

Consumers as creditors in corporate bankruptcy

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Context

- ▶ India's new bankruptcy law stumbled on the problem of consumers in the form of home buyers.
- ▶ The outcome: home buyers as financial creditors.

The mechanism

Explanation added to Section 5(8)(f):

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

any amount raised under a real estate project from an allottee shall be deemed to be an amount having the commercial effect of borrowing where the terms “real estate project” and “allottee” shall have the meaning assigned to them under the Real Estate (Regulation and Development) Act, 2016.

Why care?

- ▶ Home buyers are consumers.
- ▶ This action appears to bring in the objective of consumer protection in insolvency law.

The paper

Asks the following questions:

1. What is the status of consumers' claims in bankruptcy in other jurisdictions?
2. What is the IBC scheme of creditor classifications? How do consumers fit in this scheme?
3. Does classification as financial creditor solve home buyers' problem?
4. What is the likely impact of "home buyers as financial creditors" on IBC process?

The customer/consumer problem

- ▶ Customers key stakeholders in firms.
- ▶ Often pay advance, receive goods or services later.
- ▶ As firm approaches insolvency, problem becomes larger.

Firm tries to maximise sales, liquidity.

- ▶ Status of customer advances in insolvency. Should treatment vary for:
 - Customers versus consumers?
 - Large versus small value claims?
 - Partly delivered versus undelivered goods or services?
- ▶ Consumers a special class of customers.

Consumers as creditors

On account of:

1. Advances paid for purchasing goods or services
2. Decrees awarded by courts
3. Tort claims

We focus on #1.

Special rights in bankruptcy framework

Right to:

1. Trigger
2. Vote on a resolution plan
3. Priority of claims in resolution;
4. Priority of claims in liquidation.

Other jurisdictions

We look at UK, USA and Australia

- ▶ None have special rights for consumers in bankruptcy proceedings.
- ▶ Treated as general unsecured creditors.
- ▶ Policy debates about special treatment:
 - Australian Law Reform Commission's *General Insolvency Inquiry (1988)*
 - UK Law Commission's *Report on consumer prepayments on retailer insolvency (2016)*
 - UK's Airline Insolvency Review (2018)
- ▶ Outcome: No special treatment yet
- ▶ What then?
 - Strong pre-insolvency rights.
 - Alternate mechanisms for recovery in insolvency.

The IBC creditor framework

Unique set-up:

- ▶ BLRC intent: any creditor can trigger.

In final IBC, only financial and operational creditors can trigger.

- ▶ During CIRP:

Financial creditors v operational creditors. Right to vote in lieu of ability and intent to take haircuts today in the interest of resolution in the long run.

- ▶ During liquidation:

Super priority creditors v secured creditors v unsecured creditors.

Where do consumers fit?

- ▶ Financial or operational – unclear
- ▶ Secured or unsecured – generally unsecured;
- ▶ What about home buyers:
 - ▶ Prepayments for home purchase deemed to create the “commercial effect of borrowing”.
 - ▶ Ability and intent to take haircuts? Assess the viability of a long term resolution plan?

Solving the home buyers problem

- ▶ Does classification as financial creditor address their problem – not really.
- ▶ It gives them right to trigger, which is as per BLRC intent.
- ▶ Additional right: to vote in CoC.
The extent of this right depends on resolution plans that are received.
And on their voting share. A high voting share will give negotiating power.
- ▶ Still likely that they will not recover their advances or receive a home.
- ▶ In liquidation, which is a possibility, still unsecured creditors. Behind super priority creditors, and secured creditors.
- ▶ Cost to participate as financial creditors?

Impact on IBC process

- ▶ On Timeline.
- ▶ On CoC decision making.
- ▶ On procedural litigation.
- ▶ Precedent for other classes of customers, operational creditors to seek “commercial effect of borrowing” cover.
Already, writ on operational creditors’ rights being heard.

Consumer protection and insolvency

- ▶ Insolvency is a specific problem.
Not enough in the pot for everyone.
The law seeks to create a distribution mechanism which replicates, as far as possible, pre-insolvency priority of claims.
- ▶ Ex ante effects of insolvency priority.
- ▶ IBC has only one objective – value maximisation through timely resolution.
All elements of design geared towards this objective.
- ▶ Introducing additional objective, such as consumer protection, complicates the IBC design.

Consumer protection and insolvency

- ▶ The ILC approach unclear. On one hand gives one class of consumers some rights. On another, proposes increase in trigger threshold to Rs. 10 lakhs.
In effect, excludes small value claims.
- ▶ What then for airline insolvencies, or online retailer insolvencies?
Or any business which relies on customer pre-payments, large or small?
- ▶ Policy appears to be solving one problem at a time.

Consumer protection and insolvency

- ▶ The problem of home buyers started much before the firm became insolvent.
- ▶ The problem: consumer protection laws weak, riddled with delays.
Could not provide any redress.
- ▶ When firm became insolvent, consumers' problem viewed as insolvency problem.
- ▶ Need for a fix on the underlying issue – consumer protection framework, better contract enforcement.
For home buyers, it's RERA.

Thank you.