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**LEASING: LEGAL AND REGULATORY ASPECTS OF LEASING OPERATIONS WITH A
VIEW TO EASTERN EUROPE**

Note by the secretariat:

This paper was prepared by Professor Wim Timmermans* at the request of the secretariat as a contribution to the Guide to Financing Private Enterprises and Trade to be discussed under item 4 of the Agenda.

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Introduction

1. As a rule, lease agreements have not been defined by a law, at least in most Western jurisdictions (except France and Belgium). Lease agreements have been developed in legal practice which of course meet general requirements of contract law. The significance of leasing has increased enormously, given its advantages for financing capital goods without the need to buy such goods. The financial risks for the leasing company are low, too, as it retains legal ownership of the asset, which it may repossess in the event of default of the lessee.
2. The objective of a leasing agreement is that one party, the lessor, transfers to another party, the lessee, the use of an asset during the period of the duration of the agreement against a compensation due by the lessee to the lessor. Two types of leasing may be distinguished: *financial* and *operational* leasing.
3. The financing of an asset is the main objective of *financial leasing*: the financier - lessor – enables the lessee to use an asset while making the lessee pay – usually in periods – for its total value. To the value of the assets, the following amounts are added: interests; expenses; compensation for additional services (maintenance, etc.), risks. Typically, the duration of a financial leasing contract will more or less correspond to the economic life of the asset. Upon the expiration of the financial leasing agreement, the good will be totally depreciated and can be acquired by the lessee against payment of the residue value.
4. The main purpose of *operational leasing* is not financing but rather the use of the good.
5. Motives for leasing include off-balance financing of an asset; improvement of the proportion of own and not own capital; tax advantages; outsourcing of certain assets to a specialized leasing company (e.g. company cars); liquidation of company capital invested in certain assets through the instrument of “sale and lease back” (assets owned by a company are being sold to a leasing company and leased back by the former (“lessee”)); transferring the risks of operating certain assets to a specialized company (thus, the lessee restricts its operational risks).
6. Typically, lease objects include all types of company assets such as equipment, machinery, means of transport, including cars, trucks, vessels, and aircraft, office space, land, etc.
7. Following the progression of globalization, cross-border leases involving parties from different jurisdictions are of increasing importance as well. Such cross-border leases may raise the complexity of lease transactions, as they introduce private international law elements to the lease agreement. Reasons for the increase in the number of cross-border leases include the further internationalization of trade and finance; the huge amounts of cash involved in many lease transactions; the opportunities to gain tax benefits through international tax planning which often offers the possibility to both lessor and lessee to fully write off the lease object from taxable profits.

Leasing: General Principles

Nature of Leasing

1. Under a lease contract, a lessor provides property to a lessee in return for compensation for the temporary possession and use of the property. Revenues and other benefits generated from the use of the leased property are the property of the lessee.

Leased Property

2. The contract must contain sufficient details to precisely identify the leased object. As a rule, failing such information, a contract is regarded as null and void.

Lease term

3. A lease contract should indicate the term of the lease. If such indication of the duration has not been included in the contract, the lease will be considered as being for an indefinite period of time. With regard to specific objects, legislation may determine of maximum duration, for instance, 49 years for the lease of land.

4. Often, the parties to a lease contract will include a provision for renewal of the lease upon similar conditions, except perhaps regarding the lease payment. Often, contract law provides that, in the event that no explicit provision was made pertinent to prolongation of the lease, the lessee shall have a preferential right to conclude a new contract upon the expiration of the first lease agreement. However, this preferential right shall not be regarded as a right to continue the contractual relations on the same terms.

Lease Payments

5. The lease contract must provide for the conditions and periods for the payment of the lease sum by the lessee. If this has not been provided for by the contract, general contract law provisions will – as a rule – imply such terms. Typically, a lease contract will also provide for a review mechanism. However, if the parties fail to include a pertinent clause, the relevant law may provide for the mechanism, which – as a rule – means that the terms may not be altered more than once a year.

6. Sometimes the review mechanism provides for a reduction of the lease payment in the light of a possible deterioration of the leased object.

7. Often, the contract includes a requirement that lease payments be made in advance. Also, the lessee is often required to provide a security against its obligation to pay the lease sum. Such a security payment may, for instance, equal a few times the regular lease sum.

Transfer of Property

8. Any third party rights to the lease object must be communicated to the lessee. Typically, third party rights to the object will not be terminated upon the transfer of the property to the possession and use by the lessee.

