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Financial vs. Operational Leases: A Critical Analysis for Lessors under IBC, 2016

AUTHOR Shrishail Kittad, Ritika Dedhia, Ayush Shukla

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Background

This analysis evaluates the legal and commercial implications of structuring a lease agreement as a financial lease versus an operational lease, particularly concerning creditor classification under the Insolvency and Bankruptcy Code, 2016 (IBC). The decision by the National Company Law Tribunal (NCLT) in the case of *Orix Leasing and Financial Services India Ltd. vs. Mr. Rajendra Kumar Jain, RP**[1]**, highlights the importance of this distinction.

Our analysis shows that financial leases provide a more advantageous position for lessors. By structuring a lease as a financial lease, a lessor can be classified as a financial creditor under the IBC, which gives them enhanced rights and remedies. This classification is crucial for maximizing a lessor's recovery and influence during the corporate insolvency resolution process.

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Summary of Judicial Precedent

The NCLT's decision in the Orix Leasing and Financial Services India Ltd. case provides a crucial judicial precedent on the distinction between financial and operational leases. In this matter, Orix sought to have its claim admitted as that of a financial creditor, arguing that its lease arrangement with the corporate debtor, Zenica Cars India Pvt. Ltd., for vehicles constituted a financial lease. The Resolution Professional, however, rejected this claim and treated it as operational in nature.

The NCLT upheld the Resolution Professional's rejection, holding that the lease did not transfer "substantially all the risks and rewards incidental to the ownership" of the vehicles. The Tribunal's reasoning was based on several key facts:

- The lease term was only 15 months, which was significantly shorter than the expected 15 year lifespan of the vehicles.
- The contract lacked a clause allowing the corporate debtor to purchase the vehicles at the end of the lease term.
- Ownership of the vehicles remained with Orix, which also claimed depreciation benefits under the Income Tax Act.

Consequently, the Tribunal found that the transaction was an operating lease and Orix was not entitled to be treated as a financial creditor under the IBC. This case highlights the importance of the substance of the transaction over its form in determining creditor status under the IBC.

Legal Framework under IBC and Accounting Standards

The legal foundation for classifying a creditor as financial or operational is rooted in the definitions provided by the IBC and guided by accounting standards.

- **Financial Debt (Section 5(8)(d)):** A financial lease is a "financial debt" under Section 5(8)(d) of the IBC. A financial debt is defined as a debt disbursed against the consideration for the "*time value of money*" and includes any liability under a lease or hire purchase contract that is a finance or capital lease under the Indian Accounting Standards (Ind AS).
- **Operational Debt (Section 5(21)):** Operational debt is defined in Section 5(21) of the IBC as a claim in respect of the provision of goods or services. Most operating leases are categorized as operational debt.

Indian Accounting Standard (IND-AS 116) provides the accounting perspective, defining a financial lease as one where "*substantially all the risks and rewards incidental to ownership of an asset are transferred to the lessee*". Conversely, an operating lease merely allows the use of an asset for a limited term without transferring the underlying economic interest or benefits. This distinction, is emphasized by judicial precedents like *New Okhla Industrial Development Authority v. Manish Gupta**[2]**, where the Hon'ble Supreme Court emphasized that only finance leases are to be treated as financial debt under the IBC. Similarly, in *Anup Sushil Dubey v. NAFED**[3]**, the NCLAT held that leasing premises for commercial use constituted operational debt.

Strategic Importance of Financial Lease Classification

Structuring lease agreements as financial leases offers significant procedural and financial advantages during insolvency resolution for the following reasons:

i. Membership in the Committee of Creditors (CoC): A financial lease qualifies the lessor to be recognized as a financial creditor, which grants membership in the Committee of Creditors (CoC) under the IBC. The CoC is a powerful body that provides the lessor with substantial control over the Corporate Insolvency Resolution Process (CIRP). This includes:

- Voting rights on resolution plans.
- The power to replace the Resolution Professional.
- A decisive voice in determining the future of the corporate debtor.

ii. Higher Priority and Recovery Potential: Financial creditors are better positioned to recover a higher portion of their claims under approved resolution plans, compared to operational creditors. This advantage is further evident in the liquidation process governed by Section 53 of the IBC. The waterfall mechanism under Section 53 establishes a clear hierarchy for the distribution of liquidation proceeds. Financial creditors rank significantly higher than operational creditors. The dues of operational creditors are paid only after satisfying all workmen's dues, employee claims and unsecured financial debts. Therefore, if a lease arrangement is classified as an operating lease, the lessor's claim will be treated as operational debt and pushed lower in the order of priority. In practical terms, this often results in little or no recovery. In contrast, classification as a financial lease ensures that the creditor participates at a higher priority level in both resolution and liquidation, thereby substantially enhancing the recovery potential.

iii. Simplified Initiation of CIRP: A financial lessor, as a financial creditor, may independently initiate the CIRP under Section 7 of the IBC without the need to prove operational default or issue a demand notice. Operational creditors, on the other hand, must comply with the more cumbersome procedures under Section 9, which includes providing a demand notice and proof of default. These procedures can be more easily challenged by the corporate debtor on technical grounds.

Recommendations

In light of the legal and financial consequences described above, it is advisable for the Creditors to carefully structure lease transactions as financial leases wherever feasible. To ensure this classification is upheld in the event of an insolvency proceeding, the lease agreements should be drafted with the following key indicators:

- **Lease Term:** The lease term should be a substantial portion of the EV's economic life.
- **Transfer of Risks:** The agreements should include clear provisions transferring the usage and risk of obsolescence to the lessee.
- **Purchase Option:** A clear option for the lessee to purchase the asset at a nominal or predetermined value upon expiry of the lease should be included.
- **Accounting and Taxation:** The Creditor, as the lessor, should refrain from claiming depreciation on the EVs, as doing so implies continued ownership and would weaken the argument for a financial lease. The agreements must be unambiguously drafted to reflect the economic intent to finance the asset rather than merely rent it.

Adopting these structuring mechanisms in consultation with legal and accounting professionals will mitigate the risk of adverse classification and protect the Financial Creditors standing in insolvency proceedings involving lessees.

Conclusion

The legal distinction between financial and operating leases carries significant weight under the IBC. An incorrectly structured lease may result in your company being treated as an operational creditor, thereby forfeiting critical procedural rights and priority in recovery. The decision in the *Orix Leasing* matter the importance of the substance of the transaction over its form in lease classification.

The Creditors are strongly advised to undertake a comprehensive review of its existing lease documentation and internal practices to ensure alignment with the standards and judicial guidance discussed above. This will secure your position as a financial creditor, preserve your influence in the CIRP, and improve your recovery prospects in insolvency or liquidation scenarios.

For more details, write to us at: contact@indialaw.in

[1] IA No. 83/2022 in CP (IB) No.263/Chd/Hry/2018

[2] Civil Appeal No. 4067 of 2020 and 2022 SCC Online SC 631

[3] 2020 SCC Online NCLAT 674

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