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Need for a Separate Framework for Insolvency of Real Estate Companies

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Prepaying customers in the real estate sector needs attention in the current era. This attention is sought to enhance investment in the real estate sector. The real estate sector is considered to be the most lucrative mode of income generation for the nation. However, the current situation of home buyers is not adequately protected by the legislative regime of the nation. There are several authorities to safeguard the interest of a home buyer, but all such authorities have failed to protect or safeguard the interest of the poor home buyer. The Government has brought the Insolvency and the Bankruptcy Code, 2016 to confer rights upon the creditors to proceed against the corporate debtors. The hypothesis of the current research is to address whether the mechanism can render justice to home buyers in the real estate sector. The home buyers were not included as a secured creditor in the mechanism provided by the Insolvency and Bankruptcy Code, 2016. The illegal mode of business transactions of the real estate tycoons has persuaded the government to incorporate the home buyers as the financial creditors within the regime of the Insolvency and Bankruptcy Code, 2016. The Current research article is discussing at length the rights conferred by the Insolvency and Bankruptcy Code 2016 upon home buyers. The research article is a critical study of the rights conferred upon home buyers. The article is discussing whether the rights conferred are sufficient in nature to protect the rights of the home buyers. The issues faced in the basic framework of the Insolvency and Bankruptcy Code, 2016 may be worth persisting with for real estate space. The Insolvency and the Bankruptcy Code, 2016 may be forced to evolve further to meet certain issues and problems posed by real estate insolvencies.

Keywords: *financial creditor, corporate debtor, secured creditor, homebuyers, insolvency mechanism, real estate.*

INTRODUCTION

The Insolvency and Bankruptcy Code, of 2016 is a significant legislation that has brought major changes to the insolvency resolution framework in India. It has brought major advantages as compared to that the former legislation. The Companies Act, of 1956 was the legislation used to govern the Insolvency proceedings before the enactment of the IBC. The Companies Act, of 1956 had its regime which was a lengthy and time-consuming process envisaged only the liquidation process. It had no specific provision as to the revival or resolution of a company. The Sick Industries Companies Act, of 1986 tried to address this issue, however, it failed as the companies ended up staying within the protection of the moratorium for years without any successful procedure for revival or rehabilitation. However, with the advent of time and financial literacy, these issues were resolved and addressed properly in the Insolvency and Bankruptcy Code, of 2016. It provides for a time-bound process for insolvency resolution and decision-making by a committee of creditors of the company undergoing insolvency. If a resolution plan is not approved within 330 days, then the company is declared to be liquidated mandatory. The Insolvency and Bankruptcy Code, of 2016 had done away with the traditional approach of insolvency and resolution of the company.¹ The Insolvency and Bankruptcy Code, of 2016 brought a procedural model with stringent provisions.

With the development of the Insolvency and Bankruptcy Code, in 2016, all sorts of businesses and companies come up under its purview. However, the Insolvency and Bankruptcy Code, 2016 in its initial stages had no effective provisions for the liquidation and insolvency of the real estate sector companies. The real estate sector is considered to be the most beneficial and sought-after avenue for investments in India. The investment growth witnessed in the real estate sector cannot be compared with any other business sector in India. Such a triple multiplier return persuades investors and thousands of people in India to invest in this sector.² But the plight and the approach of the real estate companies, promoters, and developers are quite different. The real estate sector has its several shortcomings such as business failures, diversion of the

¹ MS Sahoo & Anuradha Guru, 'Indian Insolvency Law' (2020) 45(2)

<https://www.researchgate.net/publication/343302822_Indian_Insolvency_Law> accessed 15 November 2022

² *Ibid*

payments received from the purchasers into other uses (such diversions are generally illegal in nature, but not always) resulting in the company becoming insolvent, hence the buyers or the investors are left in a middle way without any refund or any sort of effective remedy. The research article shall be addressing the need for a specific separate mechanism for the real estate sector in light of historical relevance. The research article shall be dealing with the amendments made in the statutory regime of the Insolvency and Bankruptcy Code, 2016³ for the real estate sector. The legislative regimes and their shortcomings along with drawbacks and issues shall be discussed at length in the research article. The class voting issues and comparison of the secured and home buyers as unsecured creditors will be discussed in the research article. The protection afforded to the real estate sector by the virtue of the Insolvency and Bankruptcy Code, 2016⁴ needs to be strengthened to enhance future investments in the real estate sector. The article shall be discussing the current remedies provided under the Insolvency and Bankruptcy Code, 2016. The latter part of the research article shall be a critical study as to whether the current mechanism provided for the real estate sector under the Insolvency and Bankruptcy Code, 2016 is appropriate or not.

