

**ADVISORY BOARD FOR THE
PREPARATION OF A
MODEL LAW ON LEASING
First session
Rome, 17-18 October 2005**

UNIDROIT 2005
Study LIXA-Doc.1
Original: English
October 2005

Key issues raised by the preparation of a model law on leasing

(memorandum prepared by the UNIDROIT Secretariat)

In drafting a model law on leasing, certain elements will likely be uncontroversial. However, many issues require difficult policy choices and may be the subject of considerable discussion.¹ In order to invite the comments of the Advisory Board on these issues at the earliest stage possible, this memorandum identifies several areas on which the Board's views will be especially helpful.

This memorandum should not be understood as an outline of a complete model law on leasing nor as an exhaustive list of the issues that may arise in the drafting process. This memorandum is designed only to highlight particular issues, and far from being designed to limit the Board's input to comments on the issues listed here, the memorandum is but a starting-point. The Board's views on issues not listed here will be as important as its views on the issues identified. To that end, the Secretariat would encourage the Advisory Board to identify the components of a leasing law that it would anticipate being most difficult, in order that the first draft of the law might benefit from the Board's prior input. In the meantime, however, this memorandum may provide a preliminary map to issues on which the Secretariat will seek the Board's input at its opening meeting later this month.² The memorandum begins with three parts dealing with the scope of the law to be drafted, followed by three parts centred on the primary relationships in the transaction and concluding with one part discussing the rights of third parties.

I. Transactions covered

A. General definitions

1. *Definition of a lease.* The first major difficulty is in defining the lease, and specifically in distinguishing an agreement that gives rise to a lease from one that gives rise to a security interest, all while still creating room for financial leases. A variety of tests are possible, primarily focusing on the end-of-term options under the agreement.

¹ Cf. R.C.C. Cuming: Model Rules for Lease Financing: A Possible Complement to the UNIDROIT Convention on International Financial Leasing in *Uniform Law Review* 1998, 371 *et seq.* This article is reproduced in Appendix I to this memorandum.

² See also the preliminary comments submitted to the Advisory Board by Mr R. Castillo-Triana (Colombia), member of the Advisory Board, reproduced in Appendix II to this memorandum.

A focus on end-of-term options looks primarily at the extent to which the lessor can expect to receive anything of value back at the end of the term: the more the lessor can expect, the more likely that the arrangement is a lease. But because the model law will also seek to define financial leases in which equipment is leased for a substantial portion of the equipment's life, it will be important to consider whether the length of the lease in relation to the equipment's life can be a dispositive factor. Other factors to be considered would include whether the agreement permits the lessee to purchase the equipment unilaterally or to renew the lease for the life of the goods for nominal consideration, and whether the agreement requires the lessee to renew or purchase the goods. A law designed solely to attract financial leasing investment might recognise as leases those agreements in which the lessee has a right or is bound to renew the lease, even for the equipment's economic life, and those agreements in which the lessee has a right to purchase the equipment, as long as the lessee is not bound to purchase the equipment. Such a law would permit as leases all but those agreements in which the lessor *cannot* receive anything of value at the end of the term, and would include those agreements in which the lease lasts the entire economic life of the goods. However, by permitting such agreements as leases, such a law might also have undesirable consequences for accounting and taxation policies in implementing States.

2. *Definition of a financial lease*

- a. *Inclusion of financial leases.* Should the model law aim to include only traditional leases, or should it also include those arrangements known as "financial leases," which are commonly considered much closer to secured loans?
- b. *Lessee's selection of the goods.* The appropriate resolution of many issues regarding the lessee's and lessor's ongoing obligations may depend on whether the lessee itself selected the equipment, without input from the lessor. However, lessors may desire to have input in the selection of goods in certain instances, and the factor need not be made a requirement of all financial leases. The model law might just as easily, when the issue calls for it, provide for alternative treatment of leases in which the lessee selected the equipment independently.
- c. *Secondary leases.* If the law makes the lessee's selection of goods a requirement of all financial leases, the law may make it more difficult for lessors to let the same goods a second time, after the first lessee had selected the goods and returned them to the lessor at the end of the primary lease. This may be a desirable outcome, because a lessor who lets the same goods multiple times may come to resemble an operating lessor more than a financier. However, if that outcome is not desirable, the law could either create an exception to the lessee's selection rule, or might not include the lessee's selection rule at all.

- B. *Geographic scope.* Although the model law could leave the question of when a leasing arrangement is governed by the law to the implementing State's existing rules regarding choice of law, lenders and investors may prefer that the model law contain a provision that clearly defines when the statute applies.

The statute producing the clearest, bright-line test might limit the law's applicability to arrangements (1) in which the equipment being leased is to be utilised in the implementing State and (2) arrangements in which the parties specifically invoke the implementing State's laws in their contract. However, a State may also wish to expand the law's coverage to protect arrangements in which the lessee has its principal place of business (or some similar test) in the implementing State. This latter course necessarily sacrifices some clarity, inasmuch as a test turning on "principal place of business" or any similar language will surely invite litigation.

- C. *Arrangements excluded from coverage.* The Advisory Board's input on the substantive scope of the law will also be appreciated. Many arrangements that could otherwise fall under the aegis of leases might best be left outside the scope of the law to be drafted here. For example, the Ottawa Convention³ specifically excluded consumer leases and real estate leases. Consumer leases were there excluded because they are not common in the international transactions that Convention covered; even if this model law is designed to cover transactions occurring entirely within an implementing State's borders, consumer leases may have unique concerns that ought to be dealt with independently of this model law. Similarly, the Ottawa Convention excluded real estate leases due to the difficulty of interweaving the treatment of real and chattel property, an issue that may also be of concern here.

- II. **Freedom of contract.** An issue running throughout the model law will be the extent to which parties to leases covered by the law should be free to contract around its requirements. Although, generally speaking, freedom of contract is to be desired, there may be requirements that ought to be mandatory. Issues for which some might find mandatory provisions desirable may include (A) a lessor's or supplier's implied warranty of merchantability; (B) limitations on liquidated damages; or (C) the lessor's liability for grossly negligent or intentional acts that violate the lessor's duty to ensure quiet possession, among others.

- III. **Background provisions of contract law.** Another issue that will arise throughout the model law is the extent to which the law should provide basic elements of contract law, rather than relying on the implementing State's underlying contract law. To the extent that an implementing State's underlying contract law is relatively undeveloped, leasing arrangements in the State may benefit from provisions that provide basic structures regarding, for example, the formation of contracts and the statute of frauds, express and implied warranties, unconscionability, and statutes of limitations for actions arising out of contracts. On the other hand, some might consider such background provisions to be outside the scope of a law on leasing. The Board might consider various options on this issue, including drafting such a background law as part of the overall project, but leaving it distinct from the leasing provisions, so that implementing States might adopt it or not as they see fit, or — given the wide acceptance of the UNIDROIT Principles of International Commercial Contracts — incorporate an appropriate reference to the Principles, for all matters of general contract law.

³ The text of the Convention is reproduced in Appendix III to this memorandum. A select bibliography on the Convention and related matters is reproduced in Appendix IV.

IV. Lessee-lessor relationship

A. *Qualification of lessors.* Should the law include any provisions restricting the ability to enter a lease? For example, should the class of lessors be limited to financial institutions, as some may have suggested?

B. Transferability.

1. Ability to transfer

a. *Lessee's ability to transfer.* What, if any, restrictions ought there to be on a lessee's ability to sublet or transfer its interest? A lessor might, for its own security, desire that a lessee be required to obtain the lessor's consent before transferring the right to use the equipment. However, it may be desirable for the model law to impose no such restriction but leave such a restriction to the parties' contract.

When a sublease arises, the sub-lessee might then have a relationship with the original supplier either directly (as though the right were assigned) or as mediated through the primary lessee (as in a traditional sublease). The model law might include a default provision and might define circumstances in which a relationship can arise directly between the supplier and the sub-lessee — such as, for example, when the supplier previously was given notice of the financial leasing arrangement.

b. *Lessor's ability to transfer.* Should there be restrictions on transfers by lessors who have ongoing obligations under their arrangements? They might be treated differently from lessors who have no further obligations and thus presumably are free to transfer their right to receive payment. Lessors who have ongoing obligations might be free to transfer their duties but remain contractually liable, might be free to assign their duties as they desire or might be restricted from transferring their duties except with the lessee's permission.

2. *Remedies.* If a party transfers the lease interest in violation of any statutory restriction on transferability or in violation of the contract, what is the consequence of that event? Should the parties be required to wait until the transfer causes one of them harm, in which case the harmed party will have a remedy? Or should the transfer itself be sufficient to trigger a default event, regardless of whether the non-transferring party has suffered harm.