9. Furthermore, a lessor shall be under the duty to transfer the property in accordance with the conditions and specifications contained in the lease contract. All ancillary items and relevant documentation regarding the object shall be transferred to the lessee together with the lease object itself.

Liability for Defects

10. If the lease object appears to be defective to the extent that the lessee may not use the object or may use it in a limited manner only, the contract - or otherwise the relevant law - may stipulate that the defects shall be repaired at no cost to the lessee. Also, a reduction of the lease sum shall apply for the period during which its use was restricted, or compensation has to be paid by the lessor for all damages incurred by the lessee. Other remedies for the lessee may include withholding lease payments after prior notice to the lessor corresponding to the amount of the expenses incurred; or to require early termination of the lease contract with subsequent return of the leased property and adequate compensation by the lessor.

11. The contract may also provide for the exclusion of the lessor's liability, if he indicated the defects at the time of the conclusion of the contract and the lessee accepted the presence of such defects or if the lessee knew or could have known of the defects by a due diligence examination of the item.

Maintenance of the Leased Property

12. Often, a lease contract provides that capital repair of the property shall be conducted at the expense of the lessor, whereas current repair shall be at the expense of the lessee. However, given the freedom of contract, a different distribution of duties regarding the maintenance of the property also can be made.

Improvements to the Leased Property

13. The contract may provide for improvements made by the lessee to the leased object. As a rule, improvements that are severable without causing damage to the main object shall remain under the ownership of the lessee. The lessor may reimburse improvements made by the lessee at its own expense and with the consent of the lessor, if the contract so provides or the parties agree on this issue separately.

Transfer and Security Interests on the Property

14. As a rule, the lessor's consent is required for the following:

- Sublease of the object; termination of the lease agreement will entail the termination of all subleases as well; however, sometimes, this general rule is excluded by the lessee; on the other hand, a sublessee may always request the lessor to take over the lease contract upon the termination of the lease with the principal lessee. In some jurisdictions, the sublessee even is entitled to require such a continuation of the lease contract. This possibility will, however, make lessors be cautious in granting their lessees the right to sublease the property.
- Transfer of the lessee's rights and duties under the contract to a third party;
- A pledge or other security interest on the lessee's rights;
- The contribution of the lessee's lease rights as a stake to the charter capital of a legal entity.

Termination of the Lease by the Lessor

15. Contract law of most jurisdictions has general rules on the termination of contracts and sometimes specific provisions that apply to the termination of lease agreements. Often, for termination, a prior notice in writing is required. In the case of default by the lessee, the law or the contract also may provide for the granting of a grace term.

16. Under general contract law or the lease contract, a lessor may be entitled to terminate the contract if

- The property is used for purposes other than those it is intended for or in contravention of the terms of the contract;
- Deterioration of the object due to negligence or other noxious treatment of the item;
- Repeated failure to make the required lease payments;
- Failure to perform the necessary repair of the property in accordance with the contract.

Termination of the Contract by the Lessee

17. A lessee shall be entitled to terminate the contract in, inter alia, the following cases:

- If the lessor breaches his duty to transfer the property or if he prevents its use in accordance with what it is intended for or otherwise in accordance with the terms of the contract;
- Where the property is defective, and to the extent that it cannot be used in accordance with the agreement, and where such defects were not indicated at the time of the conclusion of the contract or could not have been discovered by a due diligence examination of the property by the lessee;
- If the lessor fails to carry out a capital repair where this is required under the contract under the relevant law;

- If the property is not in proper condition for use by the lessee, as the consequence of circumstances beyond the lessee's control.

Financial Lease

18. Leasing can be distinguished in financial and operational leasing, as pointed out earlier. The distinction is relevant mainly for fiscal and accounting reasons. The main difference pertains to the question as to which entity the leased object must be considered to belong: to the lessor or lessee. A financial lease has the following features:

- The lease object is a specific capital good;
- During the duration of the lease agreement, the use of the lease object rests with the lessee;
- The lessee shall be obliged to fully compensate the value of the lease object to the lessor;
- The duration of the lease agreement is related to the economic period life of the lease object;
- For the lessor, the lease object fulfils the function of a security interest.