HISTORICAL PERSPECTIVE

This part of the research article shall be discussing that how the jurisdiction of the Insolvency and Bankruptcy Code, 2016 invoked against the real estate companies. Earlier, when the Insolvency and Bankruptcy Code, of 2016 was passed and made effective had no strict direct provisions against real estate companies. The Homebuyers and the potential investors were quite upset with the repeated tendency of real estate companies by abusing the provisions of the contract or the agreement to sale entered between the home buyer and the real estate companies. The Real estate companies were failing to reach the deadlines within the time limits. There were several instances of non-delivery of the flats or duplexes or any other sort of property at a time. The home buyers tried to get remedies from the Consumer Courts, or the Real Estate Regulatory Authority constituted the parliament in 2016. However, the Consumer Courts are the courts

³ Insolvency and Bankruptcy Code 2016

⁴ *Ibid*

having a traditional approach. The procedure of the Consumer Courts and Consumer Commissions is similar to that of the traditional Civil Courts. The time taken by the Consumer Courts and Consumer Commissions is quite much in nature. On the Other hand, the Real Estate Regulatory Authority is a new piece of body established. The mechanism and the procedure of the Real Estate Regulatory Authority have no binding effect. The real estate companies and developers are least concerned with the Real Estate Regulatory Authority. The execution part and parcel of the Real Estate Regulatory Authority is the least.

Being aggrieved by these situations, the homebuyers were left with no proper remedy to address their issue. Therefore, the home buyers attempted to invoke the jurisdiction of the Insolvency and Bankruptcy Code, 2016 in the cases of real estate companies as well. The National Company Law Tribunal was called upon to determine the status of the home buyers in the Insolvency and Bankruptcy Code's creditor classification. Let's understand what creditor classification is. The Insolvency and Bankruptcy Code, of 2016 created a difference between financial and operational creditors. A financial debt is a "debt disbursed against the consideration for the time value of money". The financial debt's definition is provided in Section 5(8) of the Insolvency and Bankruptcy Code, 2016.⁵ An operational debt is a "claim in respect of the payment 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".

In the case of *Nikhil Mehta v AMR Infrastructure*⁶, the National Company Law Tribunal has held that homebuyers cannot be categorized as financial creditors as the debt in question was not given against the consideration of the time value of money. In another case, *Pawan Dubey v JBK Developers Private Limited*⁷, the National Company Law Tribunal has held that operational creditors are the ones who are providing goods, services, and employment dues. Homebuyers do not provide any such sort of services; hence they cannot be termed as operational creditors. Both these judgements of the Hon'ble National Company Law Tribunal failed to provide any blanket rule or protection to the home buyers. The homebuyers were not

⁵ Insolvency and Bankruptcy Code 2016, s 5(8)

⁶ *Nikhil Mehta v AMR Infra structure* (2017) SCC Online NCLT 219

⁷ *Pawan Dubey v JBK Developers Private Limited* (2017) SCC Online NCLT 520

recognised at all by the National Company Law Tribunal.⁸ This was quite unfortunate for the home buyers. It raised various questions and derogatory remarks against the working framework and mechanism provided by the Insolvency and Bankruptcy Code, 2016. The said rulings of the National Company Law Tribunal Created kiosks and dissatisfaction in the minds of the home buyers.

THE LEGISLATIVE APPROACH

The confusion created by the rulings of the National Company Law Tribunal persuaded the Insolvency and Bankruptcy Board of India to frame regulations providing a safeguard approach for homebuyers in India. The Insolvency and Bankruptcy Board of India is empowered under the Insolvency and Bankruptcy Board to frame regulations and to do away with the confusion created in the implementation and mechanism of the Insolvency and Bankruptcy Code, 2016. Consequently, the Board rectified the situation by introducing a different category of creditors as “other creditors” into the Insolvency Resolution Process for Corporate Persons Regulations 2016.

