

Unpaid amounts in relation to mere lease of land (not amounting to a financial lease) cannot be treated as a financial debt

In a recent judgment of *New Okhla Industrial Development Authority Vs. Anand Sonbhadra*¹, the Supreme Court held that New Okhla Industrial Development Authority (“**Appellant**”) is an operational creditor and not a financial creditor for the purposes of a corporate insolvency resolution process (“**CIRP**”) under the Insolvency and Bankruptcy Code, 2016 (“**IBC**”).

Background

The Appellant had granted a plot of land on lease for a term of 90 years in favour of Shubhkamna Buildtech Private Limited (“**Corporate Debtor**”) for development purposes.

The Corporate Debtor owed payments to the Appellant towards the lease. During the CIRP, the Appellant had filed its claim as an operational creditor by filing ‘Form B’ with the resolution professional and thereafter, filed its claim as a financial creditor in ‘Form C’. The Appellant relied on Section 5(8)(d)² of the IBC and contended that it should be treated as a financial creditor since the lease granted by it to the Corporate Debtor was a financial lease. Further, it also relied on Section 5(8)(f)³ and contended that the lease had the commercial effect of a borrowing, since under the lease deed, the amounts payable by the Corporate Debtor were structured as an upfront payment, followed by a moratorium, and then staggered payments of installment. The Appellant further contended that in order to ascertain whether a creditor can be treated as a financial creditor under any of the inclusionary clauses of Section 5(8), it is not mandatory that he must also satisfy the requirements in the main provision and that the concept of disbursement found in Section 5(8), is not required to be rigorously insisted upon in appreciating the scope of Section 5(8)(f).

After evaluating the terms of the lease deed, the National Company Law Tribunal, New Delhi (“**NCLT**”) held that the said lease of the land thereunder didn’t amount to a financial lease since it did not satisfy the requirements given under the Indian Accounting Standards (“**IAS**”) for a financial lease and hence, the Appellant was not a financial creditor. The National Company Law Appellate Tribunal, Delhi (“**NCLAT**”) affirmed the view taken by the NCLT and hence, the present appeal was filed before the Supreme Court.

¹ Civil Appeal No. 2222, 2367-2369 of 2021.

²Section 5(8)(d) of the IBC reads as follows: ““financial debt” means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes: (a) ...; (d) the amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed; (e) ...”.

³ Section 5(8)(f) of the IBC reads as follows: ““financial debt” means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes: (a) ...; (f) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing; (g) ...”.

Key Issue

Whether the Appellant is a 'financial creditor' within the purview of IBC.

Analysis and findings of the Supreme Court

(a) The Supreme Court examined the contentions of the Appellant that the debt owed to it by the Corporate Debtor under the lease deed constituted a financial lease in terms of Section 5(8)(d) of the IBC. It observed that for a lease to be constituted as a financial lease, the legislature had contemplated that such lease must be deemed to be a financial lease or capital lease as per the rules framed under the IAS. To determine this, it examined the contents of the lease and the relevant rules regarding the specification of a lease as a financial lease, as set out under rules 61 to 67 of IAS.

- (i) As per rule 61, a lessor is required to classify each of its leases as either an operating lease or a finance lease. It was observed that the Appellant had shown the said transaction as a sale and not as a financial lease under its balance sheet.
- (ii) Under rule 62 and 65, a lease would be classified as a finance lease if it transfers substantially all the risks and rewards incidental to the ownership of the underlying asset. The Supreme Court observed that:
 - (A) While the Corporate Debtor was entitled to hold the plot, it could use the allotted plot only for the purpose set out in the lease deed and did not have the liberty to use it as it would please, as would be the case of an owner;
 - (B) The lease deed prohibited any assignment of its rights by the Corporate Debtor (including the right to mortgage the land without the prior permission of the Appellant); and
 - (C) The lease deed empowered the Appellant to take back possession of the land in case of larger public interest.

The Supreme Court observed that the abovementioned provisions were incompatible with the Corporate Debtor enjoying rights/rewards incidental to ownership. Therefore, under the terms of the lease deed, there was no substantial transfer of all the rewards incidental to the ownership of the underlying asset in the present case, i.e., the land, to the Corporate Debtor.

