

Investor or developer? Real estate regulator (RERA) classifies real estate fund as a promoter

Key Takeaways

- The term ‘causes to construct’ in the definition of ‘promoter’ under RERA has been interpreted to include private funds exercising rights typical to such investments
- Protective rights of investors have been interpreted as being secondary to the rights of the homebuyers – in a conflict, the latter should be protected, notwithstanding inter-se contractual relationship between developer and fund. To that extent, if any lender or shareholder holds up the construction – it could be held to be a ‘promoter’
- Possibility of strained LP-GP relationships due to additional capital drawdown requirement for payment obligations arising due to a promoter classification
- Corporate veil selectively pierced in holding a minority shareholder jointly liable as promoter basis exercise of well negotiated investor protection rights

Introduction

In a recent order (***Order***) that could have major implications on private equity and private debt investors in real estate (***RE Funds***) – the Maharashtra Real Estate Regulatory Authority (***Regulator***) held that a private equity investor could, on a case-by-case basis, be classified as a promoter under the Real Estate (Regulation and Development) Act, 2016 (***RERA***). The consequence is significant: a promoter has various onerous obligations under RERA, and default could entail substantial monetary and, in certain instances, criminal liability.

This classification of an investor or financier as 'promoter' was made basis the interpretation of the phrase 'causes to be constructed' in the definition of 'promoter' under RERA – defined to mean a person who constructs or causes to be constructed a particular project.

As a result, RE Funds in Maharashtra may now be liable to homebuyers in the same capacity as a promoter, and may, on classification as 'promoter', have to: (a) return the consideration paid for allotment on delayed projects if the homebuyer wishes to withdraw, (b) if the homebuyer does not want to withdraw – pay interest for every month of delay in completion of the project, (c) compensate homebuyers for loss caused due to defective title, and (d) pay penalties as prescribed under the RERA. Historically, such obligations were restricted to the developer in charge of actual construction while RE Funds were generally held to be passive financial investors.

In this analysis, we examine (A) the terms of the SSHA which were read to hold that the investor is a promoter under RERA; (B) the submissions of the developer and the investor; (C) the ruling of the Tribunal; (D) the potential justification for the Regulator's interpretation; (E) the impact on various stakeholders as a result of this Order; (F) the counter-view from the perspective of RE Funds; and (G) the impact on LP-GP relationships if the fund is classified as a promoter.

A. Terms of the SSHA which were read to hold that the Investor is a promoter under RERA

The Shareholder and Share Subscription Agreement (***SSHA***) between the developer and the private equity investor (IIRF India Realty VIII Ltd.) (***Investor***) restricted the developer, amongst other things, from incurring additional indebtedness, incurring expenditure beyond a threshold limit (Rs. 25,00,000/-), changing the capital structure, restructuring the business, and establishing a new business plan (which generally lays down expenses, revenue sources, etc.) without the prior consent of the Investor. The Investor also had the right to nominate a director on the board of the developer.

These restrictions are typical to equity or debt investments and were not of a unique or sui generis nature. The SSHA also included a call and put option – and the latter was invoked by the Investor to exit the project. The exercise of the put option is the subject

© Resolut Partners 2022

matter of ongoing arbitration proceedings between the developer and the Investor.

There was a delay in handing over possession of the project and the developer sought to obtain external financing. Several attempts were made to raise external funding (especially from the SWAMIH fund - created by the Government of India to give relief to homebuyers of stalled projects) however, the terms of the SSHA required the prior consent of the Investor to access such external financing. This consent was refused by the Investor – thus preventing an infusion of funds which could potentially aid the completion and delivery of the project.

B. Submissions of the Developer and the Investor

The developer initiated proceedings before the Regulator to declare the Investor as a promoter of the project under the RERA. The developer argued that:

i. The exercise of investor rights under the SSHA has the effect of stalling or delaying the completion of the project. A financier of a project reposed with the right to effectively stall or delay the project should be categorized as a promoter; and

ii. If the Investor has the right to make decisions which limit the developer's operational control over matters of funding and indebtedness (which can also result in stalling the completion of construction), the Investor technically has the ability to 'cause to be constructed' the project and hence must be categorized as a promoter under RERA. The construct requires that any person who has operational control over the construction of a project that is delayed should suffer the consequences of a homebuyer choosing to exit the project or demanding interest on delayed handover.