C. Irrevocability.

1. *Irrevocability in two-party leases.* Should the law include a "hell or high-water" clause, under which the lessee's obligations to pay the entire rent become irrevocable at some point? If such a clause is appropriate, at what point does the lessee's duty to the lessor become irrevocable? Upon the lessee's acceptance of the equipment?

2. *Irrevocability in financial leases.* If the lessor warrants the equipment's merchantability and fitness or plays some additional role beyond pure financing, then perhaps the lessee's duty should not become irrevocable, because there are continuing obligations on each side.

D. Right of quiet enjoyment

1. *Guarantee by lessor.* On the one hand, a traditional lessee expects to enjoy the equipment free from any concerns about title. Indeed, some argue that if the lessor holds the title, the lessor ought to carry some responsibility for the goods. On the other hand, if the lessee selects the equipment, then it may be difficult for the lessor to guarantee the equipment's title.

Although the model law could provide for a right of quiet enjoyment or not, the model law could also make the lessor's obligation in this respect dependent on whether the lessee actually selected the equipment.

2. *Freedom of contract.* If the model law provides a right of quiet enjoyment, whether in all covered leases or only those meeting certain criteria, should that warranty be mandatory or should the parties be free to contract around it? If providing such a guarantee of title is appropriate but there is reluctance to limit the freedom of contract, the right could be made mandatory in certain instances. Options might include making the guarantee mandatory against interference due to the lessor's error or due to the lessor's grossly negligent or intentional acts.
3. *Guarantee by supplier.* Consideration might be given to whether, in lieu of such a guarantee by the lessor, it would be desirable to require a right of quiet enjoyment from the supplier to the lessee.

E. Default

1. Generally

- a. *Security and the right to demand assurance.* Should either party have the right, upon reasonable grounds for insecurity, to demand adequate assurance of performance, with the right to suspend performance until that assurance is received?
- b. *Excused performance.* Should the law provide circumstances in which performance is excused, such as when performance would be impracticable? Or should that issue be left to the implementing State's background contract law?

2. Default by lessor

- a. Acceptance and rejection of non-conforming tenders
 - i. *Grounds for rejection.* Under what circumstances can a lessee reject goods as non-conforming? Two key questions are (a) should rejection be permitted for any non-conformity or only those non-conformities that substantially affect the lessee's purpose and (b) what effect should a

lessee's initial acceptance of the goods have on the lessee's ability to reject the goods. With respect to the latter question, rejection following an initial acceptance could be barred entirely, limited to rejection for hidden and serious non-conformities, permitted on the same grounds as rejection prior to acceptance or made dependent on whether the acceptance was explicit and whether the acceptance was made in reliance on the supplier's representations. Alternatively, the model law could leave these questions open, if it were preferred that the right of rejection incorporate on the implementing State's background law of sales.

- ii. *Rights upon rejection.* If the lessee exercises a right of rejection, the questions arise whether the rejection can terminate the lease and whether the lessor or supplier should have a right to cure the non-conforming tender — which may depend, for example, on whether the cure would come within the original time for performance or with additional payments of the lessee's costs incurred by the non-conforming tender.

There is an additional question of whether the lessee may withhold payment for non-conforming goods. The appropriate resolution of this question may be different in a financial lease, in which the lessor has had little involvement in selecting the goods, and a traditional lease, in which the lessor and supplier are identical. In the financial lease, the lessee may have a direct cause of action available against the supplier, so it may be inappropriate to withhold payment from the lessor; that consideration is not present in a traditional lease.

- b. *Acceptance.* Assuming that acceptance can be either explicit or implicit, under what circumstances can acceptance be revoked? Should it be revocable if, at the time of acceptance, the non-conformity was unknown, unknowable or known but minimised by the supplier?

Further, if the non-conformity is discovered at some point subsequent to acceptance but not timeously raised with the supplier or lessor, does the lessee thereby waive any claims based on it? Or should such a waiver depend on whether the supplier or lessor is prejudiced by that delay?

3. Default by lessee

- a. *Lessee is insolvent but has not defaulted.* If lessee appears insolvent but has not yet repudiated or defaulted on its obligations, the lessor may be entitled to take advance action to minimise the cost of a potential default. Should that advance action include the right to stop delivery of (or refuse to deliver) the goods, without first demanding the lessee's assurance?

- b. *Right to recover goods.* If a lessee in possession of the goods defaults, should the lessor be entitled to recover the goods without first obtaining judicial permission (provided that the recovery does not breach the peace)? If not, the law may need to include provisions tailored to the judicial procedures appropriate in the implementing States.

F. Damages

1. *Governing principle.* In the event of a breach by either party, what principle should govern damages? An “expectation damages” remedy would seek to put the harmed party in a position equal to the position that the party would have been in if the lease had been fully performed; that is, if the lessor paid out \$9,000 to purchase the equipment and was to collect \$10,000 in rent, under an “expectation damages” theory the lessor would be entitled to the present value of the \$10,000 that the lessor expected to collect under the lease. Expectation damages are generally considered to result in an economically efficient outcome but they can create surprising awards when a slight breach has dramatic consequences on a large contract.

Alternatively, an “out-of-pocket damages” remedy would seek to compensate the harmed party for the cost of its own performance under the contract or to restore the party to the position it was in when it entered the lease; under this theory, the lessor in the example above would be entitled to recoup its original \$9,000 expenditure but not the extra \$1,000 profit.

Damages under either theory could be limited by a requirement that the harmed party undertake reasonable efforts to mitigate its damages, either by re-letting the equipment or seeking replacement equipment from another source.

2. *Liquidated damages.* To what extent should the parties be free to specify in their contract a damages figure, in lieu of actual damages? Liquidated damages, either in the form of a specified sum or a formula, might be deemed impermissible under any circumstances, permissible under any circumstances or permissible provided that the damages are not unconscionable or bear a relationship to the actual (or anticipated) damages sustained.
3. *Specific performance.* Should parties be entitled to seek specific performance in the event of a breach? That remedy, under which parties are ordered to perform the contract according to its terms, is disfavoured in some circles, because it forces parties to continue a relationship that one party has deemed unsustainable. However, the remedy may be desirable in arrangements that involve unique goods, for which cover is unavailable.

V. Financial leases: the lessee-supplier relationship

- A. *Notice to supplier.* In order for a transaction to come within the terms of a financial leasing statute, should the supplier be given notice of the lease’s three-way structure? If the supplier is to be held liable to the lessee, in lieu of actual

contractual privity there is an argument that the supplier ought to be informed of the nature of the arrangement. On the other hand, requiring notice to the supplier may add little economic value, so requiring notice may be undesirable. One option would be to make certain rights — such as whether variations in the supply agreement should require the lessee's agreement — depend on whether the supplier had notice of the financial lease when the agreement was entered; if the supplier had notice that the agreement was to serve the lessee, then the lessee would have the right to approve or reject any proposed modifications to the supply agreement.

A. *Risk of loss.*

1. *Lessor's risk.* A traditional lessor, entering a sale-of-goods transaction with the supplier, would bear the risk of loss at some point, even if the lessor passed that risk to the lessee. If it is desirable for the risk of loss to be treated in the manner of a traditional sale of goods, then there arises the further question of whether the model law should contain such a risk of loss provision or whether the law should simply allow that matter to be governed by the implementing State's existing law regarding the sale of goods. However, a lessor in a financial lease, like a traditional financier, desires to limit its exposure to such risks of loss, so it may be desirable to treat the risk of loss as passing directly from the supplier to the lessee.
2. *Identification of the goods and casualty before delivery.* Some jurisdictions recognise a point in which goods or equipment are "identified," at which point the lessee obtains an insurable interest. In determining when the risk of loss should pass from the supplier to the lessee (or to the lessor), consideration might be given to linking identification to passage of the risk of loss. If identification did not occur until passage of the risk of loss, each party's interest would be more clear at each stage. This clarity would be useful, for instance, when goods that have already been identified suffer casualty before they are delivered; some jurisdictions provide that in such circumstances, the entire contract is cancelled. By linking identification to risk of loss, an arrangement could survive the destruction of goods before they were delivered.
3. Note regarding right of rejection: One conceptual difficulty with the risk of loss arises with the lessee's right of rejection. If the model law permits a lessee's right of rejection to arise, in some circumstances, after the lessee has accepted the goods, then there will be occasions when the supplier could suffer loss by rejection *after* the risk of loss has passed.

