

INCLUSION OF ASSETS TAKEN ON LEASE IN THE LIQUIDATION ESTATE OF THE LESSEE

- Anita Baid

Editor's Note: *Forming a liquidation estate is a preliminary step in the liquidation process and involves 'identification' of assets which would form a part of the estate. An interesting case would be to identify whether an asset taken on financial lease where corporate debtor is a lessee shall be included in the liquidation estate. The treatment of 'financial lessor' will accordingly be determined. This article makes an effort to understand this issue.*

The lifeline of any entity is dependent upon the assets that are used for carrying out its operations. These assets can either be owned by the entity or taken on lease. As the ownership involves huge capital outflow, entities either purchase the asset by entering into a financial transaction with the lending entity or acquires the asset on lease.

With a rise in these financial transactions, there has also been a corresponding growth in financial defaults and hence there was a strong need for implementing a disciplined insolvency and bankruptcy legislation to address the default issue. Eventually, the laws relating to restructuring and insolvency of corporate persons, partnership firms and individual firms were consolidated and amended by IBC. The IBC intends to promote availability of credit and improve the ease of doing business.

The IBC provides for an institutional framework where the lenders and other stakeholders of a stressed firm try to revive it before its taken to liquidation. The intention is to save the stressed firms by way of restructuring and preserve the valuable assets and the fundamental existence of such stressed firms. However, subsequent to the implementation of IBC it has been observed that, in the resolution process there are always chances where the promoters of the corporate debtor will hesitate to co-operate with the RP and thus, in such an event there are plausible chances that the corporate debtor may face liquidation.

**Two types of
leases –
Financial lease;
and
Operating lease.**

Once the corporate debtor enters into liquidation, the liquidator is required to determine the assets of the corporate debtor available for sale and subsequently distribute the sale proceeds among various creditors. One of the issues that the liquidator faces is with respect to the treatment of assets taken on lease as a part of the liquidation estate. In this article we intent to discuss the provisions of law to determine whether the assets taken on financial lease by the corporate debtor would form a part of its liquidation estate or not.

Inclusion of Assets Taken on Lease in the Liquidation Estate of The Lessee

Concept of lease

Lease is a form of bailment where the Lessor transfers the right to use an asset to the Lessee against periodic cashflows. There are two type of leases – a) Financial lease and b) Operating lease. Legally there is no difference between the two, in both the cases, the legal title of the asset remains with the lessor through out the lease tenure. However, for all other purposes retention of asset based risks and rewards acts as the differentiating factor.

In case of a financial lease, substantially all risks and rewards are transferred to the lessee by the lessor, therefore, the lessee steps into the shoe of the owner of the asset for all practical purposes. However, in case of an operating lease the lessor retains the risks and rewards associated with the assets.

Financial lease

Financial lease provides an alternative to borrowing and is a mode of obtaining finance. Here, all major risks and awards of ownership are transferred from the lessor to the lessee. The lengthy lease period provides use of the asset by the lessee for almost whole economic life of the asset. The lessor merely finances the acquisition of the asset and retains the title over it. Usually, the ownership is transferred from the lessor to the lessee at the end of the lease. However, the same is subject to the terms agreed between the parties to the lease.

Operating lease

Unlike financial leases, the risks and rewards pertaining to the ownership of the asset are retained by the lessor himself in case of operating leases. The intent in operating leases is not of providing a mere financing facility to the lessee but to hire out the asset. The title of ownership of the asset is that of the lessor. In essence, operating leases truly focuses on usage of the asset rather than ownership, for the lessee.

However, here it is important to understand that the nature of a financial lease is admittedly a financial assistance and is akin to loan transactions. There have been several judicial pronouncements where it has been substantiated that financial leases are akin to loan. In the case of [*Association of Leasing and Financial Services Company v/s Union of India*](#), paragraph 20 and 21 of the judgment clearly brings out the fact that financial leasing and hire purchase transactions are a mode of long term funding. In case of [*Asea Brown Baveri Ltd v/s Industrial Finance Corporation of India*](#), the judgment brings fore the fact that financial lease is nothing but loans in disguise. In other words the lessor in case of a financial lease is also a creditor for the lessee.

