



**ADVISORY BOARD FOR THE  
PREPARATION OF A  
MODEL LAW ON LEASING  
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**SECOND PRELIMINARY DRAFT MODEL LAW ON LEASING**

*(prepared by the Reporter on the basis of the guidelines provided by the Advisory Board  
at its second session (Rome, 6-7 February 2006)):*

**COMMENTS**

by Mr Castillo-Triana, the Equipment Leasing Association of the United States of America,  
Leaseurope, Mr Peter, Ms Shi, and Mr Sultanov,  
members of the Advisory Board, and UNCITRAL, observer

***MR CASTILLO-TRIANA***

1. PREAMBLE: I would suggest adding an additional consideration such as this:

“Committed with the purpose of harmonising legal regulations of leasing on a global basis in order to facilitate the international flow of investments and international trade in capital goods;”

2. Article 1: At this moment I am not sure about how important it is to insert in a Model Law its Sphere of application. This makes sense within an International Convention, where the boundaries between what falls into domestic law and what into international regulations need to be defined. But in this case, the Model Law is suggested to sovereign States that, by default, already have defined the sphere of regulation of their domestic laws. I would suggest deleting the Article 1.

3. Article 2: Two comments:

a. In the definition of Asset, I would prefer the explicit inclusion of “software”, beyond its exclusion from the exclusion. As I mentioned in my presentation, it does not hurt anybody, and on the contrary, it brings huge benefits to emerging economies, leasing companies and software manufacturers;

b. Operations lease must be changed to “Operating Lease”. The term “Operations lease” is confusing, and it does not have anything to do with current practices.

4. Article 3: It seems that the change introduced deprives Article 3 of its actual purpose, which is the implementation of a registration system for leases. As drafted, it seems redundant: If a State already has registration regulations, it is certain that leasing agreements would be subject

thereto without the need of Article 3. I suggest changing the drafting to insert what we mean, namely, Registration of Leases, being a Best Practice, must be mandatory.

5. Article 7(1): There must be a typo: the meaning is that a creditor of the lessee cannot attach any interest belonging to the lessor.

6. Article 7(2): I suggest inserting a last sentence indicating "...and shall not attach the leased asset but to the extent provided under the leasing agreement". The meaning and purpose of this addition is to indicate that if a lessor's creditor attaches the asset, it must acknowledge and respect that such asset (i) has been granted for use to the lessee, and that such use must be respected, and (ii) has been promised for sale (through the offering of the purchase option) to such lessee for a given value. Both provisions must be respected by lessor's creditors.

7. There are several indications to article 0, I suppose that this is part of a work in progress. Correct?<sup>1</sup>

8. Article 11: This article fails to define who loses in the event of damages. Shall it be the lessor, the lessee or the supplier? Our juridical proposition there is incomplete.

9. Article 13(1): Again, it fails to indicate that the demand of the lessee shall be addressed to the supplier, not to the lessor.

10. Article 13(2)(b): It seems to me that the concept of "difficulty of discovering" is a source of litigation. We need to be more precise in determining the standards. Difficult is a judgment that cannot be left to the imagination or appreciation of the parties, not even to the judge. An objective parameter is needed.

11. Article 14(3): Must be deleted. I do not recall having agreed on that. This is extremely dangerous. This creates a burden of the proof on either the lessor or lessee, as the case may be, and it will potentially generate, either the breach of sound credit controls or the breach of requirements imposed on lessees under IP or competition law, which can potentially be very damaging.

12. Article 22(2) must be added indicating that lessor has the right to dispose of the asset, provided that lessee has not opted to buy the asset. This addition seems superfluous, but it is necessary to be clear, in particular in emerging markets.

## ***EQUIPMENT LEASING ASSOCIATION OF THE UNITED STATES OF AMERICA***

### **I. OBSERVATIONS ON THE ROLE AND VALUE OF THE PROPOSED MODEL LAW**

UNIDROIT is currently engaged in a project to develop a Model Leasing Law. The stated purpose for the Model Law is assumed to be the need for a legal framework under which leasing can grow in developing countries. This sentiment was stated in a communication from Martin Stanford, UNIDROIT, to ELA President Michael Fleming on June 29, 2005 following a personal meeting.

We were agreed as to the importance of keeping an open mind as to the sphere of application of the future model law, and therefore

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<sup>1</sup> Note by the Secretariat: This comment refers to a technical error in the English, clean version of the second preliminary draft. The error did not affect the French version or the marked-up English version, and a corrected copy of the English, clean version was subsequently distributed.

the possibility of it potentially covering both small and big-ticket infrastructure projects. It is clear that the principal objective of the model law must necessarily be to meet the genuine needs of the markets we have in mind, namely developing economies and economies in transition, whilst at the same time taking account of the differences in their legal frameworks.

Further, the UNIDROIT Secretariat prepared an excellent memo for the Advisory Board on issues to be addressed in developing the Model Law. In the introduction, the memorandum states:

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 conducting their work on the proposed Model Law, the Advisory Board formed to advise UNIDROIT on the scope and content of the Model Law and the Reporter for the Model Law Project, Ronald DeKoven, have focused on legal issues and to some degree the lease product(s) that would exist under the law. However, it is not clear that the higher purposes set forth in Mr. Stanford's communications to Mr. Fleming are being fully considered in the project. There is little evidence that the Advisory Board fully considered the markets and customers to be served.

Who is served by this proposed Model Law? This question should be addressed. Leasing is a powerful mechanism to create capital. In this sense, it is leasing that adds value in all economic markets, not the leasing law per se. Whether the World Bank, a government in a country with a developing economy, SMEs or financial organizations are prepared to offer lease financing – the objective is the creation of capital for productive purposes. The leasing law is only the enabler.

