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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
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DRAFT CONVENTION
ON
INTERNATIONAL FINANCIAL LEASING

*as adopted by a Unidroit
committee of governmental experts
on 30 April 1987*

with

EXPLANATORY REPORT

*prepared by
the Unidroit Secretariat*

Rome, October 1987

Draft Convention on international financial leasing

as adopted by a Unidroit committee of governmental experts
at its third session held in Rome from 27 to 30 April 1987

PREAMBLE

THE STATES PARTIES TO THIS CONVENTION,

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

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

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

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

HAVE AGREED as follows:

CHAPTER I - SPHERE OF APPLICATION

Article 1

1. - This Convention governs a financial leasing transaction as defined in paragraph 2 of this article in which one party (the lessor)

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

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

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

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

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

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

3. - This Convention does not apply to a transaction in which the equipment is to be used primarily for the lessee's personal, family or household purposes.

Article 2

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

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

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

2. - For the purposes of this article, if a party to the supply agreement or the leasing agreement has more than one place of business, the place of business is that which has the closest relationship to that agreement and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that agreement.

Article 3

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

CHAPTER II - RIGHTS AND DUTIES OF THE PARTIES

Article 4

The supply agreement may not be varied without the consent of the lessee.

Article 5

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

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

3. - For the purposes of the previous paragraph the applicable law is:

(a) [in the case of ships, aircraft, vehicles or other equipment subject to registration pursuant to the law of a State, the law of the State of registration];

(b) in the case of all other [mobile] equipment [normally used in more than one State], the law of the State where the lessee has its principal place of business; and

(c) in the case of all other equipment, the law of the State where the equipment is situated at the time when the person referred to in paragraph 1 is entitled to invoke the rules referred to in paragraph 2.

4. - This article shall not affect the rights of any creditor having a lien on or a security interest in the equipment.

Article 6

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

* It was agreed by the committee of governmental experts that the provisions of Article 5(3)(a) should be examined in advance of the diplomatic Conference by a working group of technical experts to be convened by Unidroit in order to see whether the solution proposed by the committee would be workable in practice.

Article 7

1. - (a) Except as otherwise provided by this Convention or the leasing agreement, the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent that it has intervened in the selection of the supplier or the specifications of the equipment.

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

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

[Alternative I]

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

[Alternative II]

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

3. - The previous paragraph does not affect any broader warranty of quiet possession by the lessor under the applicable law.]

Article 8

1. - The lessee shall take proper care of the equipment, use it in a manner consistent with that of a normal user and keep it in the condition in which it was delivered, subject to fair wear and tear.

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

Article 9

1. - The duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee.

2. - Nothing in this article shall entitle the lessee to terminate or rescind the supply agreement.

Article 10

1. - The lessee shall have the right, as against the lessor, to reject the equipment:

(a) if the equipment fails to conform to the terms of the supply agreement; or

(b) if the supplier fails to tender delivery within a reasonable time after the delivery date stipulated in the leasing agreement or, if none, that stipulated in the supply agreement or, in the absence of any stipulation as to date, within a reasonable time after the making of the leasing agreement.

2. - The right to reject non-conforming equipment shall be exercised by notice to be given to the lessor within a reasonable time after the lessee has discovered the non-conformity or ought to have discovered it. Rejection for non-conformity of the equipment under the supply agreement shall not preclude a fresh tender of the same equipment or a tender of other equipment in conformity with that agreement if made within a reasonable time after notice to reject.

3. - The lessee shall lose its right to reject the equipment where, if the equipment had been supplied to it as buyer, it would have lost the right to reject.

4. - Where the lessee has rejected the equipment in accordance with this article and the supplier has failed to make a fresh tender of the same equipment or a tender of other equipment in accordance with paragraph 2 of this article, the lessee shall be entitled to terminate the leasing agreement, meanwhile having the right to withhold rentals payable thereunder, and to recover any rentals and other sums paid in advance. Nevertheless, the lessee shall be obliged to pay the lessor a reasonable sum for the benefit the lessee has derived from the equipment.

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

Article 11

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

2. - Where the lessee's default is substantial, then subject to paragraph 5 of this article the lessor may also terminate the leasing agreement and after such termination may:

(a) recover possession of the equipment; and

(b) recover such compensation as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms, except in so far as the lessor has failed to take all reasonable steps to mitigate its loss.

3. - The leasing agreement may provide for the manner in which the compensation referred to in paragraph 2 (b) of this article is to be computed and such provision shall be enforceable between the parties unless such compensation is disproportionate to the compensation provided for under paragraph 2 (b).

4. - Where the lessor has terminated the leasing agreement it shall not be entitled to enforce a term of the leasing agreement accelerating payment of the rentals.