B. *Warranties.* If an implied warranty of merchantability and fitness for a particular purpose is desirable, should those warranties come from the supplier or the lessor? Again, in a traditional sale of goods and lease, the lessor would likely warrant the equipment's quality to the lessee. However, if the financial lease is purely a finance agreement, the supplier's warranties may run directly to the lessee.

VI. Rights of third parties

A. Priority rules

1. *Choice of law.* To what extent should the law simply rely on the implementing State's rules governing priority of interests? The law could either be silent in this respect, or it could provide for priority for certain interests. When an implementing State has existing rules, it may be hesitant to disrupt those rules with additional provisions; however, protecting a lessor's interest here may be critical to gaining lessors' acceptance.
2. *Lessor's interest.* When the law is deemed a lease rather than a security interest of any kind, it may be desirable to specify that the lessor's interest takes priority over the interests of any of the lessee's creditors. The priority of the lessor's interest may be made dependent on the lessor's compliance with any notice requirements of the implementing State or the model law may include a reporting structure for any jurisdictions that do not already have one.
 - a. *Statutory liens.* The lessor's interest may take subject to statutory liens, in order not to minimise disruption to the implementing State's existing priority rules.
 - b. *Lessor's creditors.* Should the law provide priority rules with respect to the lessor's creditors? Given the lessee's interest in obtaining the equipment free from any concerns regarding title, protecting the lessee against the lessor's creditors may be desirable. However, this might be accomplished through means besides the priority rules; guaranteeing the right of quiet enjoyment, for example, may satisfy this concern.
3. *Mechanics' lien.* Should the lessor's interest take priority over the interest provided in a traditional mechanics' lien? The unique status of mechanics' liens may warrant maintaining their priority, with the statutory lien, over the lessor's interest.

- ### B. *Third parties in tort.*
- Existing tort principles may give rise to actions against the lessee or lessor when a third party is harmed by the leased goods or equipment. However, it may be inappropriate to hold the lessor liable when the lessor played no role in selecting the goods. Thus, whilst it may be inadvisable to interfere with implementing States' determinations of when liability should exist, it may be appropriate to define which party to the lease should be liable for a particular harm.

APPENDIX I

**Model Rules for Lease Financing :
A Possible Complement to the UNIDROIT
Convention on International Financial Leasing**

Ronald C.C. Cuming *

In Memoriam

It was a privilege for me to be asked to contribute a paper for a publication in memory of Malcolm Evans, deceased, former Secretary General of UNIDROIT. I had the good fortune to work with Secretary General Evans as the Canadian member on the Committee of Governmental Experts which prepared the Conventions on International Financial Leasing and International Factoring that were adopted at the Ottawa Diplomatic Conference in 1988. My association with the Institute and with Mr Evans did not end upon completion of those projects; it continued when I was appointed a member of the Study Group for the draft Convention of International Interests in Mobile Equipment.

During the more than ten-year period of my association with the Institute, I experienced the kindness and generosity of Malcolm Evans and gained from his deep understanding of both private and public international law. I observed his skill as an administrator and consummate diplomat who was able to gather together experts from many countries in order to bring these projects to fruition.

In the following paragraphs I have proposed that the next step in the development of modern leasing law be taken. It is my view that the greatest tribute that can be paid to Malcolm Evans is to continue the development of international commercial law that was started under his leadership of the Institute.

I. – INTRODUCTION

The diminution of the role of the State in former East Bloc countries and other developing countries which has occurred in recent years, and the concomitant need for private business activity to fill the gap, have resulted in a dramatically increased demand for credit facilities by small businesses in these countries. While there are obvious exceptions, investment capital is generally not lacking; the problem is that it is not readily available to those who require it for creation or expansion of businesses. In many countries, banks hold savings that they are not prepared to make available as

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loans other than on a very short-term basis to very low-risk borrowers. The result is that business activity is hampered and development opportunities are lost. Often, the basis for the extremely conservative credit policies of lending institutions is the inadequacy of legal infrastructures within which credit can be granted.

Frequently, both domestic and foreign investors are prepared to provide credit to customers who have not established a credit record if the additional risk involved is covered, at least in part, by a right to seize or have seized property of the borrower in the event of default in payment under the credit contract. The property (collateral) provides an alternative source of payment. However, secured credit transactions cannot exist in a legal vacuum and the parties cannot through agreement control all the relevant factors. What is required is a legal infrastructure that regulates the various aspects of the relationships that arise in the context of secured financing transactions.

A problem that is faced by many developing nations is that sophisticated secured financing regimes are necessarily complex and costly to establish and maintain. This is so particularly where registries are central to the priority features of the regimes. Added to this is the fact that often the concepts and structures of a modern secured financing regime are foreign to the legal system of a country and are not understood by credit grantors and their legal advisors. While considerable progress has been made in recent years to assist these nations in the development of modern secured financing law,¹ it is unlikely that effective systems will be in widespread use in most of these countries for several years yet.

An increasing number of countries that encounter these problems have looked to lease financing as a method to address the lack or inadequacy of legal infrastructures for secured financing.² This form of secured financing is being embraced as an easily implemented interim measure. However, a considerable amount of conceptual confusion has resulted. This confusion is often a product of the failure to recognize the essential nature and functions of financing leases.

¹ For example, the European Bank for Reconstruction and Development (EBRD) reports that its Model Law on Secured Transactions, published in 1994, has been the basis for recent law reform proposals or new legislation in Azerbaijan, Hungary, Kyrgyzstan, Latvia, Moldova, the Russian Federation and the Slovak Republic. Through the efforts of the World Bank, draft secured financing laws have been prepared for Jordan and areas of the West Bank and Gaza governed by the Palestinian National Authority. Other organisations such as the National Law Center for Inter-American Free Trade and the Center for Economic Analysis of Law have prepared studies which are being considered as the basis for reform of secured financing laws of Central and South America.

² Of course, this is not the only reason for the dramatic increase in the use of lease financing that has occurred in many countries. Lease financing is common in countries that have sophisticated and efficient secured financing systems. There are also economic reasons for the growth in this type of secured financing. For example, because of its flexibility, leasing has been used as a vehicle to encourage through taxation laws the acquisition of new capital goods, thereby facilitating the modernisation of the manufacturing capacity of the country. It is used to stimulate capital goods production during periods of recession. Leasing can be used as a method through which alternative sources of finance can be made available in an otherwise oligopolistic or excessively restrictive loan market. Leasing can often be arranged more quickly and simply than conventional loan financing and the leasing contract can be easily structured to meet the cash flow needs of the lessee. Since leasing companies are generally not deposit-taking institutions, there is less need to subject them to regulatory controls and limitations imposed on credit grantors who rely on deposits for funds.

The International Institute for the Unification of Private Law (UNIDROIT) has provided the first set of international rules dealing with financial leasing transactions. The *UNIDROIT Convention on International Financial Leasing*, Ottawa, 1988 (hereinafter, the "*Convention*"), describes the essential features of one important type of modern leasing device: the tripartite financial leasing transaction. While the *Convention* was designed to deal with international financial leasing transactions and not to be a model for domestic law, it is increasingly being looked upon as a pattern for the development of national law dealing with this type of financing. While this should be encouraged, it is important to recognize that the *Convention* was not designed to address the legal and functional distinctions between true (operating) leases and financing leases. For the most part, it embodies the traditional approach to the relationship between lessors and lessees found in most legal systems. The lessor is treated as the owner of the leased property and not as a credit grantor who has provided financing for the purchase of the leased equipment by the lessee.

It is the view of the author that UNIDROIT should marshal the expertise that is available to it and develop a companion convention or model law that would not only provide rules applicable to international lease financing transactions but would also be a model for the development of national laws applicable to lease financing generally. Such a project would be a natural extension to the *Convention* and an appropriate addition to the project on secured financing that UNIDROIT has decided to undertake.³

II. – WHAT IS A FINANCING LEASE?

There is no precision in the use of labels for transactions of the kind examined in this paper. This is a product of both conceptual and terminological inconsistency within legal systems and between legal systems.

The term "lease" generally denotes a transaction under which the owner of property, a lessor, contractually grants possession of the property to another person, a lessee, for a specified period of time – the lease term – which is less than the useful life of the property, in return for periodic payment of money – the lease payments. At the end of the term, the property is returned to the lessor. During the term of the lease, the lessee has no property interest in the leased property other than that which, under the applicable law, is associated with possession. This type of transaction is generally referred to as an "operating lease".