The UNIDROIT Model Law cannot play an enabling or expansive role if it is drafted for the economic markets as they are rather than the economic markets as they can and should be. National economies and SMEs need to be served by this law. For example, the proposed law cannot create capital effectively if it favors a lease product that is limited to only a fully amortized lease product. This is only a purchase with financing. It limits the market's choice. Leasing works best to create capital where a lease is non-full payout and residual positions are taken and secondary markets for equipment develop. The proposal ignores the market reality that customers / lessees often can benefit from a shorter-term lease of two to three years. Options, flexibility and choices build economies.

Does the Advisory Board see its goal as the Model Law, or is it looking at the role it wants leasing to play in the developing economies? Quite different versions of a Model Law could result depending on the goal. Is the Advisory Board focusing too much on *what is* or what the advisors are *comfortable with* in drafting a law instead of enabling a wider market within which there can be change and growth over time?

Who speaks for the thousands of enterprises in developing and maturing economies who have a wide variety of needs for equipment acquisition financing? The law should be market-driven. It is probably safe to say that most SMEs will opt for simple full payout transactions in the beginning.

But the Model Law should not be drafted to dictate that as these companies become more sophisticated and their national economies grow, the available lease product will remain narrow with limited ability to keep up with their enterprises' needs and what *could be*.

National governments will look to this Model Law; they will rely on it. It should be drafted broadly. Individual national governments can enact it more narrowly if they believe that circumstances warrant a narrower version. However, the Model Law should not be limited – it is *The Model*.

In the April meeting of the Advisory Board, it is hoped that all attending interests will consider whether their objective for a Model Law should be *GOOD ENOUGH* or *AS GOOD AS IT CAN BE*.

## II. OBSERVATIONS ON THE PROPOSED MODEL LAW'S SPECIFIC PROVISIONS

The Equipment Leasing Association (the "ELA"), through its 2006 ELA Unidroit Working Group (the "Working Group"), has reviewed the Second Preliminary Draft Model Leasing Law ("Model Law") and considers it to be unsatisfactory. It is the consensus of the Working Group that the Model Law will not serve to promote leasing within the targeted jurisdictions. This conclusion was further supported by discussions with various ELA member companies actively leasing on a global basis. The view of both the Working Group and those ELA lessors actively leasing internationally is that the Model Law fails because it does not offer any meaningful legal incentives and protections to financing sources to offering lease products. The role of a lessor under a lease where the lessor is merely a financing source is analogous to that of a lender in a loan transaction, and any law pertaining to lease financing works best when it is created and enforced with the similarities in mind of a finance lessor and lender. To the extent they assume parallel obligations and have analogous rights, the finance lease industry in the adopting state should develop and grow. To the extent a funding source like a bank or a finance company is considering entering a marketplace (like China) and determines that the law treats a lender better than a finance lessor, that funding source will probably lend and not lease, and if it does lease, it will do so at a higher cost to account for the additional legal risks, and only to that narrow range of customers that can satisfy the tighter credit conditions necessitated by these additional risks. In any event, the leasing industry will suffer. That is proven by our experience. There are a significant number of countries in which ELA member companies will lend but will not lease due to legal or regulatory hindrances.

It is in the best interest of any country seeking to develop a leasing law, as well as the best interest of lessors and potential lessees, to ensure that the final version of any model leasing law reflects the need to attract funding sources toward leasing as well as lending. The Advisory Board surely is aware of the advantages for the local economy of a thriving leasing market: the availability of 100% financing; the access of start-ups, or smaller, less creditworthy companies to this kind of equipment financing, many of whom would not qualify for loan financing; and the ability to shift residual value risk from the lessee to the lessor. These advantages will not be achieved if artificial barriers are erected or if, in the hopes of protecting lessees from overreaching or unscrupulous lessors, statutory provisions are enacted that will cause lessors not to enter the leasing market or do so at a higher cost. While protecting lessees in this regard is a laudable goal, in advancing that goal the Model Law should not lose sight of its primary goal of growing the leasing industry in developing countries.

The Working Group's comments to specific Model Law provisions:

**Definition of Financial Lease.** The single most significant issue we see with the Model Law continues to be the requirement that the rent paid under a "financial lease" has to be "calculated to take into account the amortization of the whole or a substantial part of the cost of the asset." Whether or not the rent paid under a lease amounts to a full recovery of the cost of the asset being leased is irrelevant to the legal protections accorded to a lease where the lessor is merely acting as a financing source. The important factors ought to be only whether the lessor acquired the asset

for lease to a lessee, the lessee selected the supplier, the lessor is not the supplier of the asset and both the lessee and the lessor expect to rely upon the supplier with respect to the asset and its design, quality, condition, and fitness for a particular purpose. The Model Law's requirement of a full payout lease is an artificial device that is not important to either lessors or lessees. This requirement ignores the reality that most lessees benefit from a shorter-term lease. They are able to better manage their equipment, respond to changes in their local economies and in their business prospects, guard against technological obsolescence, and can take advantage of market fluctuations with respect to residual value. The Model Law ought to encourage this flexibility, but by requiring a full payout lease the Model Law will cause lessees to hesitate before they lease because the consequences of a full-payout lease are much more significant on the lessee's bottom line. Among the negative consequences of this decision are that lessees will have excess equipment when the local economy or its business slows, and lessees will be saddled with an asset at the end of the lease term that may not be the most efficient for its business. Our concerns would be satisfied if clause (c) is modified to change "are calculated" to "may be calculated."