In order to succeed in initiating corporate insolvency resolution process against a debtor, it is *sine qua non* to prove that the creditor falls within the ambit and scope of the definition of either 'Financial Creditor' or 'Operational Creditor'.

Treatment of lease transactions under the IBC

Financial Creditor and Financial Debt

A financial creditor is defined under Section 5(7) of the IBC as-

"financial creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred".

In order to ascertain whether a person is a financial creditor, the debt owed to such a person must fall within the ambit a 'Financial Debt' as under Section 5(8) of the IBC. Further, a financial debt is defined under Section 5(8) of the IBC:

"financial debt" means a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money and includes—

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(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;

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In case of operating lease, the lessor retains the ownership along with all the risks and rewards associated with the asset and the asset is capitalized in the books of the lessor. Hence, there is no doubt on the ownership or title of the asset being vested with the lessor. However, the treatment is different in case of financial lease. In a financial lease, the lessor recognizes only its investment in the lease transaction, which is similar to the treatment of the loan transaction. The asset is capitalized in the books of the lessee and a corresponding liability is created to recognize the liability towards the lease rentals.

Therefore, it may be noted that a financial lease transaction, in all practicalities, is no different from a loan transaction and the IBC also does not differentiate between a loan transaction and a financial lease transaction, as the definition of financial debt specifically includes finance lease.

Under IBC, a financial creditor which is a secured creditor always sits at the top of the priority list for payment upon realization. This gives rise to the question whether a financial lessor, who is also a financial creditor, can be treated as a secured creditor for the purpose of IBC, which has been examined at length below.

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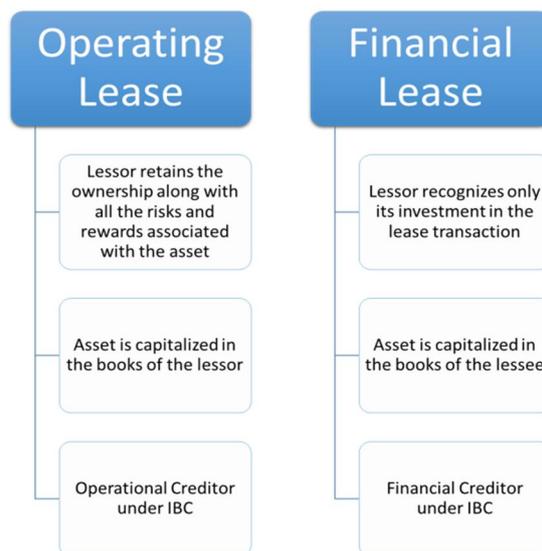


Figure 18: Difference between Operating and Financial Lease

Secured Creditor and Security Interest

Under IBC, the definition of secured creditor states that:

(30) "secured creditor" means a creditor in favour of whom security interest is created;

Further, security interest has been defined to mean the following:

*(31) "security interest" means **right, title or interest or a claim to property**, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement securing payment or performance of any obligation of any person: Provided that security interest shall not include a performance guarantee;*

A secured creditor is someone who has created a security interest on the property of the lessee. In a normal loan transaction carrying a collateral, the borrower creates a security interest on the property in favour of the lender. This can be in the form of mortgage, hypothecation, pledge etc. However, in case of a lease transaction such is not the case as the lessor continues to be the owner of the property through out the lease tenure.

Therefore, arises a question – whether financial lessor can be treated as secured creditor for the purpose of IBC, more importantly whether the interest of a financial lessor be treated as security interest for the purpose of IBC as the answer to the first question would depend on the answer to the second one.

In case of a financial lease the legal ownership of the asset vests with the lessor. It is only at the end of the tenure that the lessee has an option to effectuate transfer of ownership in its favour. During the tenure of the lease, the asset is not held by the lessee and hence it cannot be said that a security

interest is created on the asset in favour of the lessor. As the lessor being the legal owner of the asset has all the rights over the asset, without any particular assignment of right in its favour.