This inclusion allowed and permitted the homebuyers to submit their claim to any ongoing Corporate Insolvency Resolution Proceedings. But, the Insolvency and Bankruptcy Code, 2016 does neither provide rights to vote on resolution plans (accorded to financial creditors under the code) nor guarantee any payment commensurate with their liquidation value (accorded to the operational creditors under the code).⁹ Hence, the said inclusion of the other category of creditors under the Code did not provide any substantial relief to the home buyers. The need to amend the law was felt at this point.

Resultantly, the Insolvency and the Bankruptcy Code, 2016 was amended on August 17, 2018, with a lot of deliberations, debates, and discussions. The Insolvency Law Committee introduced the recommendation for the said amendment in its report dated 26.03.2018. The ILC very specifically laid down in its report that any amount due to the homebuyers are financial debt.

⁸ Sahoo. M & Anuradha Guru, ‘Indian Insolvency Law’ (2020) 45(2) Vikalpa - The Journal of Decision Makers

⁹ Dilip Kumar Dutta, ‘Industrial Sickness in India - An empirical Analysis’ (2013) 25(2) IIMB Management Review

Accordingly, the definition of financial debt was amended with the said incorporation along with its implication. The relevant excerpts of the report are as “*forward sale or purchase agreement having the commercial effect of borrowing, and the ILC deliberated that the amounts so raised are used as a means of financing the real estate project and are thus in effect a tool for raising finance, and on the failure of the project, money is repaid based on the time value of money. Therefore, not all forward sales or purchases are financial transactions, but if they are structured as a tool or means for raising finance, there is no doubt that the amount raised may be classified as financial debt under Section 5(8)(f).*”¹⁰ The section 5(8)¹¹ was amended to include an explanation in section 5(8)(f) as following:

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

Explanation: For this sub-clause - (i) any amount raised from an allotted under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing; and (ii) the expressions, “allotted” and “real estate project” shall have the meanings respectively assigned to them in clauses (d) and (zn) of section 2 of the Real Estate (Regulations and Development) Act, 2016 (16 of 2016).

IMPLICATIONS OF THE AMENDMENT

The said amendment to the Insolvency and Bankruptcy Code, 2016 was the utmost requirement of the time. The homebuyers were now considered and recognised as the financial creditor under the Scheme of Insolvency and Bankruptcy Code, 2016. The said amendment has conferred different rights under the Corporate Insolvency Resolution proceedings. Now, the homebuyers were having equal status as the banks and financial institutions as the financial creditors.

The homebuyers were accorded the right of representation and voting in the Committee of Creditors (CoC). Section 25A¹² was incorporated in the Insolvency and Bankruptcy Code for representation through the authorised representative. The representation could be done by the homebuyer on their own or maybe with the help of any other authorized representative. The

¹⁰ Insolvency and Bankruptcy Code 2016, s 8(f)

¹¹ Insolvency and Bankruptcy Code 2016, s 8

¹² Insolvency and Bankruptcy Code 2016, s 25A

authorised representative was required to take instructions from the homebuyer before voting and vote in accordance in the light of the instructions received.¹³ As the homebuyers were now considered to be the financial creditor, that established and stipulated that he/she will always have an edge over the Government and Operational Creditors.

The homebuyer as a financial creditor was also having the right to initiate a CIRP Proceedings against the defaulter real estate Company, promoter, or developer by applying Section 07¹⁴ of the Insolvency and Bankruptcy Code in the instances of default committed by the Real Estate Company. Although Default has not been defined in the code, however, section 18¹⁵ of the Real Estate Regulatory Act, 2016 defines default as the non-delivery of the home or non-refund of the advance amount received from the buyer with interest.

THE DRAWBACK OF THE AMENDMENT

The amendments were incorporated in the Insolvency and Bankruptcy Code 2016 to provide protection and an adequate representation of the homebuyers to enable them to participate effectively in the Corporate Insolvency Resolution Proceedings. However, with time, a few issues had come up that need deliberation. The scheme of class voting has proposed new issues in the form where a large and disparate class represented a large proportion of the CoC. There are specific percentage votes required to progress the resolution.