We also believe clause (a) of the defined term "Financial Lease" should be modified to delete therefrom the clause "without relying primarily on the skill and judgment of the lessor." This seems to introduce a subjective test and one without any requirement that the lessee's reliance has to be reasonable or even known to the lessor. Under this text the mere suggestion by the lessor may be enough to satisfy this subjective reliance test. Rather, in our view, the question is which party selects the supplier. If the lessee selects the supplier, how it arrives at that decision is immaterial for purposes of the financial lease. Underlying this language appears to be the notion that the lessee is the weaker party and needs to be protected perhaps even from its own bad decisions. The Model Law ought to reflect the fact that lessees are capable of managing their own businesses and are not as a matter of law incapable of making their own decisions based on their understanding of what is best for themselves, including which parties with which to contract.

**Definition of Supply Agreement.** We suggest that a term that is as important as "supply agreement" and is used as often as it is ought to be defined. The supply agreement is critical to many of the duties and rights of the parties and, surely, if the Model Law feels it important to define "centre of main interests" an effort can be made to define "supply agreement." We encourage using the definition we supplied in connection with the prior draft.<sup>1</sup>

**Chapter II.** The Working Group understands the rationale for deleting the general contract provisions of Chapter II. However, the consensus of the Working Group is that these general contract provisions provided some certainty to lessors entering a market that a law existed covering these general contract principles. This view was reinforced by our discussion with ELA lessors experienced in doing business in developing countries. Their view was that in many countries the application of general contract laws to their transactions is problematic and local counsel is often unable to opine with any certainty as to which statutory provisions governed some of these general contract law issues. Most notable is the uncertainty of whether a parol evidence rule applies in a given transaction. Thus, the Working Group asks the Advisory Board to reconsider the removal of Chapter II. The Model Law can provide that to the extent other laws of the enacting jurisdiction govern a general contract issue then the Model Law defers to those other laws.

**Article 4. Freedom of Contract.** As we suggested in our comments to the prior draft, Article 4 ought to make clear that not only are lessee and lessor free to determine the content of a lease they are also free to vary the effect of the Model Law. The concept that ought to be made explicit under "freedom of contract" is that lessor and lessee are free to determine whether to apply

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<sup>1</sup> *Note by the Secretariat:* Under the definition that the E.L.A. supplied in the previous draft, "Supply Agreement means the contract under which the lessor buys or leases equipment from the supplier for lease to a lessee, whether such lessee or the related lease agreement has been identified at the time of such purchase or lease. A supply agreement may consist of one or more records."

particular provisions of the Model Law. If, for example, lessee and lessor choose to apply differing provisions regarding termination it would be helpful if the Model Law makes explicit their right to do so.

**Article 6. Lessee under financial lease as beneficiary of supply agreement.** Clause (c) carries forward the concept that a lessor is required to use "commercially reasonable steps to assist the lessee overcome" any disadvantage resulting from the lack of contractual privity between the lessee and the supplier. This is an unnecessary burden on the lessor. Under a financial lease the lessee selects the supplier, and the lessee is quite capable at the time of selection to deal with the supplier and require that it add to the supply agreement whatever provisions it thinks advisable. Using a test of commercially reasonable steps ignores the likelihood that the lessor might lack the capacity to undertake these steps. The lessor may be a local enterprise with limited resources and the supplier might be located halfway around the world. In this situation it seems unfair to expect the lessor to argue legal issues under the supplier's local laws. Does the Model Law really wish to expose those lessors to assuming supplier's duties under the supply contract? Imposing that kind of burden will not foster the growth of a local leasing industry. Further, the standard giving rise to lessor's duty is that the lessee is disadvantaged by a lack of privity. It could be argued that the lack of privity is always a disadvantage as lessee is forced in the first instance to prove it has the right to enforce the supply contract either as a matter of law, such as the Model Law, or that it is the intended beneficiary under the supply agreement. While the ELA firmly believes that the concept ought to be deleted, should it be retained, the test ought to be whether the lack of privity precludes the lessee from enforcing the supply agreement.

**Article 8. Liability for death, personal injury, or property damage caused to third parties.** Again the text introduces the concept of lessee's reliance on the lessor's skill and judgment coupled with the new concept of lessor's intervention in the selection of the supplier. The former concept was a bad idea in the definition of financial lease and it is not improved by being included in this article. There are only two sure results of this language: First, any lessee facing a loss of the kind covered by Article 8 will be economically incentivized to argue it relied on lessor's skill and judgment. Second, because of the first result lessors will be reluctant to lease assets that may expose them to this kind of claim or acquire assets from suppliers whose goods have been subject to this kind of claim. The new concept of intervention is very troubling because it is so vague. Collectively the Working Group has almost a century's worth of experience in the leasing business and we could not agree on what actions are covered by this language. Why should anyone expect a judge in a jurisdiction with little history of finance leasing to understand the text? We suggest lessors will be unwilling to assume this risk.

**Article 9. Irrevocability.** Clause (b) is another example of the Model Law's creation of burdens without commensurate benefits. Why does each duty have to be specifically identified? We imagine lessees would understand if a lease stated "all of lessee's duties are irrevocable and independent."

**Article 10. Risk of Loss.** Paragraph 1 ought to make clear that risk of loss passes from the supplier to the lessee and not from the lessor to the lessee.

**Article 12. Acceptance.** We prefer the version of Paragraph 2 in the prior draft, as modified by our comments thereto.<sup>2</sup> As drafted, we assume the supplier and not the lessor will pay the damages referenced and, if so, it would be helpful if the text made this clear.