19. However, as a rule, a financial lease agreement has many other clauses pertaining to, *inter alia*, maintenance of the object; insurance; distribution of risks; rights obligations of the parties upon the expiration of the agreement, such as an option or obligation to buy the object, etc. Such clauses, however, are not distinctive as to the question of whether the agreement shall be regarded as financial or operational.

Operational Lease

20. The objective of operational lease is the use of the object rather than its financing. As a rule, the lessee has the option to cancel the operational lease contract, if he no longer wishes to use the object or wants to replace it by another object. Usually, the lessor will stipulate that the contract may not be cancelled during a relatively short period of time, which is at any rate shorter than the economic life of the object. After that period the lessor will assume the risk that the good is returned to him and that he will have to find a new lessee for the object. With a view to the possibility of cancellation, a lessor will – in most cases – assume the obligation to maintain the leased good. This type of lease will be applied for goods that are in high demand.

Different Forms of Leasing

21. *Direct leasing* is a leasing contract that is concluded directly between the lessor and the lessee, i.e., not as the result of the intervention of an agent or a broker. Typically, both types of leasing (operational and financial leasing) can have the form of a direct leasing contract.

22. *Indirect leasing contract* involves at least three parties, one of which acts as the broker to the contract. A broker may act in its own name and at its own risk or on behalf of one of the parties.

23. A *sale and lease back* contract refers to the situation where an owner of a good sells the good to a financier, with which the seller immediately concludes a lease contract to lease the good back from the financier. As a rule, such a transaction is concluded with a view to raising cash. The difference with normal lease contracts is that the lessor obtains the title to the lease object directly from the lessee in lieu of from a manufacturer or deliverer. The risk for the lessor in this type of transaction is that it is difficult to establish whether the lessee already carried out such a transaction or a similar transaction like a pledge, transfer of title, etc.

Cross-border Leasing

24. Cross-border leasing means that the lease transaction involves parties from different jurisdictions. This will have implications as to the proper law that will govern the contract, the court (or arbitration tribunal) that has jurisdiction in settling possible disputes under the lease contract, as well as the recognition and enforcement of a court decision or arbitral award. Given the complexity of cross-border leases and, consequently, the expenses for concluding such transactions, typically cross-border leases are used only in major transactions such as vessels, aircraft, factories, power plants, etc.

25. As to the choice of law, specific jurisdictions may be chosen for reasons of their favorability *vis-à-vis* leasing, in particular, with regard to such questions as “is retention of title allowed?”; “may the owner of the good be held liable for damage caused by a good?”; “will a – leased – good become a part of another thing as the result of accession? Will bankruptcy affect the status of a leased good? Typically, tax issues will be of major importance, too, for determining which law will govern the lease transaction. Often, for leasing, a special purpose company is founded in a jurisdiction that is most favorable to the specific leasing transaction.

26. With cross-border leasing two important issues in the law of conflicts (private international law) have to be taken into account: (a) proper law; and (b) competent court.

27. As a rule, parties have the freedom to make their contract subject to any law they wish. In most cases, a court will honor such a choice of law, unless public order forbids the application of foreign law. If the parties fail to make a choice of law, special reference rules in the national law will determine the proper law. Such rules may give preference to the law of the country where the contract was signed (*lex loci contractus*) or the law of the country of the domicile of the party that must fulfil the primary performance requirements in the contract.

28. As regards the choice of law with respect to property, usually parties have less freedom to make a choice of law. With regard to real estate, conflict rules often require the application of the law where the estate is situated (*lex rei sitae*). Problems may also arise with goods that are subject to registration in one country in order to enforce one’s rights to the property, whereas such requirements do not apply in the

country where the leased goods are used. In that case, it will be difficult to enforce one's rights to the property.

29. In principle, choice of forum is also free. If no choice has been made, the normal rules of establishing the court that has jurisdiction will apply, which – as a rule – will be the court of the defendant's domicile. However, in respect of real estate, in most jurisdictions, the court of the district where the real estate is situated will have exclusive jurisdiction.

Conclusions

30. Leasing – and in particular, finance leasing - is a most important instrument for the financing of equipment in industry. With a view to their complex nature, leasing contracts must be used within sophisticated regulatory frameworks, the minimum requirement for such a framework being that it does not invalidate provisions that are commonly applied in the leasing business. However, given the lack of experience in enforcing and using contractual instruments in those countries in transition toward a full fledged market economy, a strictly contractual basis is not sufficient for the operation of leasing. A regulatory framework that at least supports leasing is very much desirable as well.