However, the term "lease" is also used to refer to transactions that have as their essential function the financing of the purchase of movable property, usually equipment. These transactions come in many different configurations; however, in each case the intended end result is that the owner of the property has recovered its investment in the property and a return on that investment (an imputed rate of interest on the investment), while the person who acquires possession of the property has rights and obligations that, in practical effect, parallel those of a buyer. It is clear that, in functional terms, the

³ The reader will immediately appreciate that the conclusions reached by the author of this paper are ones that are heavily influenced by his views as to what are the conceptual underpinnings and functional characteristics of a modern secured financing regime. These views have been developed through experience in the context of the secured financing regimes of Canada and the United States.

transaction is a secured financing device and not a true lease, even though all the superficial trappings of a lease are used by the parties. In the balance of this paper, this type of arrangement is referred to as a "financing lease".⁴

There is no exhaustive list of factors the presence of which dictates the conclusion that a particular contract is a finance lease and not an operating lease. The problem of characterization of transactions in the form of leases is exacerbated by the fact that a particular transaction may have characteristics both of an operating lease and of a financing transaction. In these circumstances, it is necessary to determine which category of characteristic predominates. However, there is no shortage of "guidelines" available to anyone faced with the task of distinguishing finance leases from true leases. In both Canada and the United States there exists a wealth of academic literature⁵ and case law on the subject. In addition, §1-201(37) of the United States *Uniform Commercial Code*⁶ provides a list of factors that point to the existence of a security agreement in the form of a lease. In some countries, income tax laws or regulations provide rules for characterizing transactions as true leases or as security agreement. In addition, guidance may be obtained from national and international accounting standards.⁷

It is not possible in the context of this short paper to address fully all the factors that should be taken into account when determining whether a particular transaction is in substance an operating lease or a financing lease. However, it is possible to list those factors that are considered to be the most significant by legislators and courts who have had the task of identifying the fundamental differences between the two types of transactions. Generally, these factors are the ones that indicate which of the lessor and the lessee is the economic owner of the property. If the lessee has the bulk of rights and obligations generally associated with ownership of the property, the transaction is treated as a secured financing device used to secure the purchase price of the property.

If the lessee is required to pay what is the equivalent of the lessor's capital investment plus a credit charge at the commercial rate existing at the date of the agreement, and if the lessee has the right to possession of the property for all or a substantial part of

⁴ It is common in Canada and the United States to refer to these transactions as "security leases", since under the laws of most of the provinces of Canada and all of the states of the United States they are treated as security agreements subject to the regulatory regime that is applicable to all types of secured financing transactions involving movable property as collateral.

⁵ The issue has been the subject-matter of a significant volume of North American legal literature. The following is a sampling of this literature: R. CUMING, "True Leases and Security Leases under Canadian Personal Property Security Acts" (1982-83), 7 *Canadian Business Law Journal*, p. 251; G. GILMORE, *Security Interest in Personal Property*, Vol. II (Boston: Little Brown & Co., 1965), at pp. 337-9; H. ABRAMS "The Diminishing Difference Between Selling and Leasing Tangible Personal Property" (1979), 24 *Villanova Law Review*, p. 706; C. MOONEY, "Personal Property Leasing: A Challenge" (1981), 36 *Business Lawyer*, p. 1605; P. COOGAN, "Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?" (1981), 56 *New York University Law Review*, p. 1036; J. AYER, "On the Vacuity of the Sale/Lease Distinction" (1983), 68 *Iowa Law Review*, 667; I. JONES, "Lease or Secured Transaction – The Saga Continues Under the Bankruptcy Act" (1985), 90 *Commercial Law Journal*, p. 281.

⁶ See American Law Institute and National Conference of Commissioners on Uniform State Law, *Uniform Commercial Code*, Article 2A, 1987 Official Text amending Article 1, §1-210(37).

⁷ See International Accounting Standard No (17).

its useful life,⁸ a financing lease is involved. However, leases with terms less than the useful life of the property can also be financing leases. Where a clause in the lease gives to the lessee the option to purchase the property at less than its expected market value (as determined at the date of execution), the economic reality is that the lessee will exercise the option and acquire legal title to the property. Consequently, the transaction is a financing lease.

Some leases provide that rental payments made up to the point when the option is exercised are to be "credited" to the lessee and deducted from the amount payable under the option. By itself, the fact that any amount is credited to the lessee has little significance; it remains necessary to determine if the amount of new money to be paid by the lessee represents the reasonably expected fair market value of the property at the time of exercise of the option. If the new money is equal to or near the market value of the property, the "credit" is of no significance. If the amount of new money is significantly less than the market value of the property, the term of the contract providing for the credit is an overt recognition that the amount paid through its lease payments has been allocated by the lessor to the purchase of the property.

One of the more popular types of leases currently in use in many countries is the "open-end" lease. While a variety of different provisions are used in these leases, the general pattern is to fix the term for a period less than the useful life of the property. The lease provides that at the end of the term the property will be returned to the lessor, who will then sell it. The lessee may purchase the property from the lessor at its appraised value. Whether the lessee or a third person buys the property, the lessee agrees to pay to the lessor the difference between the amount recovered by the lessor on the sale of the property and a predetermined amount specified in the lease. If the sale yields more than this amount, the surplus is to be paid to the lessee. Since the term is for less than the useful life of the property and it is not predictable that the lessee will purchase the property at the end of the lease term, one might conclude that this type of transaction is a true lease. However, when other aspects of an open-end lease are examined, it becomes clear that the transaction is more properly characterized as a financing lease. Under an open-end lease, the lessor has no right to retake the leased property and assert ownership over it. It is returned to the lessor at the end of the term solely for the purpose of sale on behalf of the lessee. Under the terms of the lease, the lessor surrenders his unfettered right to possession of the property at the end of the term. Any unusual depreciation or appreciation of the property while it is in the hands of the lessee accrues to the lessee and not the lessor. Accordingly, the lessee is the person who is affected by the price obtained upon sale of the property by the lessor.

Before leaving characterization, it is necessary to remove uncertainty as to the meaning of another term: "financial leasing transaction".⁹ In the balance of this paper, the term "financial leasing transaction" is used to refer to a special tri-partite relation-

⁸ The fact that the initial term of the lease is less than the useful life of the property is not determinative. If the lessee is given an option to renew the lease for one or more terms equivalent to the useful life of the property and the rental payments during the new terms are significantly less than the market rate for leased property of the type involved, the economic reality is that the option will be exercised and the lessee will have possession of the property for its useful life.

⁹ Some of the relationships that arise in this type of transaction are regulated by the *Convention*.

ship between the supplier, the lessor and the lessee. A financial leasing transaction involves two separate, but related, contracts. The first contract is a supply contract, containing terms, approved by the lessee so far as they concern the lessee's interest, between the lessor and a supplier of property who is named by the lessee and who is aware that the property is to be leased to the lessee. The ownership of the property is transferred to the lessor under this contract. When selecting the supplier and the property, the lessee is not relying primarily on the skill or judgment of the lessor. The second contract is a lease of the property by the lessor to the lessee. While the transaction between the lessor and lessee under a financial leasing transaction is usually a financing lease,¹⁰ it is sometimes an operating lease.

Financing leases can be used either by lessors who are not suppliers and who assume the role of third party financiers for the acquisition of equipment, or by lessors who are suppliers of the equipment. When determining whether a lease is an operating lease or a financing lease, it is not relevant that a supplier of the leased property is or is not involved.

III. – WHAT DOES A FINANCE LEASING OFFER ?

Not many developing States have effective legal structures for secured financing. States of the former Soviet Union have only what can be recalled from the pre-Soviet era. States which inherited or have adopted civil codes are likely to have unsophisticated secured financing regimes, since traditionally the civil law did not recognize non-possessory secured financing devices.¹¹ States which inherited the English common law have the conceptual structure for secured financing, but may not have the necessary administrative legal infrastructure that allows them to take full advantages of devices such as conditional sales contracts and legal and equitable mortgages. Indeed, many of them will have inherited the peculiarities of English sale of goods law that induced the development of "hire-purchase" in England as the principal legal device for the financing of the purchase of equipment and durable consumer goods.¹²

Modern, efficient secured financing regimes such as those found in the states of the United States of America and most of the provinces of Canada are complex and function in the context of registry systems which are expensive to establish¹³ and require expert management. It is difficult enough to implement these regimes in societies which have

¹⁰ The extent to which this is recognised in the *Convention* is addressed later in this paper.

¹¹ Most civil codes recognise title retention sales contracts which, however, are not viewed as secured financing devices.