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<sup>2</sup> *Note by the Secretariat:* The version of paragraph 2 in the first preliminary draft, with the modifications proposed by the E.L.A., read as follows: "~~One~~ Except in the case of a financial lease, once a lessee has accepted equipment, the lessee may still be entitled to damages for any non-conformity, ~~but~~ and the lessee may ~~reject~~ also revoke its acceptance of the equipment under [the Article regarding rejection] only if the non-

**Article 14. Transfer.** In connection with its review of the first draft of the Model Law, the Working Group submitted the text of a waiver of defenses clause in its comments to this provision.<sup>3</sup> The waiver of defenses provision was not included in the revised draft. We think the decision to not include a statutory waiver of defenses provision is a mistake. It ignores the reality that a lessor has to raise capital to acquire goods and enter into leases. Lessors typically borrow funds by selling or pledging the rental streams from existing leases. For the rental stream to serve most efficiently as collateral, lenders will need assurances that so long as the lessee is capable of paying the rent, the rent will be paid, and this includes protections for lenders from any claims made by the lessee against the lessor. This form of financing is very common in both the United States and elsewhere and seems to have not resulted in a significant hardship on lessees. On the other hand, denying these funding sources a statutory waiver of defenses provision would only serve to limit lessors' access to working capital and to increase the cost of the capital that is available, which, in turn, will retard the growth of leasing in the applicable jurisdiction.

Paragraph 3 is another serious problem likely to subvert the growth of a leasing industry. Generally, speaking, if a transfer is prohibited it ought not be effective if the parties nevertheless proceed. Any assignee, whether taking from the lessor or the lessee, is charged with knowing what it is acquiring and if a transfer is prohibited by the terms of the lease or by other law, what purpose does the Model Law believe it is serving by giving effect to this transfer notwithstanding such prohibition? There ought to be an appreciation that not all transfers are alike, and that some disparate treatment is merited. One obvious difference is between that of dealers and equipment users. If lessor leases goods to a dealer in goods of that kind the lessor has little to complain about when the dealer in fact subleases those goods. However, when a lessor leases goods to an equipment user, that lessor is relying upon the credit strength and reputation of that user. The lessor ought to be able to rely upon those characteristics through the entire lease term. Our comments to the prior draft identified several categories of transfers that could be consummated even if otherwise prohibited<sup>4</sup> but as those comments were rejected we assume this Article applies to every type of transfer and that is too much. That text ignores the lessor's interest in the assets under lease and the need to ensure that the party using them respects that interest.

**Article 21. Termination.** Paragraph 2 could make clear that the discharge of the parties' duties does not discharge any remedies available to the injured party. We prefer to see in this article an opportunity to cure any default prior to allowing termination. Absent a cure right, we are

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conformity substantially impairs the value of the equipment and either (a) the lessee accepted the equipment without knowledge of the non-conformity, owing to the difficulty of discovering it, or (b) the lessee's acceptance was induced by the lessor's or supplier's assurances."

<sup>3</sup> *Note by the Secretariat:* The text proposed by the E.L.A. regarding the waiver of defenses clause read as follows: "An agreement by a lessee that the lessee will not assert against a transferee of lessor's interest any claim, defense, recoupment, setoff or right to cancel or terminate the leasing agreement that lessee may have against the lessor is enforceable by such transferee if such transferee (a) accepted such transfer in good faith, (b) gave lessor value for such transfer, and (c) did not at the time of such transfer have notice that the lessee had a defense, claim, recoupment, setoff or right to cancel or terminate the leasing agreement. 'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing. A transferee takes for 'value' (i) to the extent that the agreed consideration has been performed, or (ii) when such transferee accepts a transfer of the leasing agreement in payment of or as security for an antecedent claim, or (iii) when such transferee gives a negotiable instrument for such transfer."

<sup>4</sup> *Note by the Secretariat:* The E.L.A.'s comments on the previous comments proposed that the Model Law provide that a transfer prohibited by the leasing agreement be effective if "(a) Such transfer is an assignment of the lessor's right to receive, and to enforce payment of, monies payable to it under the leasing agreement; or (b) another statute of this State expressly authorizes a transfer of a lessor's or lessee's rights notwithstanding contractual prohibitions thereon."

concerned that a party may use a technical or non-material default by the other party as an excuse to get out of a lease that it has determined is not in its best interest. We also are unclear on what happens to an assignee of a lessor's interest in a lease if lessee, upon lessor's default, terminates the lease. Is the Model Law suggesting that the assignee has no further rights in the lease and the rental stream?

## **LEASEUROPE**

### **I. COMMENTS OF LEASEUROPE FOLLOWING THE SECOND SESSION OF THE ADVISORY BOARD, 6-7 FEBRUARY 2006<sup>1</sup>**

Following the invitation made by UNIDROIT in the document "Study LIXA-Doc.5 – February 2006" to submit - before the revised second draft will be available – suggestions for the preamble's contents and to identify provisions that in our opinion should be mandatory, we would like to highlight the following issues:

#### 1) Preamble's contents:

At the European level and for companies rated at the Stock Exchange which need to implement IAS and for other companies insofar as their local Authority decided that way:

2 categories are to be considered:

a financial lease - contract where there is a substantial transfer of risks and rewards to the lessee

an operating lease - other contracts which are not financial leases

In both cases, the lessor has the title of ownership.

It is pointed out however that the classification in one or another category does not depend on the existence of a purchase option.

#### 2) Qualification of the Lessor in the financial lease

We strongly believe that in the Definitions of the Model Law there is the need to specify that in the financial leases the lessor has to be a credit institution or a financial institution authorized by its own country's rules and laws.

#### 3) Differences between the English and French Document

We noticed a difference between the English and the French versions of the document of the first draft of the model law: in the French text, in the definition of financial leases, lessor and lessee are called *crédit-bailleur* and *crédit-preneur*, while in the definition of lease the lessor and lessee there is written *Preneur* and *Bailleur* only. Maybe it could be useful to specify that those terms (*Preneur* and *Bailleur*) will refer also to *crédit-bailleur* and *crédit-preneur*. It should be stressed however that in French, the words "Preneur" and "Bailleur" are best suited to a simple "lease" contract (as opposed to a financial lease contract).

