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

*Comments by Mr E.M. Bey (France/Tunisia),
Member of the Advisory Board,
on memorandum prepared by UNIDROIT Secretariat*

I. Transactions covered

- A. General definitions
 - 1. Definition of a lease
 - 2. Definition of a financial lease

The classic bailment contract, although it constitutes the hard legal core of the different types of leasing, would need to fall outside the model law itself, but not in the particular details of each type of transaction. The problem then arises as to the selective criteria permitting the delineation of the sphere of application of the law in relation to the classic bailment contract.

In this regard, we would note, that the model law must indisputably cover the category of financial leasing, which is financial in nature in that, on the one hand, it substantially includes a financial option to purchase in favour of the lessee and the rental represents amortization of the lessor's investment (the capital), and on the other hand, the parties have respected the principle of freedom (as regards the choice of the equipment, the choice of the seller, determination of the financial conditions for the purchase, conditions for delivery) and that principle's corollary, the principle of the lessor's neutrality which explains and justifies the exemptions from liability from which the lessor benefits and the direct legal link against the supplier of which the lessee benefits.

Furthermore, and although not being strictly speaking financial in nature, the category of leasing which includes the principles of freedom and neutrality, the direct right of action against the supplier-seller (the transfer of the warranties linked to the contract of sale) in particular, and a duration corresponding to the exhaustion of the usefulness of the equipment leased at the expiration of which the lessee has no option to purchase the equipment leased, should also be covered by the model law.

This type of leasing is close to the leasing practiced in certain Islamic law countries, which prohibit an interest-bearing loan but which allow the lessor to receive rentals guaranteeing the amortization of the purchase price of the equipment leased and the profit-margin allowed for. 'Parenting' seems

to have a real interest for these countries. The model law could therefore submit these transactions to its provisions, or to certain of its provisions.

The problem may equally arise as regards the 'follow-up', that is, the situation involving the continuation of a contract which has reached its expiry, but which the parties wish to continue on financial terms that take account of the rentals paid without any consideration linked to the market value of a lease of the object and, moreover, not involving any purchase option in favour of the lessee. This would therefore be a classic type of bailment, in which the rentals do not necessarily have a corresponding counterpart of the enjoyment of the equipment leased, and the parties bound by the specific provisions of the initial leasing contract.

Should one include all the leases covering second-hand equipment, resulting for example from a court case? For instance, take the scenario in which certain lessees default and present to the lessor a successor, who would resume or continue their contracts without making any modification at all. Should the model law consider these contracts which are continued as falling within its sphere of application?

What of those classic bailments, without any option to purchase, in which the rentals determine the financial character and some of which rentals may be assimilated as advances? Such will be the case of a contract with a very short duration, without any relationship for example to the duration of the fiscal accounting amortization of the equipment leased, and only requiring the payment of a few rentals (two or three or even one only) but including a significant option to purchase.

In our opinion, it is very desirable that the contracts for the lease of consumer goods, as distinct from capital equipment, should be excluded from application of the model law. The same would be true for those leases covering real estate, by reason of the complexity of the operations involved and the special legal techniques used, for example in France, like the *bail construction* or the *contrat d'entreprise*

- a. Inclusion of financial leases
- b. Lessee's selection of the goods

The question raised in I-A-2-b is important given that in all contracts, the free choice of the equipment to be leased financially (the basis of a whole group of rights commonly referred to as 'technical') is reserved to the lessee, it is this reservation to the lessee of the free choice of equipment that justifies the departures from the classic law of bailment and the special duties encumbered on the lessee, and which also makes the arrangement unique and reinforce its financial character.

In the event of the lessor intervening in the selection of goods, in our opinion it would be appropriate to exclude the exceptions from the common law of bailment, which he ordinarily would benefit from; this would tend to bring it closer to the classic type of lease and would require the model law to envisage the consequences of the lessor's default.

In the dual interest of providing uniformity and practical effectiveness, the suggestion made in I-A-2-b seems to us to be relevant.

- c. Secondary leases

In that regards I-A-2-c, see *supra*.

- B. Geographic scope

C. Arrangements excluded from coverage

In that regards I-C, see *supra*.

II. Freedom of contract.

As regards II, Freedom of Contract, in our opinion the principle of mandatory provisions is relevant, but its application must respect the nature of the transaction being examined (type of leasing), its logic, and its characteristics.