The Investor argued that:

i. Day to day operational control over construction and completion of the project vested in the developer;

ii. Admittedly, the Investor is not directly involved in the construction of the building(s) and made the investment approx. 4 years after construction of the project began;

iii. The developer alone is responsible for applying for clearances and permissions from the town planning authority.

iv. Veto rights are designed to protect the interests of the Investor and do not vest operational control in them. The exercise of such rights only ensure that the commercial terms on which the Investor agreed to make an investment are honoured and that the affairs of the developer are conducted in the manner represented at the time of soliciting the Investor's investment.

© Resolut Partners 2022

C. The Tribunal's Ruling

The Tribunal accepted the developer's submissions and held that the Investor should, in the facts of this case, qualify as a 'promoter' for the reasons summarised below:

i. Purpose Test – Homebuyer Rights are Paramount

The purpose of RERA as a statute is to protect the interests of homebuyers who are vulnerable to financial distress if projects that they have invested into face roadblocks. To prevent such adverse impacts on homebuyers and encourage real estate activity, the statute recognises an identifiable entity who would be held responsible and liable towards homebuyers in case of any breach of their rights.

Given this intent, the legislature has, in defining 'promoters' '*cast the net wide enough to ensure that any actor who makes a promise in the context of the real estate industry is held to its promise*'. The construct of 'promoter' under RERA is wide and applies to any person who either 'constructs' or 'causes to be constructed' any project. A purposive interpretation was given to the term 'causes to construct' – and to that extent the words / also include within its ambit, one who causes **not to** construct. In essence, the Order holds that any entity with the power or authority to limit the inflow of funds which restricts the developer's ability to complete the construction should be included within the ambit of a promoter.

The Regulator held that investors exercising such rights had the power to cause / stall / delay the construction of the project. Therefore, it was held that the Investor is not a passive investor – rather one who is actively involved in the process of construction.

ii. Investor protection rights versus homebuyer interest

While the Regulator acknowledges that affirmative rights are necessary for RE Funds to protect their investment interests and for overall comfort in investing into the real estate sector, it observed that it is the homebuyer who eventually bears the cost of these protections. The homebuyer must therefore be able to enforce their statutory right to exit / receive compensation for delay against the investor. The purpose of RERA is to attribute liability on all persons who are responsible for the construction of a project. On balancing the rights of a homebuyer with the Investor – the Regulator held that a homebuyer should be entitled to proceed against an investor who has exercised rights having a material bearing on the completion of a real estate project. Needless to say, the RE Fund would have contractual remedies against the developer in case of breach of timeline estimates of the project.

D. A justification for the Regulator's interpretation

© Resolut Partners 2022

Though misplaced in our view, the Regulator has, in essence, based its decision on the following line of thought. An RE Fund that invests in a project typically retains a bouquet of rights to protect its investment, including the right to withhold consent for further indebtedness or expenses by the developer. If this consent is not provided, the developer may not be able to continue with the construction and may lead to delay or even cancellation of registration granted for the project.

The purpose of establishing the real estate Regulator is to protect the interests of homebuyers. One way of doing this is to identify the promoter i.e., the entity or entities against whom homebuyers may enforce their statutory rights under RERA.

The definition of promoter is wide, and it appeals to equity that where an RE Fund is practically obstructing project construction by withholding consent for additional cash flow infusion, they are, in effect, preventing completion. The ability to prevent construction is seen as a necessary corollary to the ability to cause construction. The inference is tenuous, but possible.

E. Implications of the Order

While the Order paves the way for homebuyers to target claims against investors – typically solvent, liquid funds – it will undoubtedly discourage investments into the real estate sector, resulting in far-reaching implications.

One can potentially accept the rationale of the Order if the investor retains and in fact exercises a right to substitute the developer for itself or a nominee, but short of such an express right, it is difficult to accept the rationale of the Order.

i. <u>Does every RE Fund now run the risk of being classified as a promoter?</u>

The Order leaves this position unclear. It expressly states the Order is not to be read as painting every investor as a promoter. This determination must, according to the Regulator, follow from an examination of the instrument of investment in a given factual situation.