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<sup>1</sup> Note by the Secretariat: Leaseurope submitted the comments appearing here in Part I on 3 March 2006, prior to circulation of the second preliminary draft.

- 4) Articles to be considered mandatory
- Article 10 [new Article 6] - Lessee under financial lease as beneficiary of supply agreement
  - Article 13 [new Article 8] - Liability for death, personal injury, or property damage caused to third parties
  - Article 14 [new Article 10] - Risk of loss
  - Article 18(1) [new Article 15(1)(a)]- Warranty of quiet possession

## II. COMMENTS OF LEASEUROPE ON THE SECOND PRELIMINARY DRAFT

### 1) Article 2 – Definitions

- We strongly believe that in the Model Law there is the need to include the principle that **in the financial leases the lessor** has to be a "credit institution", a "financial institution" or a "corporate company" authorized by its own country's rules and laws.
- We noticed a **difference between the English and the French versions** of the document of the second draft of the model law:
  - in the English text, within the definition of "Financial lease" and "Lease" the parties are called *lessor* and *lessee*;
  - in the French text, more correctly, within the definition of "Crédit-bail", lessor and lessee are called *crédit-bailleur* and *crédit-preneur*, and within the definition of "Bail" they are called "Bailleur" and "Preneur".

Our proposal is to insert a specific definition of the "**Lessor in the financial lease**" ("Crédit-Bailleur" in the French text) and of the "**Lessee in the financial lease**" ("Crédit Preneur" in the French text).

- We believe that the new definition of "Asset" should clearly state a reference to **real estate** and **software leases**, as it is not clear in the definition.
- There should be a better definition of "**Operations lease**" ("Operating lease" would be a better wording).

### 2) Article 9 – Irrevocability

In our view, the lessee's duties to the lessor should become irrevocable and independent, in a financial lease, when only the leasing agreement has been signed by the parties.

We do propose to delete "*and supply agreement*" from the article.

### 3) Article 10 – Risk of loss

In our opinion, in a financial lease, if the time of passage is not stated, the risk of loss should pass to the lessee when only the leasing agreement has been signed by the parties.

We do propose to delete "*supply and*" from the article.

## ***MR PETER***

**Preamble:** IFC is mentioned in a special section. It's absolutely justified, but do you think it is politically wise?

**Article 2 Definitions:** I do not like the word "person". Is there no better designation? We deal with commercial bodies – so "person" to me seems not to be appropriate.

**Financial Lease:** I would like to have added the fact that the Lessor buys the equipment only on the request of the Lessee for the purpose of leasing it to him. (See also the IFC definition and the Unidroit Essentials.) In addition, I propose to add explicitly that various options at the end of the Lease contract are possible (without changing the legal nature of the contract!).

**Operation Leasing:** I would like to add one or two of the criteria of the IFC definition of Operating Leasing – mainly the legal and commercial difference.

**Article 8(2):** I would like to add: ..... its capacity of lessor [and owner].

**Article 13(2)(a):** Delete the last sentence or define what "reasonable" means. Two parties will probably never agree on this term – so the judge has to be involved – that's not our goal.

Are the minimum rights of the lessee in case of **repossession** considered appropriate? I doubt it and suggest that we find a wording which is sufficiently clear and helps to avoid the judge having to define imprecise wording.

## ***MS SHI***

In addition to the results of my research discussed in my presentation at the end of the second session, the biggest debate — and a fundamental issue for the Model Law on Leasing — is how to understand leasing, whether from the legal perspective for our purpose, or from other related relevant perspectives, like the leasing markets, the accounting, the taxation and the supervision, sometimes the leased assets. On the other hand, for what are we going to legislate?

The confusion that our members of the Advisory Board face is that we do not know clearly why we are legislating this law, because of the members' incomplete understanding of the leasing industry.

Furthermore, our members of the Advisory Board confuse the accounting issues into our law regarding the legal aspects.

Let me roughly explain the reasons that and the purposes for which the accounting regulator concentrates on the relationship between the amount of amortisation and the leasing investment. First, the creation of the finance lease in the 1950s in the leasing industry (here I mean all kinds of lease transactions) created a puzzle for the accounting regulator. The accounting regulator thought that the finance lease did not meet the requirements of the accounting principle that a lessee in such a transaction should both undertake the real investment risk and enjoy the revenue from using the leased asset without recording the leased assets in his relevant account according to the accounting requirements of the time. Why did such a puzzle happen? What was wrong? After many years of debate in the accounting area, the accounting regulators finally developed a new kind of ownership — economic ownership — and changed the accounting principle. That is, recording of an asset is in substance based on its economic ownership rather than that of legal ownership. Therefore the leased asset should be recorded on the accounts of its economic owner. Furthermore, the relationship between the amount of amortisation and the lease investment became critical

criteria to distinguish the economic owner of a leased asset, between lessor and lessee, in addition to the option choice of the leased assets at the end of lease term.

Following the above philosophy, we can find that one of the disadvantages of the Ottawa Convention on International Financial Leasing is that, in defining the transaction of financial leasing for the purpose of the law, it takes into account an accounting criterion for the purpose of distinguishing the economic ownership.

But I feel pity that our members ignore the advantage of the Ottawa Convention on using a proper expression of financial leasing, a term that has been widely accepted by the industry worldwide. What I guess is that our members are adopting improperly the classification criteria of the leasing industry other than the law.