If, by example, one accepts the principles of the lessor's neutrality at the technical level (choice of equipment, choice of supplier, ...), a mandatory provision could relieve the lessor from his warranties, and from his duty to maintain the equipment as a consequence of this neutrality and the initiatives recognized to the lessee in this field. This, though, would require some restriction where the lessor has brought the lessee into the situation of a buyer vis-à-vis a seller, and in which he has consequently benefited from the rights and actions attached thereto. Must the lessor force the lessee in this case to perform the lease even though the equipment has not been and cannot be delivered — especially given that under certain legal systems, the non-delivery of the equipment leased causes the contract to be avoided for want of an object? And what about in financial leasing, a financial technique used to promote investment, the lessee benefits from a substantial purchase option that is so important that it determines the whole character of the transaction? The purchase option would itself be subject to avoidance, on the grounds that there were no object! And the whole financial leasing option would fall.

The limitation of damages must be made mandatory. Once damages seek to compensate for the damages sustained by the lessor and the lease is of the financial type, the amount of the damages must not be higher than the total amount that he would have received if the contract had been carried out according to its terms, not taking into account costs (procedural). This equitable principle would also apply to penalty clauses in those countries that recognize their validity, and acknowledge that their coercive nature and purpose is authorized up to a certain level, but this level must be controlled by the judge (see *infra*).

III. Background provisions of contract law

Regarding general provisions, one might observe that bailment is well known and is as old as the legal world itself (because of Hammurabai, the Amorite) but the questions raised merit being dealt with, given that differences do exist. What about short and long time-bars on actions? Should one, as in France, apply to financial leasing, a method of financing, the five-year time bar provided by the Code Napoléan for ordinary leases?

It seems to us that any regulation of this question must proceed in the law of contract, from the economic logic of the transaction, of its substance, and take into account other principles, such as the UNIDROIT principles, that are not incompatible with it.

IV. Lessee-lessor relationship

A. Qualification of lessors

Logic dictates that if the transaction is financial in nature, and the economic objective of the lessor is to carry out financial transactions, the said lessor must be a financial institution in a broad sense, insofar as his country allows.

B. Transferability

1. Ability to transfer

- a. Lessee's ability to transfer
- b. Lessor's ability to transfer

The lessee must be able to assign his contract — and not the equipment, of which he is not the owner — so long as the law in his country allows it, and to sublet the leased equipment; he can assign this — the ownership of the equipment leased, serving in financial leasing as a guarantee or security — with the authorization of the lessor, who can only oppose it where he has a just reason that will need, however, to be defined. The model law may add that the lessor has a direct priority right against the sublessee with respect to the rentals due to the sublessor.

The model law should, in the logic proper to financial leases, make the assignment of the lease contract effective against the supplier and enable the assignee to exercise the rights which the hire and sale contracts recognize to the original lessee against the supplier.

However, what about public notice of the assignment of the contract?

The model law should, in the same logic, envisage the assignment by the lessor of his lease contract, in light of the same rights conferred on the lessee (parallelism of rights and duties) and of the assignment of the leased item during the term of the leasing agreement. One can take one's inspiration from the French law, *Crédit-Bail*!

What about the right of the lessee to assign his purchase option?

What about the assignment of the lessor of his rentals? On what terms (notifications to be made to the lessee, time limits...)? Quid about the right to oppose assignments, and priority rights?

What about a possible transfer of a substantial or non-substantial duty of the lessor to a third-party, whereas the financial leasing contract is concluded *intuitu personae*?

2. Remedies

Several countries know the adage 'there is no right of action without an interest'. But the fact of breaching a contract in itself creates a default which gives rise to liability. But how to quantify the theoretical damage? On the other hand, the lessor must be able to solicit a judge to re-establish the situation that was breached or to terminate the contract on the terms fixed in the contract.

C. Irrevocability

1. Irrevocability in two-party leases

The law chosen by the parties seems to us to impose itself here. However, the principle of irrevocability will apply once the conditions for entry into force of the contract have been accomplished.

2. Irrevocability in financial leases

A lessor departing from his financial role will come closer proportionately to the classic role of bailor, consequently leading to the correlative approximation of the same classic law of bailment. The freedom of contract would thus play the positive role that characterizes it.