The Order implies that it is not the existence of such rights, but its enforcement which determines whether the RE Fund should be classified as a promoter. Should the RE Fund allow the developer to raise additional funding or incur additional indebtedness to complete the project, the RE Fund would not be ‘stalling’ or ‘delaying’ the completion of construction and would not be classified as a promoter. It remains to be seen whether the mere existence of such rights without their exercise can qualify an RE Fund as a promoter.

ii. <u>Implication on bank lenders</u>

© Resolut Partners 2022

A pertinent question is whether similar rights in the hands of bank lenders also qualify them as promoters. Banks usually prohibit further indebtedness without their prior approval. Logically then, the rationale of the Order should squarely apply to banks which enforce such restrictions against the developer. Having said that, there has been an inherent regulatory bias in favour of banks and financial institutions as against private equity funds.

F. What the Regulator did not probably appreciate

The July 2015 Report of the Select Parliamentary Committee reviewing the Real Estate (Regulation and Development) Bill, 2013 does not provide much insight into the legislative intent behind having a wide definition of 'promoter'. The stated object of the Bill is that *'The proposed Bill will induct professionalism and standardisation in the sector, thus paving the way for accelerated growth and investments in the long run.' In fact, it acknowledges that "the investors/financers play an important role in the real sector and their interest also needs to be protected suitably in the bill. In their absence, the real estate sector might suffer a serious setback."*

From a real estate fund perspective, the Order seems rather misplaced on the following grounds:

a. Investor protection rights vis-a-vis control rights

This Order, seemingly decided on equitable grounds, has the effect of recasting investor protection rights as control rights. Protective rights are generally not exercised in the ordinary course of events, but only on default or likely default by the investee entity.

If the RE Fund is said to exercise control over the promoter by exercising protective rights, this would violate and fundamentally contravene the principles of global deal-making. The RE Fund must either be afforded an exit from the project per the terms of the investment, or sanctity be afforded to investor protection rights.

b. Unique nature of real estate investment – cost overruns

Real estate construction / development is very different from other growth assets. Projects have a definite life and a pre-determined cost. The indebtedness costs or expenses are usually determined and pegged well in advance. A detailed business plan is agreed beforehand, taking into account normative projections, and an RE Fund underwrites costs and risks basis such projected expenses / revenues and timelines. The developer covenants, as is the case here as well, that any deviation will be to the developers account and the RE Fund (being limited life and limited capital entities) can in no situation be held liable for more than what is contractually promised. It would be a stretch to imagine that the RE Fund could be held liable for

© Resolut Partners 2022

inefficiencies in management by the developer despite such clear understanding in contract and principle. The commercial foundation and rules of deal-making should be upheld.

c. The nature of private investment is passive

While home-buyer interest is paramount, the provisions of the statute should not be construed in such a manner that changes the very nature of an otherwise passive private equity investor into an active promoter. In most cases, as in the current case, the RE Fund is not involved in the day-to-day activities of the business and is heavily dependent on the developer for information regarding the same. Even in the context of board representation, RE Funds generally have a minority position on the board (in this case it was a single board seat), with limited decision-making ability. This could, at best be called a participatory right and can in no way be said to be a controlling right over board decisions. Further, protective rights given to investors should not be interpreted as making the investors active participants in the construction and project completion process. In the salutary endeavour to protect homebuyer interests, the Regulator has fundamentally changed the landscape for investment in real estate projects.

d. Selective piercing of corporate veil

The Order, while categorising the PE Fund (an investor into the project SPV) as a promoter, does not simultaneously provide a similar promoter classification to other shareholders of the SPV. This amounts to selectively piercing the corporate veil. Either sanctity of the SPV is respected such that the SPV is considered the promoter, or else all shareholders in the SPV should be classified as a promoter. To that extent, why even stop at the shareholder of the SPV? The veil could possibly be pierced right until the ultimate shareholder exercising control.

G. Impact on LP-GP relationship

If a fund is classified as a promoter and is made liable for penalties / compensation to the homebuyers, it may result in a strained relationship between LPs and the GP. The Regulator has probably not appreciated the nature of private funds, which are mere money managers of third-party capital.

For one, a pertinent question is the source of funds for payment of such penalties. The GP would be required to drawdown capital from the LPs. While fund documents (and LP-GP relationships) may be tested for such draw downs, LPs may hesitate from committing further capital to India-centric real estate funds.