My conclusions:

1. A lease is a kind of transaction, other than sale or loan etc., in which a person, the lessor, acquires an asset and then grants a right to use and benefit to another person, the lessee, for a term in return for rentals.
2. From the legal perspective, based on the criteria of decision-making of a lease investment, a criteria that tells us who, lessor or lessee, owns the basic right in the transaction, all kinds of transactions in the lease industry can be divided into two: one class, in which the lessor selects the leased asset, called an operational lease, rent, short term lease, traditional lease etc.; and a second class, in which the lessee selects the leased asset, called financial leasing, a category that contains the finance lease, operating lease, sub-lease, leveraged lease and so on depending on how they are classified.
3. The financial leasing is the newcomer in the lease industry. Only financial leasing is related to the capital markets, and it has a much more important economic function in a society. Those are the historical and economic reason why we need to legislate a law for it!!
4. The rights and obligations we are formulating for finance lease in the current draft are actually the ones for financial leasing.

## ***MR SULTANOV***

### **I. COMMENTS TO THE DRAFTED ARTICLES**

#### **Article 2. Definitions**

##### **Definition of an asset**

*Comment:*

It is recommended to provide in the commentaries that not all movables and fixtures can be leased assets. There shall be a limitation that only non-consumable assets can be leased. The definition of non-consumables does exist in many jurisdictions, and explanation can be provided that non-consumable goods are goods which are not destroyed or transferred into another form/condition once used and which retain their original form during the use and depreciate gradually.

## Definition of financial lease

### *Comment:*

In clause (c) of the proposed definition of a financial lease it is recommended to apply the term “compensation” instead of “amortization”. For example, in several former USSR countries chapters which regulate leasing in civil codes were primarily based on the Convention which applies term “amortization” as well. “Amortization” was translated as “depreciation”, and the definition of a lease payment<sup>1</sup> was tied to the norms of depreciation of a leased asset, which is incorrect for the following reasons:

- 1) The periodicity and amount of lease payment shall be agreed between the parties and shall not depend on the norms of depreciation;
- 2) Depreciation amount is changing depending in revaluation of the fixed assets, and the amount of lease payment shall not necessarily be equal to the depreciation amount of the leased asset.

As long as the context essentially presupposes that it is the **cost** of the leased asset that must be amortized/compensated and not the leased asset **depreciated**, it is recommended to apply a different term (compensation, reimbursement etc.) to avoid erroneous interpretation of the meaning “amortization”.

## Definition of “Lease” and “Operating lease”

### *Comment:*

The Draft by introducing two definitions of “operating lease” and a “lease” creates a big ambiguity to the understanding of the sphere of regulation of the Model Law. “Lease” is essentially a 2-party transaction and in a sense it is already a “lease other than a financial lease” (definition of operations lease), therefore it is difficult to 1) draw a distinction between these two transactions; and 2) see why the definition of “lease” is necessary in the first place if it is not to be used in the Law. It is recommended to remove the term “lease”.

The Draft Model Law achieved the necessary legal balance between the notions of financial and operating lease and constitutes a consistent approach with regards to the regulation of leasing and its various types and may serve as a useful guideline with regards to the way the legislation shall address leases in general. Nonetheless the assessment needs to be made regarding the extent to which the States will be able to rightly incorporate both notions of financial and operating lease in the legislation. The problem which may arise is that the State will face several options of incorporating the Model Law:

1. Adopt the law on leasing and use the Model Law which regulates both financial and operating lease transactions. Because the legislation in force if the State already regulates operating lease (transaction is called “rent” or “property hire” etc. depending on jurisdiction) several provisions of the Law on Leasing regarding operating lease may conflict with other laws which deal with the same issue, and therefore it will be necessary to either bring other relevant laws in conformity with the Law on Leasing or to substitute the provisions of the Law regarding operating lease with the national legislation.<sup>2</sup> The danger here is that most likely the State may adopt the Law on Leasing

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<sup>1</sup> Lease payments which lessee pays under the lease agreement include the cost of the appropriate part of the depreciation of the leased asset, other expenses incurred by the lessor and lessor's profit. (Belarus legislation)

<sup>2</sup> In the letter case the whole purpose of addressing the operating lease will be defeated.

based on the Model and will not make necessary amendments to relevant laws to reconcile property hire and operating leases, therefore creating confusion.

2. To adopt the Law on Finance Lease and use the provisions of the Model Law regarding finance lease only.

### **ARTICLE 3 OTHER LAWS**

*Comment:*

In the commentaries to this Article it is important to stress that although a leasing agreement subject to the Model Law is also subject to any other law of the State applicable to registration of a leasing agreement, the State shall not seek registration of all lease agreements insofar as it constitutes an administrative barrier and does not add value to the parties to a lease. Registration of the deals that by law must be registered (real estate, vehicles, etc.) is a matter to be addressed by these laws, which must provide that any deal for transfer of such assets is to be registered whether the deal is sale-purchase, lease, renting and etc. However, mandatory registration of all lease contracts is a burden for the parties to a lease that can serve as a disincentive for these parties to enter into a contract.

### **II. OTHER AREAS FOR THE LAW TO ADDRESS:**

*1. Transfer of ownership over the leased asset to a third party.*

The Law shall recognize that transfer of title to a leased asset (as the case may be when lessor sells an asset, when a third party exercises foreclosure of the leased asset, or the leased asset is sold at an auction as a part of the bankruptcy proceedings, etc.) to a third party will not result in modification or termination of the lease agreement. Thereupon, the lessor's rights and obligations specified in the lease agreement are transferred to the new owner. The party that acquires the lessor's assets as a result of the latter's default is only able to enforce the rights of the original lessor under the lease, i.e., the receipt of lease payments. The new owners are not able to take possession of the asset in any case in which the lessee is still meeting its obligations under the lease. The obligations and rights are simply assigned from the original lessor to a new party.