The positive voting of 51%, 66%, or 90% of the CoC was required to start the administrative proceedings. If the members do not send their instructions to the authorised representative, then the CoC does not find itself in the position to progress the resolution process of the corporate debtor. The JIL liquidation process is the classical example to illustrate the cost power shortcomings. After the amendment, the homebuyers constitute approximately 60% of the CoC. But the vote casting was done by a very small chunk of home buyers. Despite all the other members casting their votes, the required threshold of 51% was not met to initiate routine

¹³Arindam Bandyopadhyay, 'Predicting probability of default of Indian corporate bonds: logistic and Z-score model approaches' (2006) 7(3) *The Journal of Risk Finance*

¹⁴ Insolvency and Bankruptcy Code 2016, s 7

¹⁵ Real Estate Regulatory Act 2016, s 18

administrative decisions, leading to the concern that the minimum threshold of 66% of the CoC could not be met and dooming JIL liquidation to the dark.

UK Law Commission noted the said situation and quoted the statement, "...consumers are also often unaware of the legal situation, and in some cases, conflicting information from administrators further confuses the situation."¹⁶ It cannot be assumed that this type of condition was not foreseeable. Individual consumers can't have the time, resources, and expertise to attend such bankruptcy proceedings. Even the ILC which recommended the class voting provisions had identified this as a potential issue, noting that if the CoC comprises a large number of creditors, the likelihood of abstinence is high, and may lead to disruption in the decision-making ability under the CoC. These types of issues and problems are the newer ones. They were also witnessed and seen in the proceedings conducted under the Companies Law. The Company's Act 1956 had also been subject to major criticism for this issue. The class voting concept is an issue that required deliberation and a decision.¹⁷ Class voting on schemes of reorganisation under the Companies Act is on a "present and voting" basis. Therefore, the High Court of Karnataka explained the concept of the class voting rationale underlying the principle as follows in the case of *Maharashtra Apex Corporation Limited*.¹⁸

*"If the creditors who have been duly served with notices of the meeting...chose not to be present in the meeting and express their view one way or the other, the only inference that could be drawn is prima facie, they have no objection for the said scheme being approved. Any other interpretation in this regard would make it impossible for any company to get any schemes approved."*¹⁹

In light of the said ruling of the High Court of Karnataka, the Insolvency and Bankruptcy Code, 2016 was amended once again to give effect to the said proposition. The amended Code now

¹⁶ Tibor Tajti (Thaythy), 'Unprotected Consumers in the Digital Age: The Consumer-creditors of Bankrupt, Abandoned, Defunct and of Zombie Companies' (2019) 24(1) *Tilburg Law Review* <<https://tilburglawreview.com/articles/10.5334/tilr.139>> accessed 15 November 2022

¹⁷ Kashif Hussain et al., 'Sustainable tourism and resulting resident satisfaction at Jammu and Kashmir, India' (2015) 7(5) *Worldwide Hospitality and Tourism Themes* <<https://www.emerald.com/insight/content/doi/10.1108/WHATT-06-2015-0024/full/html>> accessed 15 November 2022

¹⁸ *Maharashtra Apex Corporation Limited* (2004) SCC Online (Kar) 645-670

¹⁹ *Ibid*

implies that the decision of the voting members of a class shall be deemed to be the vote of the entire class. If one will refer to the case of JIL, then it would be easy to understand. The homebuyers were representing 58% of the CoC, out of which only between 5-6% voted on any administrative matter.

The decisions of this group would apply to the entire 58%, and as a result, the same, effective decision-making power was now accorded to the small group. This amendment was quite a significant change in the Insolvency and Bankruptcy Code, 2016 as now the fate of the insolvency proceeding resolution shall lie with the small faction of the group. , the Insolvency and Bankruptcy Code, 2016 had introduced a minimum threshold for initiating the CIR process by homebuyers, and now requires the lower of 10% of the total allottees by number, or 100 allottees of a real estate project, to jointly file such an application.