© Resolut Partners 2022

Conclusion

The ostensible intent for the phrase ‘causes to construct’ in the definition of ‘promoter’ is to capture situations where a developer awards the contract for developing the project to a third-party construction company. The investor rights analysed in the Order, basis which the Investor has been classified as a promoter, are typical. Relying purely on the scheme of the Order, RE Funds could now be qualified as promoters if they exercise rights contractually negotiated at the time of investment.

While the Order has been passed only in relation to real estate activities in Maharashtra, there is a strong possibility of other local real estate authorities following suit and classifying RE Funds as promoters. This Order therefore has industry wide implications.

In terms of investments, interest of global funds in Indian real estate has waned over the past few years and the Order would further discourage private equity investment. Currently, when a lender enforces their security – whether mortgage or pledge – they are temporarily and purely for technical reasons classified as a promoter. However, a broad classification of RE Funds as promoters would change the foundational commercials on which real estate deals are structured, and can significantly impact private equity activity in the real estate sector.

The Regulator, in importing a wider meaning to the phrase ‘causes to construct’, is driven with the regulatory intent of pinning responsibility on those impeding construction and compromising flat-buyer interest. However, in doing so, a lopsided interpretation of the statute has been adopted, destroying the well-established doctrines of corporate veil and personality.

The Order is also a tool in the hands of unscrupulous developers to browbeat investors and prevent the exercise of contractually negotiated rights given the risk of promoter classification. A mere financier of a project could now be held to be a developer and jointly liable to pay penalties to homebuyers under RERA, simply for having standard investor protection rights.

The Order is currently under appeal.

© Resolut Partners 2022

Authors:



Isha Sen

Isha's practice focuses on private equity and private debt in real assets (real estate and infrastructure) transactions and has been involved in structuring captive investor-developer investment platforms. She has advised on investments into stabilised yield generating assets as well as legal, regulatory, and tax...*read more*



Ruchir Sinha

Ruchir has 17 years of experience advising clients primarily on private equity, PIPE, M&A and structured finance transactions. With background in fund formation and tax, he has been involved in developing the first generation of -asset-specific tax optimized investment platforms...*read more*



Priyank Kapadia

Priyank is an of-counsel at the firm and helps manage the dispute and pre-dispute advisory practice at the firm. He practices predominantly in the Bombay High Court, National Company Law Tribunal, Mumbai, Civil Courts, SAT / SEBI in Mumbai. He has appeared in matters...*read more*

About our Private Equity Practice:

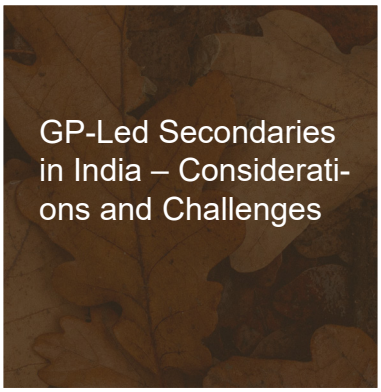
Our private equity practise is driven by a practical understanding of the vulnerabilities and value proposition of offshore financial sponsors, LP-GP relationships, and importantly, governance standards required by fund managers. Our advice takes into careful consideration the value of relationships between fund managers and founders, and the optimum governance and incentive structures that deliver sustainable growth for the portfolio companies. We don't just execute, but structure solutions that are innovative, tax optimised and risk calibrated for institutional investors...*read more*

© Resolut Partners 2022

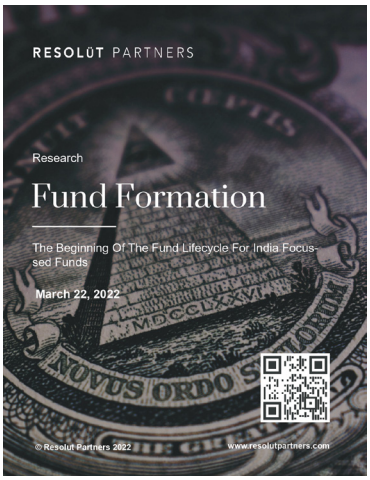
Recent Analysis:







Recent Papers:







© Resolut Partners 2022