D. Right of quiet enjoyment

1. Guarantee by lessor

Although the lessee chose the equipment leased, the lessor in a finance lease involving a purchase option in favour of the lessee, must guarantee the lessee's ownership, subject to a showing of the lessee's negligent behaviour in concluding the sale contract. Saving this, the purchase option would have no purpose and would in certain legal systems be null and void, thus carrying with it the nullity of all the contracts forming the financial leasing transaction. It should be observed that French law and related legal systems (African legal systems) define financial leasing as a 'transaction' made up of several contracts (sale, hire, unilateral promise of sale,...) which practice builds upon, according to the circumstances of the case, by others.

In the logic of leasing, relieving the lessor of his warranties is the corollary of the free choices of the lessee (regarding the equipment and the supplier...). It therefore seems to us important to keep this syllogism which, in our opinion, could even be made into a guiding principle!

2. Freedom of contract

From the moment that the contract is analyzed as a bailment, in our opinion, the warranty would have to be stipulated; but the financial nature of the contract and/or the rights exercised by the lessee at the technical level may justify exceptions to this duty and thus give legal force to the contractual will of the parties, but at that point it would be explained and justified by the action of the lessee (as laid out in the above-mentioned syllogism).

But this exception must not be to profit the supplier. Therefore, it is necessary to involve the supplier and to permit the lessee to act against the supplier when the supplier is at the root of the problems caused.

Furthermore, there cannot be any exception when these problems are provoked by the lessor, who should not be able to use his own turpitude against the lessee (intentional act and/or gross negligence).

3. Guarantee by supplier

In our opinion, it is not possible to lay legally a warranty in a lease on the supplier who is not party to it. This duty exists in the sale contract, but the sale contract is not similar to that of the lease contract as to extent, duration, ... (parallelism of warranties). A better solution would be one permitting the lessee to act against the supplier, by way of guarantee, within the limits of what the seller would normally owe to his purchaser, subject to showing negligence providing the basis of the complement to the warranty.

In the event of sale by the supplier to the lessor of something belonging to someone else, which brings with it a claim by the original owner, the supplier must be bound to warranty title, just as the lessee has rights vis-à-vis the lessor, when the lessee freely chose the supplier and the object being claimed without any intervention by the lessor. Failing this, the lessor could be held liable in proportion to the extent of his intervention.

E. Default

1. Generally

a. Security and the right to demand assurance

The response would be negative where the lessor has the right to terminate the contract for nonperformance or imperfect performance. But the lessee must have the same right. Failing this, one would introduce in the two cases, in the performance of the contract, certain elements of uncertainty, sometimes of subjective assessment, which one party in bad faith would then be able to use to the prejudice of the other.

b. Excused performance

In our opinion, excused performance only makes sense if it is *exceptio non adimpleti contractus* or an exception to nonperformance in countries upholding this means of defense. But excused performance for 'impossibility of performance' goes rather to the right to terminate the lease or avoid the sale. Furthermore, one would note that the certainty of transactions suggests the need to avoid these situations of waiting for something to happen without a final solution.

Besides, in the case of impossibility of performance, one needs to envisage the consequences of this on the relations of the contracting parties, namely their relations to third parties. All this suggests, it seems to us, referring to the contract law of the state of the performance of the lease or sale, depending on the case; this would not prevent the model law from laying down a principle, mandatory or not, protecting all parties.

2. Default by lessor

a. Acceptance and rejection of non-conforming tenders

i. Grounds for rejection

ii. Rights upon rejection

Preliminary comments: Here, we are talking about the technical area generally reserved to the lessee in financial leases and the consequences of the technical area. Several sale and lease contracts have envisaged harmoniously this important and difficult situation, on which in some countries there is a large amount of case law.

The refusal in good faith of a nonconforming tender is lawful; but it must be communicated to the lessor — who has not substantially intervened in the organisation and performance of the duty of delivery of the supplier-seller (a job left in certain countries to the delivery note on the receipt of the goods linking the payment of the price of the equipment to its conforming delivery, duly noted in this document) — for him to be able to act usefully once he is legally a party to the sale contract, which is imposed on him. Such refusal is also justified by the fact that the object was only required to satisfy the (economic, financial, and managerial) needs of the lessee, who furthermore should benefit in certain legal systems and for certain types of financial leasing, from a purchase option with respect to the object; this confers on him an active, logical, and necessary role, imposed by the nature of the operation realized.