*2. Bankruptcy of the parties to a lease.*

It is recommended that the Law addresses issues of bankruptcy of the parties to a lease.<sup>3</sup>

*Lessor's bankruptcy:* The Leased Asset in case of lessor's bankruptcy shall become part of the insolvent's pool of assets. The right of the lessee to continue with the lease contract shall be available notwithstanding the fact of the bankruptcy proceedings against the lessor. The creditor of the lessor that receives the leased asset in his ownership as a part of his remedy shall become the new lessor and shall have no right to impose new conditions in the agreement or demand the termination of the contract as long as the lessee is not in default himself.

*Lessee's bankruptcy:* If a decision to liquidate the Lessee or declare his bankruptcy is issued the leased asset shall not be included in the general security of the creditors and shall not be considered part of the liquidation or bankruptcy assets.

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<sup>3</sup> Despite that in many developing countries it is a practice to include various types of regulation in one single act (civil regulation, taxation, procedural and administrative issues, bankruptcy etc.) the Model Law should regulate the rights, obligations and responsibilities of the parties to a lease and therefore it is recommended to address issues of bankruptcy in the commentaries.

### *3. Licensing and supervision of the leasing activity.*

The recommendation is to provide in the commentaries to the Model Law that States shall not seek licensing and supervision of the leasing activity. Arguments to support this can be found in the IFC's "Leasing in Development: Lessons from Emerging Economies".

## **UNCITRAL**

### **I. General comments**

1. These comments have been prepared for the third session of the UNIDROIT Advisory Board preparing a model law on leasing ("the draft Model Law"), which will take place in Rome from 3 to 5 April 2006. Comments are limited to the relationship between the draft Model Law and the UNCITRAL draft Legislative Guide on Secured Transactions ("the draft Guide").

2. Under Article 1, the draft Model Law applies to "any lease of an asset". The term "asset" is defined as "all property used in trade or business". According to recommendation 3(c) (see A/CN.9/WG.VI/WP.21),<sup>1</sup> the draft Guide applies to security rights in all movable property (except securities and wages), as well as to fixtures (i.e. movables attached to other movables or immovables; see A/CN.9/WG.VI/WP.22/Add.1, para. 21 (l)). In addition, under recommendation 3(e), the draft Guide applies to transactions serving security functions, irrespective of their form, which means that it applies to financial leases and hire-purchase agreements (see also definition of "acquisition security right" in A/CN.9/WG.VI/WP.24/Add.5). As a result, financial leases and hire-purchase agreements relating to equipment would fall under the scope of the draft Guide. To that extent, there is overlap between the draft Guide and the draft Model Law.

3. This overlap and the potential for conflict would be significantly reduced, if the draft Model Law excluded leases that, under the law of the State in which the leased assets are located (or, in the case of mobile goods, in which the lessee is located), were treated as security devices. Alternatively, but less preferably, the draft Model Law could be subject to secured transactions law where the secured transactions law applied. Another alternative to avoid overlap and conflict would be to limit the draft Model Law to contractual issues. If none of these alternatives were adopted, the draft Model Law would need to be aligned with the recommendations of the draft Guide.

### **II. Article-by-article comments**

#### **Article 1: Sphere of application**

#### **Article 3: Other laws**

#### **Article 5: Enforceability**

4. While Article 1 of the draft Model Law is a scope-, and not an applicable-law, provision, it may have the effect of an applicable-law provision combined with other articles of the draft Model Law. For example, Article 3 provides that registration is left to law of the enacting State other than the draft Model Law and Article 5 provides that a leasing agreement is effective and enforceable between the parties and against third parties except as otherwise provided in the draft Model Law. These articles, combined with Article 1, in effect refer registration to the law of the State where the

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<sup>1</sup> All UNCITRAL documents referred to in these comments are available on the UNCITRAL web site (<http://www.uncitral.org>).

encumbered/leased asset is located, the law of the State where the grantor/lessee has the centre of its main interests, or the law of the State whose law governs the security/lease agreement.

5. Such a result would be inconsistent with recommendation 136 of the draft Guide (see A/CN.9/WG.VI/WP.24), according to which the law applicable to the creation, third-party effectiveness (including registration) and priority of a security right (including the right of a financial lessor) in movable property would be the law of the State where the encumbered/leased asset is located. There are two exceptions to this rule. The first relates to security rights/financial leases in mobile equipment with respect to which the law of the State where the grantor/lessee is located applies (location is defined by reference to place of central administration if the grantor/lessee has a place of business in more than one State). The other exception relates to security rights/financial leases in movable property that is subject to title registration with respect to which the law of the State under whose authority the registry is maintained applies.

6. The above-mentioned result of Articles 1, 3 and 5 of the Model Law would be equally inconsistent with recommendation 148 of the draft Guide (see A/CN.9/WG.VI/WP.24), under which issues relating to the enforcement of a security right/financial lease are governed by the *lex fori* or the law governing the security/lease agreement.

#### **Article 7: Priority of liens**

7. The draft Model Law deals with certain conflicts of priority, while leaving to other law perfection (third-party effectiveness in the terminology of the draft Guide) and other priority conflicts.

8. Under Article 7(1) and (2), a creditor (including a secured creditor) of the lessor or the lessee and the holder of any interest in land or personal property take subject to the rights under the leasing agreement. Under recommendations 67 to 69 of the draft Guide (see A/CN.9/WG.VI/WP.24/Add.4), the result is the same but, if the asset leased is inventory, this rule applies only if the lessee takes the lease in the ordinary course of business of the lessor. In addition, under the draft Guide, for the holder of any interest in land to take subject to the rights under the leasing agreement, the leasing agreement has to be registered in the land registry (see A/CN.9/WG.VI/WP.24/Add.3, rec. 83 and A/CN.9/WG.VI/WP.24/Add.5, rec. 130 ter).