The statement of objects and reasons of the amendment act includes “to prevent potential abuse of the Code by certain classes of financial creditors”, and comes in the backdrop of a proliferation of such applications by homebuyers against builders. Ironically, this now places homebuyers, insofar as the initiation of insolvency applications is concerned, behind even ordinary operational creditors, who can initiate an insolvency application for any default above INR 10 million.

NEGOTIATION PROCESS: A COMPARATIVE ANALYSIS

The protection of homebuyers is the mandate within the legitimate policy of the Insolvency and Bankruptcy Code. It is imperative to understand at this juncture that the negotiation process between the homebuyers and the real estate companies is generally unilaterally designed as the homebuyers are not in an appropriate position to bargain and negotiate the contract. On the other hand, the negotiation process between the Real Estate Company and the secured lender, shareholder, or employee is bilateral in nature. The secured lender or the employee is in a good condition to negotiate the contract and they are granted specific protection in the form of disclosures, mandatory compliances, penalties, and regulatory oversights. The better standing of the shareholder’s secured creditors and employees may lower the process of the homebuyers

in the corporate insolvency resolution proceedings. This is one of the other drawbacks of the Insolvency and Bankruptcy Code. Although the homebuyers are included as the secured financial creditor to provide an effective resolution process between the homebuyers and other creditors such as employees, shareholders, secured creditors, etc. The bargaining and negotiation power in this process is highly hindered as each party has the intent to extract the maximum value from the other. These misaligned incentives may prevent a resolution altogether, a problem that the IBC seeks to sidestep by excluding operational creditors from the bargaining table completely.

On one side, the homebuyers are willing to prioritize speedy delivery of the construction apartment. The intent to get the delivery of the constructed unit is the only objective behind such an insolvency proceeding. On the other hand, the secured creditor or the shareholder has the objective to get its return back in the monetary form invested by him/her in the company. The potential resolution applicant has the task of effectively allocating the resources between the construction expenses and payment to secured creditors. The success of the resolution plan is subject to garnering CoC votes, this decision is likely to be impacted by the composition of the CoC.

At first glance, this may appear to be an appropriate solution, reflecting as it does the investment by various stakeholders in any particular case. Indeed, this is the basis for a negotiated settlement amongst other classes of financial creditors, such as unsecured and secured creditors. However, the bargaining position may not be fully accurate. Homebuyer claims are calculated based on the amounts paid by them, together with interest for delayed delivery, and this may not accurately reflect the investment required to satisfy their claims.

Concerns also exist regarding homebuyers' ability to negotiate with each other. The IBC prescribes no formal mechanism for this, and it is up to homebuyers to organize themselves. This tends to result in a proliferation of resident welfare organizations, each with its own opinions on how the insolvency should be proceeded with. As the IBC provides for a single representative to represent the entire group of homebuyers, it becomes difficult to represent this multiplicity of views in the CoC. The scheme of the Insolvency and Bankruptcy Code, 2016

down does not allow for multiple views to be represented through the voting system. This type of scheme forces homebuyers to approach National Company Law Tribunal. It leads to an increase in litigation and the wastage of time the home buyers.

The solution provided by the Insolvency and Bankruptcy Code, 2016 to the said problem is not adequate. It proposed mandatory liquidation in cases where the resolution process cannot be equally applied to both types of creditors. The debts of the homebuyers are generally unsecured in nature, where a corporate debtor is liquidated then the proceeds of the liquidation are disrupted to creditors by pre-specified waterfalls, which creates havoc for the unsecured financial creditors or home buyers. Unsecured financial creditors are always placed behind secured financial creditors such as employees, shareholders, etc. The threat of liquidation applies unequally to secured lenders and homebuyers. It creates incentives for secured lenders to hold out for liquidation rather than attempting for resolution.

FUTURE INVESTMENTS

There are concerns which are existing in the resolution process of real estate companies. Such sort of issues may discourage investment in future real estate projects by secured lenders as well as home buyers. The major issue pertains to situations where home buyers may lose their investments due to the failure of the real estate company. On top of it, the home buyer would be liable to pay the home loan installments for the loan facility availed by the home buyer. In addition to the distress that liquidation may cause to homebuyers, long-term consequences for the real estate sector are also significant. If investors perceived those businesses in some financial trouble faced immediate liquidation, they would likely have two responses: they would not invest their money to start businesses, or they would direct their business investments toward less risky enterprises.