¹² Under established legal doctrine, a hire-purchase transaction is not a mortgage (or other agreement providing for a security interest or charge), since there is no disposition of the property by the owner in favour of a creditor. It is not a sale of goods so long as the lessee has no obligation to purchase the leased property. However, in this respect, English common law has adopted form over substance.

¹³ Not all registry systems are computerised. However, in order to be effective, registrations relating to interests in mobile property should be centralised; there should be a single registry for all such interests. Centralisation results in the need to handle large numbers of registrations. Unless the system is mechanised, it will be very labour-intensive and the administrative costs will be high. Furthermore, manual handling of registration documents often results in long delays in effecting registration and obtaining search results.

long experience with secured financing and the use of registries for security interests.¹⁴ It is much more difficult to implement them in States in which secured financing is not well understood by legislators and business communities. Successful implementation depends upon the availability of business and legal expertise that may not be available.

The principal advantages of finance leasing over more traditional secured financing devices is familiarity and apparent simplicity. The concept of lease is a feature of all legal systems. It is easily understood and can be implemented without the necessity for a complex legal infrastructure. The lessor's "ownership" provides the security for the obligations of the lessee-buyer. Upon default in payment, the lessor can repossess the leased property or have it seized and returned to it. The finance lease contract is very flexible, with the result that the parties have broad scope to arrange their *inter partes* affairs to meet their particular circumstances. Unless the law of the jurisdiction applies the civil law principle of "*en fait de meubles, la possession vaut titre*" to lease transactions, the lessor's ownership gives to the lessor protection against third party claims and the lessee's trustee in bankruptcy without the need to comply with public disclosure requirements.

IV. – THE PRACTICAL LIMITATIONS OF FINANCE LEASING

Finance leasing is not a complete substitute for an effective, modern secured financing regime. It has an important, but limited role. As such, it can be viewed as a first step in a transition to a complete regime of secured financing law.

Finance leasing is a device that works well when financing is required for the acquisition of equipment or other high-priced durable movable property. As noted above, it can be used in cases where the financing is being provided by a supplier of the equipment or where it is being provided by an independent financier. In addition, it is possible to use a highly formalistic version of financing lease, the sale and lease-back, as a method of securing a loan made by the lessor to the lessee essentially on the security of the lessee's equipment. In technical terms, the borrower sells the property to the

¹⁴ States with modern, advanced economies such as the United Kingdom, Australia and New Zealand have yet to adopt such systems, notwithstanding the recommendations of experts that they do so. See The Committee on Consumer Credit, *A Critique of Present Credit Law*, Her Majesty's Stationery Office, London, (Cmnd. 4596), 1971; A.L. DIAMOND, *A Review of Security Interests in Property*, Her Majesty's Stationery Office, London, 1989; Australian Law Reform Commission, *Personal Property Securities*, Report No. ALRC 64 (interim) (1993); Queensland Law Reform Commission and Law Reform Commission of Victoria, *Personal Property Securities Law: A Blueprint for Reform*, Discussion Paper QLRC 39, Discussion Paper VLRC 28 (1992); New Zealand Law Commission, *Report No. 8: A Personal Property Securities Act for New Zealand* (1989). See also J. FARRAR and M. O'REGAN, New Zealand Law Commission *Preliminary Paper No. 6: Reform of Personal Property Security Law: A Report to the Law Commission* (1988). For a brief discussion of these reports, see R. CUMING, "The Internationalization of Secured Financing Law: the Spreading Influence of the Concepts of UCC, Article 9 and its Progeny", in *Making Commercial Law*, Cranston ed. (Oxford: Clarendon Press, 1997), p. 499 at pp. 511-517.

lender and then leases it from the lender under a financing lease arrangement. In effect, the lessee is buying back the property.¹⁵

However, finance leasing cannot be used as a vehicle for financing the acquisition of inventory. It is fundamental to a finance leasing contract that the lessee-buyer retains the equipment, since this is the lessor's security. By definition, inventory collateral will be sold by the debtor in the ordinary course of its business. Further, lease financing law provides no method for securing direct advances of funds made to the lessee-buyer after delivery of the leased property. A finance lease provides security only for the "purchase price" of the property acquired under the lease and default charges. Further, lease financing law provides no conceptual basis on which to recognize a security interest in proceeds received by the lessee-buyer from use of the leased equipment. The only security available to a lessor under a finance lease is its "ownership" of the leased property.

A modern secured financing regime does not have these deficiencies. A central feature of such a regime is the recognition that an obligation can be secured, not only by property of any kind owned by the debtor at the date of execution of the security agreement, but also property acquired by the debtor at a future time during the currency of the agreement. Consequently, the purchase price of property and any other obligation of the debtor to the secured party can be secured through a security interest not only in the property itself, but also by other property then owned or later acquired by the purchaser.

V. – THE CONCEPTUAL CONFUSION ASSOCIATED WITH FINANCE LEASING

As noted above, a financing lease is in substance not a lease, but a secured financing device in the guise of a lease. While this form of legal fiction can be useful, it can also be a source of confusion and injustice. If the rights of the parties to a financing lease are regulated on the basis that the contract between them is a true lease, the law becomes distorted and important economic interests can be overlooked.

The paradigm for a secured financing regime is a debt or other obligation that is collaterally secured by an interest in property of the debtor. In substance, a security agreement is one under which the owner of property recognizes through an agreement that another person has or will automatically acquire an interest in that property in order to secure an obligation. The function of a security agreement is to provide to an obligee an *in rem* interest¹⁶ in property of the debtor that secures the obligation.

A lease is a fundamentally different transaction. The lessor "owns" the leased property; the lessee has temporary possession of it under the terms of the lease contract. Unlike a secured financing transaction, the purpose of a true lease is not to finance the acquisition of the property by the lessee. The lessor expects to get its property back at

¹⁵ Of course, this type of transaction may well be viewed under the applicable law as nothing more than a mortgage. However, this will not be the case in jurisdictions where formalism dominates.

¹⁶ This could be "ownership" transferred to the secured party or a charge on the debtor property interest in the collateral. However, even where a transfer of ownership is involved, most systems recognize that the secured creditor is not to be treated as having unfettered ownership. In common law systems, the debtor is treated as the equitable or beneficial owner.

the end of the lease term. Consequently, when a transaction cast in the form of a lease is used as a financing device, what is hidden in the relationship between the lessor and the lessee is the fact that the lessee is acquiring under the transaction an economic interest in the leased property that goes well beyond temporary use of it. By making the lease payments, the lessee is "buying" an interest in the leased property.

The commercial realities of financing leases present an important conceptual and functional question: what type of legal regime is needed to recognize fully and accurately the relative rights of the parties to a financing lease and the rights of third parties who acquire interests in leased property from lessees in possession? It is clear that traditional leasing law is inadequate; it does not reflect the fact that the purpose of the transaction is to finance purchase price property being acquired by the lessee. Further, it is not possible in most jurisdictions to describe the rights of lessors and lessees under financing leases by analogy to the seller-buyer relationship arising under a title retention sale of goods contract. Under most legal systems, a buyer is not recognized as acquiring any proprietary interest in the goods until the full purchase price is paid. This approach is not confined to systems based on traditional civil law, which does not accept the concept of "equitable" or limited interests in property. It is applied as well in most common law jurisdictions,¹⁷ including England.¹⁸ The problem for many legal systems in accepting that the lessee has an *in rem* interest in the leased property commensurate with the payments made to the lessor is that this conclusion cannot be supported by analogy to any existing legal construct.

Legal systems that give explicit recognition to the interest of the lessee-buyer and provide a conceptual basis for this recognition treat the lessee as an owner of the property who has charged that property. This is possible because these systems adopt function, not form, as the primary factor on which characterization of transactions is based. Transactions in the form of leases that function as secured financing devices are treated as secured financing devices and, consequently, are fully integrated into secured financing regimes.¹⁹ This is not an option for many countries that are looking to lease financing as a device that can address at least in part the lack of other modern forms of secured financing. While strict adherence to formalism may be weakening in many parts of the world, it is too much to expect many legal systems to recognize that a lessee under a financing lease is to be treated in law as the owner of the leased property subject to a charge held by the lessor.²⁰

¹⁷ Other than the provinces of Canada and the states of the United States.

¹⁸ See R.M. GOODE, *Legal Problems of Credit and Security*, 2nd ed. (London: Sweet & Maxwell, 1988), p. 6.