Since, a financial lessor does not hold any security interest on the property, therefore, it cannot be treated as secured creditor of the lessee, despite being a financial creditor. However, in that case, the rights of the of the financial lessor will be way superior than other secured creditors of the company, because, the rights of a secured creditor under section 52 is limited to either enforcement or relinquishment of the security interest. Whereas, a financial lessor is the legal owner of the asset and has all the rights to sell or dispose off the asset in any manner as it may deem necessary even before a secured creditor exercises its rights under the aforesaid section upon liquidation of the lessee.

However, a financial lessor will be free to dispose off the asset only if it does not form part of the lessee's liquidation estate. The scope of liquidation estate has been laid down under section 36 of the IBC and the same has been discussed at length below:

Liquidation Estate

Under IBC, NCLT can order for liquidation under Section 33 of the IBC if no resolution plan has been submitted to it before the expiry of the corporate resolution insolvency process period, or if it rejects a plan because it does not comply with the provisions of the IBC. The liquidation of a corporate debtor involves the selling of its assets piecemeal and the distribution of the sale proceeds among its various creditors.

For the purposes of liquidation, the liquidator shall form an estate of assets which shall be called "Liquidation Estate". Section 36 is the relevant section dealing with the inclusions and exclusions-

36. (1) For the purposes of liquidation, the liquidator shall form an estate of the assets mentioned in sub-section (3), which will be called the liquidation estate in relation to the corporate debtor.

(2) The liquidator shall hold the liquidation estate as a fiduciary for the benefit of all the creditors.

(3) Subject to sub-section (4), the liquidation estate shall comprise all liquidation estate assets which shall include the following:—

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(4) The following shall not be included in the liquidation estate assets and shall not be used for recovery in the liquidation:—

(a) assets owned by a third party which are in possession of the corporate debtor, including—

a. assets held in trust for any third party;

b. bailment contracts;

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in the Liquidation Estate of The Lessee***

- c. all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund;*
- d. **other contractual arrangements which do not stipulate transfer of title but only use of the assets;** and*
- e. such other assets as may be notified by the Central Government in consultation with any financial sector regulator;*

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Usually under a lease arrangement, the ownership of the asset rest with the lessor and only the right to use the asset is transferred to the lessee. A lease transaction usually does not by itself result into a transfer of title. However, in certain cases of financial lease, the lease contract may provide for an option to buy the asset with the lessee.

Any financial lease transaction shall result into an automatic transfer of asset after a period of time to the lessee, if it has been pre-decided at the time of the execution of the lease agreement itself that title of ownership is sure to change hands at the end of the lease term. In such a situation, where the lessee is given an option to buy the asset at the end of the lease tenure at a nominal price at which there is reasonable certainty that the lessee will exercise the option to purchase asset, it would be regarded as an automatic transfer of the property.

In a hire purchase transaction, the entire cost of asset along with the expected rate of return of the financier is collected from the customer and an option is given to the customer to buy the asset at a nominal price, normally, as low as Re. 1 or such. In such cases of hire purchase, since the entire amount is recovered from the customer during the tenure of the transaction, the option to buy at a nominal price is not a real option, as the probability of the customer not exercising the option is nil. Therefore, in a hire purchase transaction, there is a certainty that the title of the goods will pass on to the customer at the end of the tenure.

Here, it is important to note that the option to purchase at the end of the lease term must be real and the lessee must not be compelled to exercise the option. For instance, in case the option price is very nominal, like hire-purchase transactions, it will be irrational to assume that the lessee will not exercise the option. The option in such a case remains just a formality since the lessee shall otherwise lose the entire rentals paid if the option is not exercised, therefore, the principles of common wisdom indicate that exercising such an option is certain.

Further, to determine the nominality of the option price, one should compare it with the expected market value or residual value of the asset at the end of the lease term. The determination of nominality is a case specific matter that is ascertained based on prudence and applicable market practice.

