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Analysing developments impacting business

NOIDA DUES NOT FINANCIAL DEBT UNDER IBC – SUPREME COURT

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INTRODUCTION

In a significant judgment pronounced in a batch of appeals on 17 May 2022 titled *New Okhla Industrial Development Authority v. Anand Sonbhadra, Civil Appeal No. 2222 of 2021*, the Supreme Court (SC), declared that New Okhla Industrial Development Authority (Noida) is an operational creditor (OC) and not a financial creditor (FC) for the purposes of a corporate insolvency resolution process (CIRP) under the Insolvency and Bankruptcy Code 2016 (Code).

The pronouncement comes in relation to real estate companies undergoing CIRP (Corporate Debtor) where Noida had provided land under lease agreements/deeds (Lease Deed), and outstanding dues of lease premium or lease rentals under the Lease Deed were claimed by Noida as financial debt. The claim of Noida was based on two grounds, one that the Lease Deed was a 'finance lease' as per Indian Accounting Standards (IAS), and alternatively, the Lease Deed entailed a transaction having 'commercial effect of borrowing'.

The National Company Law Appellate Tribunal (NCLAT) took a view that Noida was an OC. Aggrieved by the decision of NCLAT, Noida approached the SC in appeal.

CASE OF NOIDA

Noida argued that there was transfer of risks and rewards akin to ownership under the Lease Deed and therefore it is a finance lease as per IAS. The lessee in fact is given the benefit of ownership under the Lease Deed in as much as it is free to fix the amount of consideration from buyers and appropriate entire profits thereof and the transaction is recognised as 'sale' in the books of Noida. Noida only regulates the lessee as per the provisions of Uttar Pradesh Industrial Area Development Act, 1973.

Further, Noida as a custodian/trustee of public properties and monies ought to have a say in the committee of creditors. Noida's position is comparable to a bank as the Lease Deed stipulates only payment of 10% of the lease premium upfront and the remaining amount is to be paid over 16 half yearly instalments along with interest. Thus, the Lease Deed effectively leads to raising of funds by the Corporate Debtor on reasonable terms. This leads to a transaction having commercial effect of borrowing. Noida raised an argument that 'disbursal' under Section 5(8) of the Code can mean the flow of funds from debtor to creditor and also the other way round.

Noida is also similarly placed as homebuyers who are not traditionally FCs but finance the builder by payment of advance and staggered payment of installments.

FINDINGS

Whether Noida falls within the definition of a “financial creditor” under Section 5(8) of the Code

- The essential requirements to attract Section 5(8) are that there must be a debt along with interest, if any, which is disbursed against consideration for the time value of money. SC recognised that there is a debt under the Lease Deed on which interest is payable as per the terms thereof.
- However, in relation to disbursement, SC did not agree with Noida that the requirement of disbursement is fulfilled by the payment of 10% down payment.
- The SC held that ‘disbursement’, within the meaning of Section 5(8), is the payment of money, which flows to the debtor, and in the Lease Deed in question, there was no disbursement of any debt (loan) or any sums by Noida to the lessee.

Can Noida be equated to homebuyers

- SC noted that homebuyers advanced sums to the builder and were driven by profit motive. On the contrary the lessee has not raised any amounts from Noida and there has been no disbursement.

Whether Lease Deed is a Finance Lease?

- Section 5(8)(d) of the Code provides that a financial debt includes the amount of any liability in respect of any lease or hire purchase contract which is deemed as a financial or capital lease under IAS.
- To test whether substantially all risks and rewards of the underlying asset have been transferred to the Corporate Debtor by Noida, SC analysed the illustrations provided under IAS to render the following findings:
 - There is no transfer of ownership of the underlying asset, i.e. the land, by way of the lease by Noida. In fact, by the end of the lease, third party rights are created over the built-up-space/plot constructed by the lessee.
 - There is no option for the lessee to purchase the land at the end of the lease period..
 - The lease in question is for a period of ninety years. The principle of economic life of underlying asset, i.e., land, does not apply as the value of land increases with time. Moreover, flats and apartments constructed by the lessee do not qualify as the underlying asset as it is the lessee who finds allottees and transfers these units by way of sub-leases and the consideration paid by the allottees is in fact appropriated by the lessee and not by Noida.
 - As on the commencement date, what is paid by the lessee is only 10% of the total premium which does not represent substantially all of the fair value of

the underlying asset. Further, there is no option for renewal of the lease at the end of 90 years.

- The lease in the present case does not confer any power on the lessee to cancel the lease.
- Amongst other provisions whereby Noida retains control of the land, SC also relied on the powers of Noida to cancel the Lease Deed to hold that the Lease Deed is not a 'finance lease', and Noida not a FC under Section 5(8)(d) of the Code.

Status of Noida as an OC

- SC held Noida to be an OC, but it did not delve deeper into this question in view of concurrent findings of NCLT and NCLAT.

CONCLUSION:

This provides a much needed relief to stakeholders involved in several real estate projects whose CIRPs have been stalled by authorities like Noida on account of their demand to be classified as a FC. In fact, this will also be beneficial for homebuyers as affected CIRPs would be concluded expeditiously.

The flip side of this judgment is that Noida has in essence been declared as the owner of the land, which gives it the right to cancel a Lease Deed. If Noida was in fact to cancel a lease deed with a real estate company or developer, further litigation may not be ruled out. A via media could be that potential resolution applicants could offer Noida pay outs akin to FCs.

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