¹⁹ See *Uniform Commercial Code, Article 9, supra* note 5, §9-102, and *The Personal Property Security Act, 1993*, Revised Statutes of Saskatchewan, Ch. P-6.2, Sections 2 (qq) and 3 (which is representative of secured financing law that has been adopted in ten of twelve Canadian provinces and territories). See generally, R. CUMING and R. WOOD, *Saskatchewan and Manitoba Personal Property Security Handbook* (Calgary: Carswell Co. 1994), pp. 41-49.

²⁰ The difficulties associated with getting agreement at the international level with respect to the characterisation of transactions which involves rejecting formalism was recently demonstrated in the context of the draft UNIDROIT Convention on Interests in Mobile Equipment. It was not possible to get agreement among the members of the Study Group to treat financing leases and title reservation sales

It is the view of the author that the most realistic approach is to provide special measures in the context of the law applicable generally to leasing which recognize the peculiar relationships that arise in the context of lease financing. In practice, if not in theory, this would entail accepting that the lessee has a legally recognized interest in the leased property beyond temporary possession which requires legal protection. As the secured financing law of a jurisdiction develops to the point where it can absorb lease financing as a secured financing device, these special measures can be repealed and the legal fiction that the transaction is a lease can be dropped.

In the following paragraphs, the author describes these special measures and explores the extent to which they can be found in the *Convention*.²¹

VI. – SPECIAL LEGISLATIVE MEASURES

1. *Disposition of the lessor's interest*

A lessor under a true lease is the owner of the leased property who has agreed to surrender possession of the property to the lessee for a specified period of time. Once that period has expired or is prematurely terminated because of default by the lessee or for some other reason, the lessor is entitled to regain possession of the leased property. As owner, the lessor has full rights of disposition of ownership in the property before and after termination of the lessee's right to possession.

The rights of a lessor under a financing lease should be quite different, since they must be limited to the extent that it is necessary to recognize the lessee's interest in the leased property. Under most financing leases, it is the expectation of the lessee that full economic, if not legal, ownership of the leased property will ultimately vest in the lessee. It follows that any disposition by the lessor of its interest in the leased property must be subject to the rights of the lessee arising under the lease contract, including,

agreements as security agreements. Three distinct types of transactions are addressed in the *Convention*: security agreements, leases and title reservation agreements. See Article 1, clauses (i), (v) and (w). Whether or not an agreement in the form of a lease is treated as a security agreement is a matter to be determined by the law of the forum. The result is that, if the matter comes before a court of the United States or Canada, a financing lease would be treated as a security agreement; however, if it comes before a court of a civil law jurisdiction, the same transaction is likely to be treated as a lease.

²¹ While it is possible to apply the *Convention* to financial (tripartite) leasing transactions involving an operating lease, its primary focus is on transactions involving finance leases. Article 1, paragraph 2 defines a "financial leasing transaction" as a transaction involving a number of features including a lease under which the "the rentals payable ... are calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment." Article 1, paragraph 3 provides that the "*Convention* applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental." Although there are several factors that point to the existence of a finance lease, the most common is the requirement that the lessee pay all or most of the cost of the leased equipment. While it is conceivable that the market conditions at the time a lease is executed are such that the lessee under an operating lease is prepared to pay lease payments that cumulatively amount to substantially all of the lessor's capital cost of the leased property, this would be very unusual.

upon performance of the lessee's obligations under the contract, the right to be treated as the owner of the property.

The *Convention* provides in Article 14 that the lessor "may transfer or otherwise deal with" its rights in the equipment, but a transfer does not "relieve the lessor of its duties under the lease agreement ..." Clearly, the Article was designed, not to preserve as against a third party the rights of the lessee, but to supplement Article 8, paragraph 2 which states the warranty of quiet possession. The *Convention* appears to leave to the applicable law the effect of a transfer of the lessor's ownership on the rights of the lessee under the lease.

2. *The lessee's interest in a surplus*

The lessor must have full rights to recover possession of the leased property in the event of default by the lessee. However, repossession by the lessor should not result in termination of the lessee's rights under the lease contract other than the right of possession. Since the lessee has made payments that implicitly have been applied to the purchase price of the leased property, the lessor should not be able to ignore the economic interest in the property that the lessee has acquired through these payments.

Article 13 of the *Convention* provides that upon "substantial default"²² by the lessee, the lessor may terminate the contract and recover possession of the equipment. The Article provides that the lessor may recover such damages as will place the lessor in the position in which it would have been had the lessee performed in accordance with the lease terms, and that the value of rental payments made "may be taken into account" in computing the damages. However, there is no requirement that the lessee's commercial interest in the leased property be protected except to the extent that this interest is reflected in calculation of damages recoverable by the lessor. Consequently, there is no requirement that the lessor account to the lessee for any surplus. This, also, is a matter to be left to the applicable law.

The way in which the lessee's interest can be recognized is to require that the lessor sell the leased property or in some other way determine its market value. The lessee's interest is the amount that this value, when added to the payments made by the lessee, exceeds the amount owing to the lessor under the terms of the lease. This amount should be returned to the lessee since otherwise the lessor would recover more than it would receive if the lessee had not defaulted.

3. *Protecting the lessee's "right of redemption" and the lessor's "security"*

There are other ways in which the lessee's economic interests in property under a finance lease should be recognized. A lessee should have a right to "redeem" its interest after default by tendering to the lessor the balance owing to the lessee under the agreement. In consumer lease situations at least, the lessee should have a limited right to reinstate the agreement and retain or regain possession by correcting any default. There is no recognition of these rights in the *Convention*.

Some jurisdictions provide *de facto* protection to lessee's interests in leased property by limiting the repossession rights of lessors. These limitations usually come in

²² This term is not defined in the *Convention*.

two forms: a prohibition on the right of the lessor to retake possession until there has been failure on the part of the lessee to make several lease payments,²³ and the requirement that the lessor obtain a court order before repossessing the leased equipment. There is nothing that would make these limitations conceptually unacceptable in the context of financing leases; however, it is the view of the author that neither of these measures should be applied in this context. In practice, they diminish the economic value of lease financing.

While a case can be made for limiting a lessor's right to repossession of property leased under a financing lease by requiring a pre-seizure notice to the lessee so as to allow the lessee to correct any default and avoid the costs of repossession, it is important that the period between default and repossession be short. The requirement that the lessor refrain from retaking possession for other than a short period after default or that it obtain a court order before retaking possession or having the property seized, seriously diminishes the efficacy of finance leasing.²⁴ Since the role of the transaction is to provide for the sale of the leased property and security for the amount owing by the lessee, there is generally a direct relationship between the value of the property and the amounts payable under the lease agreement. If the lessor is precluded from exercising its right of repossession for a significant period after default by the lessee, there is a real chance that the lessor will experience loss on the transaction in the not unlikely event that property depreciates rapidly in value while in the possession of a judgment-proof lessee.

4. *Third party protection*

Most modern secured financing systems provide for the public disclosure of security interests in order to protect third parties from loss when they acquire property subject to security interests enforceable against them. However, few legal systems provide for the registration of lessor's ownership in leased property. Like any other owner, a lessor is entitled to assert his or her ownership against the claims of third parties.²⁵ A UNIDROIT Study Group has already adopted this approach for leases of equipment that fall within the scope of the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment which, in this respect, treats leases (whether operating leases or financing leases), security agreements and title reservation agreements in the same way. A registration relating to the transaction must be effected in a registry established pursuant to a protocol if the lessor's interest is to be enforceable against other competing

²³ As noted above, the *Convention* does not permit termination of the lease contract and repossession of the leased property unless there has been a "substantial default" on the part of the lessee.

²⁴ This is not to suggest that a lessor should be able to retake possession without a court order when to do so would result in a breach of the peace. However, even in such situations, the order which the lessor will require should be made available through expedited proceedings so that the period between default and the date of seizure is very short.

²⁵ This generalisation does not apply to most of the common law provinces in Canada, which subject all personal property leases having a term of more than one year to the registration and priority rules applicable to security interests in personal property. See, e.g., *The Personal Property Security Act, 1993*, Revised Statutes of Saskatchewan, Ch. P6.2, Sections 2 (qq) and 3 (which is representative of secured financing law that has been adopted in nine of twelve Canadian provinces and territories).

interests in the leased property. See generally, Articles 16-22 and 28-29.²⁶ The issue arises as to whether the formal characterization of a financing lease as a leasing transaction or the economic reality that it is a secured financing transaction should prevail in the context of the question whether or not it should be subject to public disclosure requirements.