In order to avoid abuses, it is desirable and even recommended to lay down a system of proof, leaving however the job of organising this system to the parties.

It does not seem to us reasonable to make ‘substantially non-interference with the lessee’s purpose’ a cause for refusing the object when — and this is the essential condition — these objectives do not have any contractual worth, as they are not known in the sale contract and the lease contract. The situation would be otherwise if the objectives had been revealed to the parties and considered as factors determining the undertakings of the lessee. This was the case for certain very large investments in the maritime and aviation fields. They constitute rare exceptions.

If, notwithstanding this comment, it is considered that the model law should envisage a solution, it would be necessary for it to define what is meant by ‘substantially non-interference with the lessee’s purpose’, and more precisely, ‘non-interference’, ‘substantial’, and ‘purposes’. This is necessary so as to avoid what could otherwise be an important cause of litigation.

Refusal is also justified when the equipment is affected by apparent and/or hidden defects, revealed as to regard to the latter in the course of use; this would imply preliminary delivery, thus acceptance, and not a refusal of the object concerned. The model law may nevertheless consider that under this law, equipment delivered and accepted by the lessee would be considered to be refused if, within a reasonable time having regard for circumstances, a hidden defect has revealed that the good is not fit for the purpose for which it is required.

The law must also envisage the consequences (the return of the equipment, the return of the price paid, the burden of costs of pre-rentals and rentals paid, the retaining of rentals due?) on hire and sale contracts, in the knowledge that, in our opinion, their fates have to be linked by reason of their legal and economic relationship. It could limit its role to defining the basic law and referring its implementation to the law of the State of the lessee or to the law chosen by the parties.

b. Acceptance

A posteriori (post-delivery) revocation of acceptance must be based on the breach of certain technical, specific clauses of the sale contract, which have been duly ascertained and communicated to the supplier and lessor within the time agreed by the parties in the sale and lease contracts or within a time which is reasonable under the circumstances (which the parties may define in their contracts or according to the law of the state of the lessee).

What about the duty to return the object (conditions, methods, cost)? What about the enjoyment of the equipment in the meantime (problem of damage, assurance, and allowance for enjoyment), remuneration for the non-productive use of the lessor’s capital, and more generally, compensation for loss sustained? Is it for the model law to envisage these situations, and to give the appropriate legal reply?

What about the replacement of defective goods?

3. Default by lessee

a. Lessee is insolvent but has not defaulted

This gives rise to a delicate problem of proof. Besides, what criterion should one use to pronounce that the lessee is not solvent? Should the question be referred to the bankruptcy law of the country of the lessee?

It can be left to the assessment of the parties, who could determine the criteria for this in their contract.

What about this assessment when the lessor has serious real and/or personal securities or simply sufficient such securities to cover the sums due to it, independent of the lessee? Should one leave it up to the lessor to assess this with regard to the entirety of the debts of the lessee and his undertakings in relation to the whole of its other creditors? Should the handling of these questions, which are both complex and practical, come within the sphere of the model law? Wouldn't it be more appropriate to refer these issues to the bankruptcy law of the State of the lessee?

This seems to us to be all the more desirable in that the lessor's rights may enter into conflict with the specific rules of bankruptcy law.

b. Right to recover goods

It seems to us more appropriate to refer the authorization for recovery to the judge following the procedural law of the place where the equipment is being used. Failing this, the model law could envisage the return at the order of the judge of this place, rendered on a simple request.

What about the use of the goods, without any counterpart, since the default of the lessee and during the proceedings? Must one have recourse to the judge, for him to order the equipment be sealed, thus prohibiting its use, or entrust the custody of the equipment to an official ... and in which circumstances, and under which conditions?

What about abuses by the lessor?

F. Damages

1. Governing principle

The basic principle, which seems both equitable and legal, is simple. Once the lessor has paid for the equipment to the supplier, in accordance with the terms of the contracts of sale and hire known to the lessee, this co-contracting party owes compensation to the lessor for the entirety of the loss he has sustained through his fault, including — as required by legislation of many countries — the *damnum emergens* and the *lucrum cessans* (loss sustained and income missed) in the knowledge, however, that in the assessment of this loss, account must also be taken not only of the purchase price of the equipment returned or the rentals payable on its release but also the different costs incurred by the lessor on the occasion of this abnormal situation.