If therefore liquidations became common in real estate insolvencies, homebuyers would likely not be willing to invest in them in the future. The courts consider liquidation as the last resort in the cases of real estate companies considering the protection of the rights of the home buyers. Scholars argue that the process of insolvency and liquidation contemplate relationships that do

not take into account every contingency when entering into a contract with the corporate debtor. Hence, bankruptcy specifically creates unforeseen instances of distress that could not have been foreseen by the policymakers or the home buyers. Home buyers are not well aware of the likelihood of liquidation when entering into a contract with the h corporate debtor or a real estate company. The contract does not envisage the results or consequences of bankruptcy when the corporate debtor is declared to be bankrupt.

Similar concerns exist for secured creditors, as delays in resolution cause the corporate debtor's assets to deteriorate in value and increase their losses. Moreover, the IBC provides that the business of the company is to be carried out during the insolvency resolution process by a resolution professional appointed for this purpose. For real estate companies, this results in the company continuing to construct and deliver homes during the CIR process, thus applying the company's cash flows towards the settlement of homebuyer claims, while the claims of secured lenders are frozen at the commencement of the CIR process and cannot be paid during the process. Liquidation too is not a realistic option. The final resort to be achieved by Insolvency and Bankruptcy Code, 2016⁹ is to provide an effective resolution in a way that enhances the investor's confidence in the long run.

Thus, even though home buyers would not like to prefer to have the protections provided to them by the Insolvency and Bankruptcy Code, the Code provides for the procedure and mechanism which is quite a time taking, long and exhaustive. In the end, there are probabilities that, there may be no solution accorded by the whole insolvency proceeding. Home buyers are already burdened with the repayment of the home loans which they have availed to finance their apartments/houses. It is necessary to amend the Insolvency and Bankruptcy to the extent that a reasonable case could even be made to distinguish homebuyers from trade creditors and customers who are perhaps better equipped to negotiate contracts, and from other consumers by the significantly larger sums that homebuyers pay for their apartments. Home buyers need specific protection from the legislative intent.

CONCLUSION

The current research article is based on the integral aspects of real estate companies and corporate insolvency proceedings. The article started with a historical relevance as to the need for a separate procedure for real estate companies. The need was felt to provide a separate framework and mechanism to protect the home buyers in cases of insolvency of the real estate companies. There were hues and cries, dissatisfaction among the home buyers as they were highly aggrieved with the behaviour and commercial conduct of the real estate companies. No delivery of the units and non-completion of the units in the time frame has created the demand for a separate procedure. Resorting to the Civil Courts, Consumer Courts and Real Estate Regulatory Authority used to serve the least purpose as the execution of these authorities was least effective. The time taken to dispose of the cases was quite much in time. Hence, amendments were made in the Insolvency and Bankruptcy Code, 2016 to include the home buyers as financial creditors in the scheme of the Insolvency and Bankruptcy Code, 2016. The response of the legislature was quite remarkable and praiseworthy as it accorded them certain rights to proceed against the defaulter real estate companies. The other part of the article is discussing the relevance of the amendments incorporated in the Insolvency and Bankruptcy Code, 2016. The researcher has critically analysed the newly inserted provisions of the Insolvency and Bankruptcy Code, 2016.

The aspect of Class voting and the specified criteria of a quorum to initiate the insolvency proceedings have been critically discussed at length. A comparative study between secured and unsecured creditors has been examined in the research article. The standing of the home buyer in the form of an unsecured creditor has also been focussed upon in the research article. The inclusion of the home buyer is not serving any effective purpose as the home buyer is placed in a position behind the secured lenders. The last part of the article is dealing with the future of investment in the real estate sector. It is highly imperative to amend the current existing regime to ensure a proper effective redressed mechanism under the Insolvency and Bankruptcy Code, 2016 for home buyers. Home buyers should be at par with the secured financial creditors as they

are the ones who invest highly in a real estate company. The existing regime needs to be amended so that home buyers feel safe before investing with a real estate company.