It is the view of the author that a strong case can be made for treating a financing lease in the same way as a security agreement in this respect, and requiring public disclosure of its existence. Given the fact that, in most cases, the lessee will be in possession of the leased property for a long period of time (in some cases for its full economic life) and that the lessee has all of the obligations of an owner of the property such as keeping it in repair, obtaining the necessary licences for its use and paying property tax levied on it, all of the outward indicia of ownership are likely to be present. Consequently, the potential for deception of third parties who purchase or otherwise attempt to acquire interests in the property is great.

Should this approach be adopted, the registration of financing leases could be regulated under the same regime that is applicable to security agreements. However, where lease financing is used as a substitute for effective secured financing devices, the likelihood that a functional system of public disclosure for security interests is available is small. In such cases, a second-best approach would have to be adopted such as requiring the lessor to affix a permanent notice on the leased equipment indicating that it is the "owner" of it.

VII. – SUMMARY

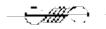
The financing lease is being widely used as an alternative to secured financing devices. Its attractiveness is based on the assumption that it is just another form of lease. However, this is deceptive. The conceptual structure of traditional lease law is not adequate to accommodate this form of financing in that it does not provide a proper basis for recognition of the lessee's economic interests in the leased property. This interest is much more than temporary possession of property owned by the lessor; it is an interest that, in economic terms, is equivalent to that of a buyer of the leased property. Although the accounting profession and tax authorities in some countries have recognized this reality, few legal systems in the world have done so.

The road block that stands in the way of legal recognition of the special nature of a financing lease is that the transaction does not fit neatly within any of the traditional categories of transactions. To treat the lessee as a buyer under a title retention sales contract does not solve the problem since, under most legal systems, such buyers are not treated as having *in rem* rights in the property being purchased until the full purchase price has been paid. While most jurisdictions in Canada and the United States treat the lessee under a finance lease as the owner of the leased property and the lessor as the holder of a security interest (charge) on the property, it is unlikely that this approach will have wide-spread appeal for the immediate future. It requires rejection of the traditional

²⁶ See Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment, *Uniform Law Review* 1998-1, p. 76.

formalism on a scale that is likely to be unacceptable to most legislators and legal theorists.

It is the view of the author that in these circumstances, pragmatism rather than traditional legal doctrine must govern. What will be required in most jurisdictions is special statutory measures of the kind suggested in the preceding paragraphs of this paper. Such measures should be viewed as temporary, however. Although the trappings of leasing law would be retained, in substance they would treat the relationship between the lessor and lessee as equivalent to the relationship between a secured party and a buyer-debtor. When a jurisdiction comes to the point of modernizing its secured financing law so as to place greater emphasis on functional considerations and less on traditional legal doctrine, the true nature of financing leases can be recognized through their complete integration into the new regime.



APPENDIX II

**PRELIMINARY COMMENTS REGARDING THE KEY ISSUES TO BE DEALT WITH IN
A MODEL LAW ON LEASING**

***by Mr R. Castillo-Triana (Colombia),
Member of the Advisory Board***

1. Definition of leasing (following the UNIDROIT Convention definition). Important to define the tripartite nature of the transaction and the rationale of the "hell or high-water" clause. Expand the concept to contemplate both operating and finance leases (if possible improve the current regulation under Articles 2 and 2A of the Uniform Commercial Code of the U.S.A.);
2. Qualification of lessors: Should lessors be financial institutions? Are market-entry regulatory barriers necessary? Can a good corporate governance regulation supersede regulatory controls?
3. Rights and obligations of the parties;
4. Effects of leasing transactions on third parties (including third party liabilities and whether a registration system similar to the Cape Town Convention on International Interests in Mobile Equipment should be implemented);
5. Remedies and enforcement of leasing transactions (can out-of-court repossession be legally possible?);
6. Special types of leasing (infrastructure leasing, embedded leasing in total solutions, pay-per use leases and others);
7. Incentives that Governments can/may/must give to the leasing industry (foundation: the Delong-Summers Study: Equipment Investment and Economic Growth: how bid is the nexus?);
8. Funding vehicles for leasing transactions (asset transferable, rights of lenders, etc.);
9. End-of-lease or terminal options.

APPENDIX III

UNIDROIT CONVENTION ON
INTERNATIONAL FINANCIAL LEASING

(Ottawa, 28 May 1988)

THE STATES PARTIES TO THIS CONVENTION,

RECOGNISING the importance of removing certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction,

AWARE of the need to make international financial leasing more available,

CONSCIOUS of the fact that the rules of law governing the traditional contract of hire need to be adapted to the distinctive triangular relationship created by the financial leasing transaction,

RECOGNISING therefore the desirability of formulating certain uniform rules relating primarily to the civil and commercial law aspects of international financial leasing,

HAVE AGREED as follows:

CHAPTER I – SPHERE OF APPLICATION AND
GENERAL PROVISIONS

Article 1

1. – This Convention governs a financial leasing transaction as described in paragraph 2 in which one party (the lessor),

(a) on the specifications of another party (the lessee), enters into an agreement (the supply agreement) with a third party (the supplier) under which the lessor acquires plant, capital goods or other equipment (the equipment) on terms approved by the lessee so far as they concern its interests, and

(b) enters into an agreement (the leasing agreement) with the lessee, granting to the lessee the right to use the equipment in return for the payment of rentals.

2. – The financial leasing transaction referred to in the previous paragraph is a transaction which includes the following characteristics:

(a) the lessee specifies the equipment and selects the supplier without relying primarily on the skill and judgment of the lessor;

(b) the equipment is acquired by the lessor in connection with a leasing agreement which, to the knowledge of the supplier, either has been made or is to be made between the lessor and the lessee; and

(c) the rentals payable under the leasing agreement are calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment.

3. – This Convention applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental.

4. – This Convention applies to financial leasing transactions in relation to all equipment save that which is to be used primarily for the lessee's personal, family or household purposes.

Article 2

In the case of one or more sub-leasing transactions involving the same equipment, this Convention applies to each transaction which is a financial leasing transaction and is otherwise subject to this Convention as if the person from whom the first lessor (as defined in paragraph 1 of the previous article) acquired the equipment were the supplier and as if the agreement under which the equipment was so acquired were the supply agreement.

Article 3

1. – This Convention applies when the lessor and the lessee have their places of business in different States and:

(a) those States and the State in which the supplier has its place of business are Contracting States; or

(b) both the supply agreement and the leasing agreement are governed by the law of a Contracting State.

2. – A reference in this Convention to a party's place of business shall, if it has more than one place of business, mean the place of business which has the closest relationship to the relevant agreement and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that agreement.

Article 4

1. – The provisions of this Convention shall not cease to apply merely because the equipment has become a fixture to or incorporated in land.

2. – Any question whether or not the equipment has become a fixture to or incorporated in land, and if so the effect on the rights inter se of the lessor and a person having real rights in the land, shall be determined by the law of the State where the land is situated.

Article 5

1. – The application of this Convention may be excluded only if each of the parties to the supply agreement and each of the parties to the leasing agreement agree to exclude it.

2. – Where the application of this Convention has not been excluded in accordance with the previous paragraph, the parties may, in their relations with each other, derogate from or vary the effect of any of its provisions except as stated in Articles 8(3) and 13(3)(b) and (4).

Article 6

1. – In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

2. – Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

CHAPTER II – RIGHTS AND DUTIES OF THE PARTIES

Article 7

1. – (a) The lessor's real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution.

(b) For the purposes of this paragraph "trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors.

2. – Where by the applicable law the lessor's real rights in the equipment are valid against a person referred to in the previous paragraph only on compliance with rules as to public notice, those rights shall be valid against that person only if there has been compliance with such rules.

3. – For the purposes of the previous paragraph the applicable law is the law of the State which, at the time when a person referred to in paragraph 1 becomes entitled to invoke the rules referred to in the previous paragraph, is :

(a) in the case of a registered ship, the State in which it is registered in the name of the owner (for the purposes of this sub-paragraph a bareboat charterer is deemed not to be the owner);

(b) in the case of an aircraft which is registered pursuant to the Convention on International Civil Aviation done at Chicago on 7 December 1944, the State in which it is so registered;

(c) in the case of other equipment of a kind normally moved from one State to another, including an aircraft engine, the State in which the lessee has its principal place of business;

(d) in the case of all other equipment, the State in which the equipment is situated.

4. – Paragraph 2 shall not affect the provisions of any other treaty under which the lessor's real rights in the equipment are required to be recognised.

5. – This article shall not affect the priority of any creditor having:

(a) a consensual or non-consensual lien or security interest in the equipment arising otherwise than by virtue of an attachment or execution, or

(b) any right of arrest, detention or disposition conferred specifically in relation to ships or aircraft under the law applicable by virtue of the rules of private international law.