2. Liquidated damages

The damages agreed (by the contracting parties) must be applied (by the binding force of contracts) within the limits of the basic principle indicated above. Failing this, and if they exceed this limit, they would be requalified by the judge as a penalty clause and thus null and void in the eyes of certain legal systems or subject to revision by the judge (under certain continental legal systems).

3. Specific performance

Specific performance may be envisaged when it is feasible; for the lessor cannot be legally bound to request the termination of the lease or to have such termination imposed on him when it will be for him to take equipment back, to insure it, and to maintain it, but the question remains theoretical concerning only certain types of equipment, such as ships and aircraft.

4. Quid about penalty clauses?

V. Financial leases: the lessee-supplier relationship

A. Notice to supplier

Notification is customarily the contractual responsibility of the lessee, even if the lessor has to intervene for the legal regularity of the sale. The problem is more complicated when the transaction concerns a large investment. In this case, the lessor is present in the development of the transaction, taking care, in general, not to interfere at the technical level concerning the operational role, according to which the smaller the investment, the less real is the intrusion of the lessor in the relations of the supplier and the lessee.

What about the financing by the lessor of equipment that was non-existent or overvalued, following a plan organized by the supplier and lessee to defraud him?

A. Risk of loss

1. Lessor's risk
2. Identification of the goods and casualty before delivery
3. Note regarding right of rejection.

The risk of loss, like other risks, are in financial leasing born by the lessee after the delivery of the equipment. The risk of ownership is generally transferred to the lessor legally enters into his ownership, but this transfer of ownership only becomes effective, according to the agreement of the parties, after signature by the lessee on the report attesting to the conforming delivery to the lessee of the equipment. In our opinion, it is at this moment that ownership and the risks attached to it pass to the lessor, to be covered immediately by the lessee's contractual obligation. It is desirable that the model law specify this in defining the conditions thereof, leaving it to the parties to provide for exceptions or to adapt it to the particular situation of their transaction and that the model law specifies the consequences of this on the fate of the sale and lease contracts. What about insurance?

As regards the right of refusal, see *supra*.

B. Warranties

See *supra*. This warranty may only be provided by the supplier, the lessor being technically incompetent, and having left it to the lessee to act at the technical level. Moreover, financial leases organise these leases in detail.

VI. Rights of third parties

A. Priority rules

1. Choice of law
2. Lessor's interest
 - a. Statutory liens
 - b. Lessor's creditors

3. Mechanics' lien

In our opinion, the response should be positive on the right of priority as regards rentals, even if it is necessary for the transaction to be known to the third parties by appropriate public notice, which must be practical (not onerous) and effective. What about default in the performance of these formal requirements?

These public notice rules could also cover the lessor's ownership rights. It may also be considered enforceable *erga omnes* by the very fact of the sale. As regards the creditors of the lessor and the rights of the lessee, the model law could establish as a principle that the lease contract (with the purchase options that it includes) is effective against all of the lessor's creditors so that the rights stipulated therein are respected by them.

Let us note that in certain legal systems, only financial institutions (in the broad sense) may enter into financial leases; this is protective of the lessee's interests. Let us add that the economic objective of such transactions in relation to the lessor being financial and the lessee benefiting from one or more purchase options in respect of the equipment leased, the person taking back the goods would logically be a financial institutions.

B. Third parties in tort

The lessee being on the one hand in charge of all the technical questions not falling within the sphere of the competence of the lessor, and on the other hand the user of the equipment concerned, it is logical and equitable that he alone be responsible for the damage that he is the origin of.

But once the lessor intervenes at this reserved level of technical expertise, he proportionately engages his liability in respect of the laws governing tortious and criminal liability.

It may be noted that for very large investments, and even for less significant investments, the lessor intervenes more or less discretely at the technical level but only to provide information and so as to appreciate fully the risks arising out of its transaction. The model law could make him liable where his behaviour is at the origin of the damage. It would, by doing this, recall the basic classic law of bailment!

What, however, about the strict liability of the lessor, taken as an owner (in the maritime field and regarding pollution)? Is a reference to the law specific to each subject desirable in these cases?

What about the defrauding of a lessor financing an asset which is non-existence which has been overvalued following a scheme put together by the supplier and the lessee to the detriment of the lessor?