. This representative conducts an intra-class vote to determine (based on simple majority - 51% of Homebuyers present and voting, which is conducted online) the Homebuyer vote.

3. What is the position of Homebuyers in the waterfall of payments?

Homebuyers are **unsecured financial creditors**. They sit **behind secured creditors** (in addition to cost of insolvency resolution and employee dues) in the waterfall of payments in liquidation (“Liquidation Preference”).

4. What is the threshold for approval of a resolution plan in the CoC?

A resolution plan is approved if 66% or more (by value) of the creditors present and voting at the CoC meeting approve the plan. Creditors have a right to dissent against the approved resolution plan.

5. How are proceeds from a resolution plan or bid distributed?

In addition to bid value, the resolution applicant or bidder, based on its judgement and commercial considerations is required to specify the distribution of proceeds among various creditors / stakeholders in its bid. The proceeds are distributed basis the waterfall specified in the approved (winning) bid. This may not necessarily be in the Liquidation Preference. In practice, most resolution plans (or bids) for a residential project will involve a plan to complete the project and delivery of units to existing buyers. The creditors who dissent to the approved plan need to be paid at least the amount they would have received if the Company had been sold at Liquidation Value (as specified by the valuer) and proceeds distributed in Liquidation Preference.

Implications: For a secured creditor, the composition of the CoC and the ability to control the same (66%+ vote share) is important. While ideal this may not be possible in all instances. At the minimum, secured creditors should ensure they control 34%+ vote share in the CoC, so they have the ability to block any resolution plan which may not be to its liking. This ensures the process moves to liquidation where proceeds from any sale / disposition are distributed in Liquidation Preference.

6. What happens if none of the resolution plans is approved by the CoC or no bid is received?

If no resolution plan approved or no bid is received, the Company is put into liquidation. Here the assets of the Company are liquidated (en block or individually) and proceeds are distributed in the order of Liquidation Preference.

Implication: If a senior, secured creditor controls 34%+ vote share in the CoC, it can take the Company to liquidation, where the secured lenders are ahead in line than the Homebuyers.

Certus View

Broadly, our view is that the risk for new investors from Homebuyers in an IBC context is low, for performing / ongoing projects. Key mitigants to this risk are

First, Project selection (mid / late stage, performing projects) and **transaction structuring to ensure early completion** of project development (i.e. extinguishment of liability towards Homebuyers) – Homebuyers are, for most part, interested in getting their homes (even with some delays) vs. litigating to recover monies (which in a liquidation scenario will be much lower than value of the apartment). So, if that is ensured, there is very limited risk from Homebuyers.

Second, Going-in basis – In credit situations, the new investor basis (**typically ~45 - 60% discount to CMP**) provides sufficient buffer for the new investor to be able to recover its dues even after factoring the cost of full project completion or exiting in any resolution process.

Lastly, minimum 34%+ representation in the CoC – Transaction structuring to ensure, new investor controls at least 34% vote share in the CoC. This ensures the new investor can take the Company in to liquidation where it (being a secured creditor) has priority over dues to Homebuyers who are unsecured creditors.

Some practical Underwriting and Diligence considerations

Some practical considerations to keep in mind to diligence and minimize risk from Homebuyers in an IBC context.

1. Underwriting:

- Invest in mid/late stage projects with major discretionary approvals in-place
- Ensure financial closure without significant reliance on incremental sales

2. Structuring:

- Vote share in CoC: Ideally, ensure 66%+ vote share in CoC. At the minimum 34%+ vote share to block a resolution plan not to our liking.
- In a lot of cases, the project cash flows may not support investment required to achieve the requisite vote share in the CoC. In such scenarios, control could be achieved by structuring the transaction through use of trust vehicles (AIFs and / or securitization trust based structures).
- Avoid lending to SPVs with multiple under development projects.

3. Diligence:

- Increased focus on group level indebtedness of the developer and an IBC risk analysis for the group in addition to the project / SPV level.
- Diligence of customer litigations (civil, RERA) and grievances to be part of pre investment diligence to identify potential red flags
- Diligence of customer receivables and delinquencies.

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