Article 8

1. – (a) Except as otherwise provided by this Convention or stated in the leasing agreement, the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent that the lessee has suffered loss as the result of its reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the equipment.

(b) The lessor shall not, in its capacity of lessor, be liable to third parties for death, personal injury or damage to property caused by the equipment.

(c) The above provisions of this paragraph shall not govern any liability of the lessor in any other capacity, for example as owner.

2. – The lessor warrants that the lessee's quiet possession will not be disturbed by a person who has a superior title or right, or who claims a superior title or right and acts under the authority of a court, where such title, right or claim is not derived from an act or omission of the lessee.

3. – The parties may not derogate from or vary the effect of the provisions of the previous paragraph in so far as the superior title, right or claim is derived from an intentional or grossly negligent act or omission of the lessor.

4. – The provisions of paragraphs 2 and 3 shall not affect any broader warranty of quiet possession by the lessor which is mandatory under the law applicable by virtue of the rules of private international law.

Article 9

1. – The lessee shall take proper care of the equipment, use it in a reasonable manner and keep it in the condition in which it was delivered, subject to fair wear and tear and to any modification of the equipment agreed by the parties.

2. – When the leasing agreement comes to an end the lessee, unless exercising a right to buy the equipment or to hold the equipment on lease for a further period, shall return the equipment to the lessor in the condition specified in the previous paragraph.

Article 10

1. – The duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee. However, the supplier shall not be liable to both the lessor and the lessee in respect of the same damage.

2. – Nothing in this article shall entitle the lessee to terminate or rescind the supply agreement without the consent of the lessor.

Article 11

The lessee's rights derived from the supply agreement under this Convention shall not be affected by a variation of any term of the supply agreement previously approved by the lessee unless it consented to that variation.

Article 12

1. – Where the equipment is not delivered or is delivered late or fails to conform to the supply agreement:

(a) the lessee has the right as against the lessor to reject the equipment or to terminate the leasing agreement; and

(b) the lessor has the right to remedy its failure to tender equipment in conformity with the supply agreement,

as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.

2. – A right conferred by the previous paragraph shall be exercisable in the same manner and shall be lost in the same circumstances as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.

3. – The lessee shall be entitled to withhold rentals payable under the leasing agreement until the lessor has remedied its failure to tender equipment in conformity with the supply agreement or the lessee has lost the right to reject the equipment.

4. – Where the lessee has exercised a right to terminate the leasing agreement, the lessee shall be entitled to recover any rentals and other sums paid in advance, less a reasonable sum for any benefit the lessee has derived from the equipment.

5. – The lessee shall have no other claim against the lessor for non-delivery, delay in delivery or delivery of non-conforming equipment except to the extent to which this results from the act or omission of the lessor.

6. – Nothing in this article shall affect the lessee's rights against the supplier under Article 10.

Article 13

1. – In the event of default by the lessee, the lessor may recover accrued unpaid rentals, together with interest and damages.

2. – Where the lessee's default is substantial, then subject to paragraph 5 the lessor may also require accelerated payment of the value of the future rentals, where the leasing agreement so provides, or may terminate the leasing agreement and after such termination:

(a) recover possession of the equipment; and

(b) recover such damages as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms.

3. – (a) The leasing agreement may provide for the manner in which the damages recoverable under paragraph 2 (b) are to be computed.

(b) Such provision shall be enforceable between the parties unless it would result in damages substantially in excess of those provided for under paragraph 2 (b). The parties may not derogate from or vary the effect of the provisions of the present sub-paragraph.

4. – Where the lessor has terminated the leasing agreement, it shall not be entitled to enforce a term of that agreement providing for acceleration of payment of future rentals, but the value of such rentals may be taken into account in computing damages under paragraphs 2(b) and 3. The parties may not derogate from or vary the effect of the provisions of the present paragraph.

5. – The lessor shall not be entitled to exercise its right of acceleration or its right of termination under paragraph 2 unless it has by notice given the lessee a reasonable opportunity of remedying the default so far as the same may be remedied.

6. – The lessor shall not be entitled to recover damages to the extent that it has failed to take all reasonable steps to mitigate its loss.

Article 14

1. – The lessor may transfer or otherwise deal with all or any of its rights in the equipment or under the leasing agreement. Such a transfer shall not relieve the lessor of any of its duties under the leasing agreement or alter either the nature of the leasing agreement or its legal treatment as provided in this Convention.

2. – The lessee may transfer the right to the use of the equipment or any other rights under the leasing agreement only with the consent of the lessor and subject to the rights of third parties.

CHAPTER III – FINAL PROVISIONS

Article 15

1. – This Convention is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Unidroit Conventions on International Factoring and International Financial Leasing and will remain open for signature by all States at Ottawa until 31 December 1990.

2. – This Convention is subject to ratification, acceptance or approval by States which have signed it.

3. – This Convention is open for accession by all States which are not signatory States as from the date it is open for signature.

4. – Ratification, acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary.

Article 16

1. – This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the third instrument of ratification, acceptance, approval or accession.

2. – For each State that ratifies, accepts, approves, or accedes to this Convention after the deposit of the third instrument of ratification, acceptance, approval or accession, this Convention enters into force in respect of that State on the first day of the month following the expiration of six months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

Article 17

This Convention does not prevail over any treaty which has already been or may be entered into; in particular it shall not affect any liability imposed on any person by existing or future treaties.

Article 18

1. – If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may substitute its declaration by another declaration at any time.

2. – These declarations are to be notified to the depositary and are to state expressly the territorial units to which the Convention extends.

3. – If, by virtue of a declaration under this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purposes of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.

4. – If a Contracting State makes no declaration under paragraph 1, the Convention is to extend to all territorial units of that State.

Article 19

1. – Two or more Contracting States which have the same or closely related legal rules on matters governed by this Convention may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral declarations.

2. – A Contracting State which has the same or closely related legal rules on matters governed by this Convention as one or more non-Contracting States may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States.

3. – If a State which is the object of a declaration under the previous paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which the Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under paragraph 1, provided that the new Contracting State joins in such declaration or makes a reciprocal unilateral declaration.

Article 20

A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession that it will substitute its domestic law for Article 8(3) if its domestic law does not permit the lessor to exclude its liability for its default or negligence.

Article 21

1. – Declarations made under this Convention at the time of signature are subject to confirmation upon ratification, acceptance or approval.

2. – Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.

3. – A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary. Reciprocal unilateral declarations under Article 19 take effect on the first day of the month following the expiration of six months after the receipt of the latest declaration by the depositary.

4. – Any State which makes a declaration under this Convention may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.

5. – A withdrawal of a declaration made under Article 19 renders inoperative in relation to the withdrawing State, as from the date on which the withdrawal takes effect, any joint or reciprocal unilateral declaration made by another State under that article.

Article 22

No reservations are permitted except those expressly authorised in this Convention.

Article 23

This Convention applies to a financial leasing transaction when the leasing agreement and the supply agreement are both concluded on or after the date on which the Convention

enters into force in respect of the Contracting States referred to in Article 3(1)(a), or of the Contracting State or States referred to in paragraph I (b) of that article.

Article 24

1. – This Convention may be denounced by any Contracting State at any time after the date on which it enters into force for that State.

2. – Denunciation is effected by the deposit of an instrument to that effect with the depositary.

3. – A denunciation takes effect on the first day of the month following the expiration of six months after the deposit of the instrument of denunciation with the depositary. Where a longer period for the denunciation to take effect is specified in the instrument of denunciation it takes effect upon the expiration of such longer period after its deposit with the depositary.

Article 25

1. – This Convention shall be deposited with the Government of Canada.

2. – The Government of Canada shall:

(a) inform all States which have signed or acceded to this Convention and the President of the International Institute for the Unification of Private Law (Unidroit) of:

(i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;

(ii) each declaration made under Articles 18, 19 and 20;

(iii) the withdrawal of any declaration made under Article 21 (4);

(iv) the date of entry into force of this Convention;

(v) the deposit of an instrument of denunciation of this Convention together with the date of its deposit and the date on which it takes effect;

(b) transmit certified true copies of this Convention to all signatory States, to all States acceding to the Convention and to the President of the International Institute for the Unification of Private Law (Unidroit).

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorised by their respective Governments, have signed this Convention.

DONE at Ottawa, this twenty-eighth day of May, one thousand nine hundred and eighty-eight, in a single original, of which the English and French texts are equally authentic.

APPENDIX IV

UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING
AND RELATED MATTERS

(updated as of September 2005)

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