9. The draft Model Law lacks a priority rule along the lines of recommendation 129 (see A/CN.9/WG.VI/WP.24/Add.5), under which the lessor's priority dates back to the time of delivery of the asset to the lessee, if the lessor registers a notice about the financial lease in the security rights registry within the time period prescribed by the law (e.g. 20-30 days). Similarly, the draft Model Law lacks a priority rule along the lines of recommendation 130bis (see A/CN.9/WG.VI/WP.24/Add.5), under which the lessor's rights have priority over the rights of a judgment creditor of the lessee. If gaps left in the draft Model Law in this respect were to be filled by application of the law of the State in which the asset or the lessee were located or the law governing the lease agreement, there would be a clear inconsistency with recommendations 136 and 148 of the draft Guide (see paras. 4-6 above).

#### **Article 8: Liability for death, etc.**

10. The issue of liability of the secured creditor/lessor for damage caused to third parties by the encumbered/leased assets is discussed in the draft Guide (see A/CN.9/WG.VI/WP.11/Add.2, para. 29) but no recommendation has been made yet.

### Articles 9-17: Performance

11. The focus of the draft Guide is on proprietary matters and includes only a few non-mandatory rules with respect to the rights and obligations of the parties to the security agreement. With respect to the maintenance of the encumbered assets, Article 17 does not seem to be in conflict with recommendation 86 and 87 of the draft Guide (see A/CN.9/WG.VI/WP.24/Add.1).

### Article 18-22: Default and enforcement

12. There does not seem to be any conflict between Articles 18-21 on the one hand and the recommendations of the draft Guide on the other. However, in line with recommendation 15 of the draft Guide (see A/CN.9/WG.VI/WP.26), Article 14 (1) should make it clear that the transfer by the lessor merely of a right to receive rentals does not impair the lessee's rights in the lease.

13. In addition, Article 22 of the Model Law seems to be inconsistent with the detailed remedies of the secured creditor/lessor under the draft Guide (see A/CN.9/WG.VI/WP.24/Add.1, recommendation 93). For example, under recommendations 94, 101 and 110, the secured creditor/lessor may repossess and dispose of the encumbered/leased asset without resorting to court. However, in the case of extra-judicial repossession or disposition, the secured creditor/lessor is obliged to give notice to the grantor/lessee and certain third parties (see recs. 99 and 111). In addition, the grantor/lessee has the right to object to extra-judicial enforcement (see rec. 100). Moreover, the secured creditor/lessor has the right to accept the encumbered/leased asset in satisfaction of the secured obligation (see rec. 116). Furthermore, there are detailed rules with respect to surplus or shortfall and the finality of the right acquired by the buyer of the encumbered/leased asset (see recs. 116-124). If gaps in the draft Model Law were to be filled by application of the law referred to in Articles 1 and 3, there would be a clear conflict with recommendation 148 of the draft Guide (see para. 6 above).

### Insolvency

14. Unlike the draft Model Law that addresses briefly only the effectiveness of a lease against the insolvency administrator in Article 5, the draft Guide discusses in detail the enforcement of a security right/financial lease in the case of the insolvency of the grantor/lessee in a financial lease (see A/CN.9/WG.VI/WP.21/Add.3). Brevity in the treatment of such important issues in the draft Model Law is bound to create inconsistencies with the way they are addressed in the draft Guide. In addition, if gaps in the Model Law were to be filled by application of the law referred to in Articles 1 and 3, there would be a conflict with recommendations 30 and 31 of the UNCITRAL Legislative Guide on Insolvency Law, which refer these matters to the *lex fori concursus* (see A/CN.9/WG.VI/WP.21/Add.3).

### Conflict-of-laws issues

15. Unlike the draft Model Law, the draft Guide includes detailed conflict-of-laws rules on the law applicable to security rights/financial leases (see A/CN.9/WG.VI/WP.24). As pointed out above (see paras. 4-6, 9, 13 and 14), there are clear inconsistencies between the draft Model Law and some of the conflict-of-laws recommendations of the draft Guide.

### III. Conclusions

16. The overlap and potential conflict between the draft Model Law and the draft Guide would be significantly reduced if the draft Model Law did not address leases that were treated as security devices under the law of the State in which the leased assets were located (or, in the case of mobile assets, the law of the State in which the lessee was located). Alternatively, the draft Model Law could be subject to secured transactions law, where the secured transactions law applied.

17. Another alternative to avoid overlap and conflict between the draft Model Law and the draft Guide would be to limit the draft Model Law to contractual issues. With the exception of Articles 5, 7 and 22 that deal with effectiveness, priority and enforcement, the draft Model Law seems to deal mainly with contractual issues. To implement this approach, Article 5 would need to be limited to effectiveness between the parties, and Articles 7 and 22 be deleted. Article 1 could then refer to the law governing the lease.

18. If the draft Model Law neither excluded financial leases nor was made subject to secured transactions law nor was limited to contractual issues, it would need to be aligned with the recommendations of the draft Guide. Concretely, effectiveness against third parties should be governed by the law of the State in which the asset is located, except if the asset is a mobile asset or subject to title registration. In the former case, third-party effectiveness should be subject to the law of the State in which the grantor/lessee is located, while, in the latter case, third-party effectiveness, should be governed by the law of the State under whose authority the registry is maintained. In addition, if Articles 7 and 22 were not deleted, they would need to be aligned with the priority and enforcement recommendations of the draft Guide (see paras. 7-9 and 13 above).