One of the factors influencing the thin line of difference between a lease and hire purchase transaction is the certainty of exercising the option. Given that the option price is very nominal, it will be irrational to assume that after paying all the rentals the lessee will not exercise the option to purchase at a nominal price. However, if the option is not nominal but a bargain price, the uncertainty still remains. Here, the option at a bargain price or a nominal price must not be regarded

as the same, since in case of the former, it will be at the sole discretion of the lessee to either exercise the option, however, for the latter it becomes certain. Accordingly, a lease transaction with an option to purchase at a bargain price shall not be regarded as a hire purchase transaction provided that the price is not nominal and the uncertainty remains.

Moreover, for an asset to be excluded from the liquidation estate the option to purchase the asset at the end of the lease term must be such that it defies common wisdom that the transfer will be effectuated that is to say it should not result in automatic transfer. To sum it up one may conclude that under the IBC law, such leased assets which do not stipulate automatic transfer of title but only right to use is transferred, shall be excluded from the liquidation estate of the lessee. The asset taken on hire purchase and those taken on lease with reasonable certainty that the ownership shall be transferred after the expiry of the lease term, shall accordingly be included in the calculation of liquidation estate of the lessee.

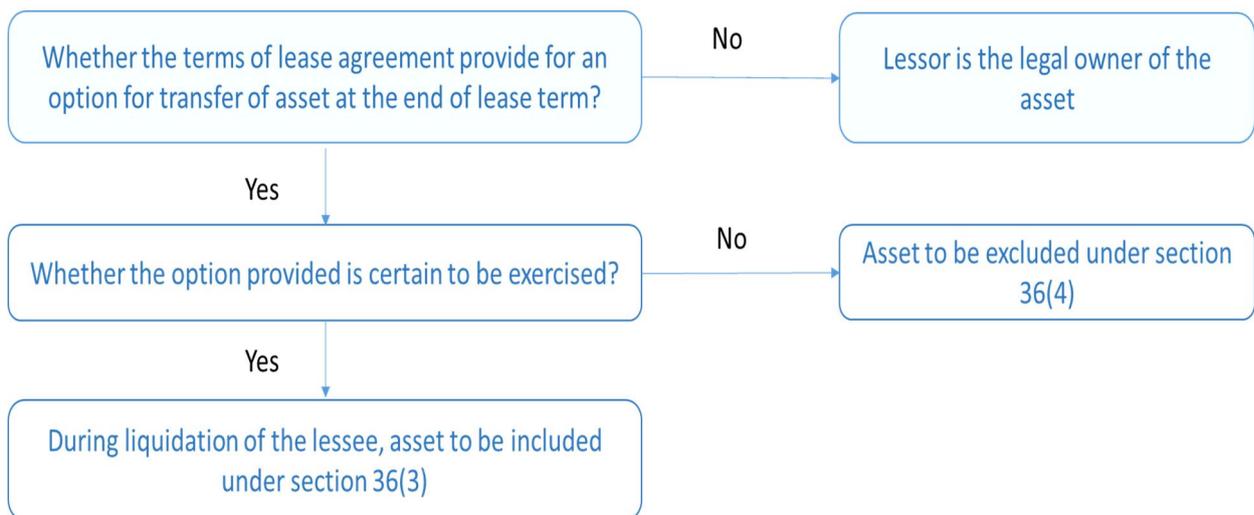


Figure 19: Treatment of Assets under Lease

Conclusion

The liquidation of a corporate debtor is the last step to end the existence of the corporate debtor. In order to effectuate the liquidation process, the liquidator is required to determine the liquidation estate of the corporate debtor. In case of a financial lease, the inclusion of the asset taken on lease would be dependent on the terms of the leasing arrangement-

- In case the lessor provides an option to buy the asset at the end of the lease tenure at a price which does not stipulate automatic transfer or reflect reasonable certainty of lessee exercising the option, the lessor will be treated superior to the secured financial creditor. The leased asset will accordingly be excluded from the liquidation estate under section 36 (4).
- On the other hand, in case the lessor provides an option to buy the asset at the end of the lease tenure at a price at which there is reasonable certainty that the lessee shall exercise the option to buy the asset or the automatic transfer of the asset is stipulated, then the leased asset shall be deemed to be a part of the liquidation estate of the lessee.