- (iii) With reference to Rule 63, it was observed that to determine if a lease would be a financial lease would depend on the substance of the transaction, rather than the form of the contract and examples of several situations⁴ were depicted in the said rule. In this regard, the Supreme Court observed that none of the given situations captured the scenario where the lease deed entered between the Corporate Debtor and the Appellant could be said to be a finance lease. It observed that there was no transfer of the ownership of the underlying asset to the Corporate Debtor on the expiry of the term of the lease. Further, there was no option under the lease deed for the Corporate Debtor to purchase the land from the Appellant on the expiry of the term of the lease. Another situation stated that a lease could be a finance lease, if the term of the lease covered the majority of the economic life of the underlying assets, even when the title of the ownership was not transferred. However, in the present case, even when there was no transfer of title, while the economic life of the underlying asset, i.e., the land was unlimited, the lease in question was only for a period of 90 years.
- (iv) As per Rule 64, a lease could be classified as a finance lease if the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee or if gains or losses from the fluctuation in the

⁴ (a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term; (b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable; (c) the lease term is for the major part of the economic life of the underlying asset even if title is not transferred; (d) at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and (e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease) and if the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than the market rent. In this regard, the Supreme Court observed that the terms of the current lease did not cover any of the situations described in this rule.

- (v) In relation to rule 66, it was observed that there was no reclassification of the lease or any claim made by the Appellant for reclassifying the lease deed as a finance lease, at the time of entering or any time after entering into a lease with the Corporate Debtor.
- (vi) Further, with reference to rule 67, at the commencement date of the lease, the Appellant should have recognized the assets under the lease in its balance sheet and the asset so recognized must have been presented as a receivable. However, there was nothing on record to establish that the land had been dealt with in the aforesaid manner by the Appellant.

Having delved into all the rules stated under the IAS, the Supreme Court held that none of the situations or examples supported the argument of the Appellant that the lease in question was a financial lease.

- (b) The Supreme Court observed that Section 5(8)(f) was a residuary and catch all provision and accounted for transactions under which any amount raised, had the effect of a commercial borrowing. The Supreme Court held that the concept of disbursement as present in the main provision appears to be mandatory in Section 5(8)(f) and the construct of an upfront payment, a moratorium and staggered payments did not mean that any amount had been raised from the Appellant under the said transaction.
- (c) The Supreme Court also differentiated its judgement in the matter of *Pioneer Urban Land v. Union of India*⁵ (“**Pioneer Case**”) from the facts in the instant case. It held that while in the Pioneer Case, there was a sale agreement between the builder and the allottee, which was held to have a commercial effect, there was no such sale of land by the Appellant under the lease deed in the present case, and mere payment of fixed premium in instalments could not be said to have the commercial effect of a borrowing. Further, in the Pioneer Case, there was a transfer of funds from the allottee to the real estate developer and such transfer was found to possess a commercial effect, since the intent of the said transaction was to raise funds for the real estate developer to construct the residential project. In stark contrast, in the present case, no amount had been raised by the Appellant from the Corporate Debtor.
- (d) The Supreme Court finally held that the lease in question did not fall under the ambit of this provision, as the Corporate Debtor had not raised any amount from the Appellant and there was no flow of funds from the Appellant to the Corporate Debtor, in any manner, which could be construed as having the effect of a commercial borrowing.

Having already established that the Appellant could not be treated as a financial creditor, and in view of the fact that the NCLT and NCLAT had proceeded on the basis that the Appellant is an operational creditor, the Supreme Court decided to not further explore whether the Appellant would fall under the category of an operational creditor and dismissed the appeals.

Conclusion

This judgment further sheds light on the nature of the transactions that would fall under the ambit of the term ‘financial debt’. This is crucial to determine the status of a claimant as a financial creditor and his representation on the committee of the creditors, which would also impact the way the resolution plan is negotiated and/or rejected or accepted.

For more details, please contact km@jsalaw.com

⁵ 2019 SCC Online SC 1005



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