5. - The lessor shall only be entitled to terminate the leasing agreement or accelerate payment of the rentals if it has by notice given the lessee a reasonable opportunity of remedying the default so far as the same may be remedied.

Article 12

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

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

Article 13

1. - This Convention applies in relation to a financial sub-leasing transaction as if the sub-lessor were the lessor, the sub-lessee were the lessee and the supplier from whom the lessor acquired the equipment were the supplier.

2. - In the case of a series of transactions involving the same equipment which includes more than one financial leasing transaction, this Convention applies as if the last financial lessor were the lessor and as if the supplier from whom the first financial lessor acquired the equipment were the supplier.

CHAPTER III - GENERAL PROVISIONS

Article 14

[1. - This Convention shall not apply where it is excluded either by the terms of the supply agreement or by the terms of the leasing agreement.

2. - [The parties may, in their relations with each other, derogate from or vary this Convention except for the provisions of Article[s 7(2),] 11(3) and (4).

Article 15

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

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

*Explanatory report on the draft Convention
on international financial leasing*

prepared by the Unidroit Secretariat

I. - BACKGROUND TO THE DRAFT CONVENTION

1. - Unidroit's work on this draft Convention goes back to February 1974 when the 53rd session of the Unidroit Governing Council was seized of a proposal from the Unidroit Secretariat recommending the preparation of a preliminary study looking into the desirability and feasibility of drawing up uniform rules on leasing. The Governing Council agreed to this proposal, giving the topic priority status on Unidroit's work programme for the 1975-77 triennium and empowering the President of Unidroit to convene a working group to study an international unification of the applicable rules on the subject.

2. - The preliminary report prepared by the Unidroit Secretariat pursuant to this decision was considered by a small working group of the Governing Council⁽¹⁾ which met in Rome on 21 April 1975 to examine the feasibility of drawing up uniform international rules on the leasing contract. This group made a number of policy recommendations: first, to exclude real estate leasing from the scope of the proposed exercise, because of what was seen as the limited incidence of such operations at the international level and the enormous difficulties that would obtrude in any attempt to unify principles of the law of real property and the law of personal property in the same text; secondly, to exclude the leasing of ships, because of the special nature of the contract involved, which was considered to have more in common with charterparties; thirdly, to exclude the leasing of aircraft, also because of the special characteristics of the contract involved and in view of the study then underway within the International Civil Aviation Organization (ICAO) of the problems arising out of the lease of aircraft in international operations; fourthly, not to limit the scope of the work proposed to the tripartite financial leasing transaction but, for the time being at least, to envisage also the bilateral operating lease; fifthly, not to attempt, in view of the enormous difficulties that would be involved, any uniformisation of the law pertaining to exclusively domestic leasing operations but rather to address specifically international leasing. The working group finally recommended the circulation of the Secretariat's report amongst experts with a request for comments and the gathering of further information on the precise nature of international leasing transactions.

(1) The members of this group, all members of the Unidroit Governing Council at the time, were: Mr Richard D. KEARNEY, Ambassador, Deputy Legal Adviser to the Department of State of the United States of America; Mr Tudor R. POPESCU, Professor of Law in the University of Bucharest; Mr Jean Georges SAUVEPLANNE, Professor of Law in the University of Utrecht and Mr Benjamin A. WORTLEY, Professor of Law in the University of Manchester.

3. - Following the endorsement of these recommendations by the Governing Council at its 54th session in April 1975, the Secretariat sent out a questionnaire to leasing operators and experts the world over, designed both to clarify certain legal problems peculiar to leasing transactions in general and to throw light on cross-border leasing in particular. Replies came in from all four corners of the world and were analysed by the Secretariat in a paper submitted to the Governing Council at its 55th session in September 1976. One of the major facts to emerge from this inquiry, as has been indicated above, was that the successful mounting of truly cross-border leasing transactions, as opposed to indirect international leasing transactions concluded through subsidiaries of the lessor incorporated in the country into which the latter wished to lease or by means of joint ventures, was still a rare occurrence, even if the sums involved in the small number of transactions actually mounted successfully were enormous, and that this was in no small measure due to the varying legal treatment accorded leasing from one country to another. Interest among those responding to the questionnaire leaned accordingly more towards a uniform international regulation of the rules governing leasing transactions in general rather than rules cast with international leasing specifically in mind. The primary purpose of the drafting of uniform rules was therefore seen as the resolution of the legal vacuum affecting leasing at the domestic level with a view to facilitating and thereby extending the possibilities for the use of this means of financing international trade.

4. - Twin doubts nevertheless persisted in the minds of members of the Governing Council regarding the aptness of this subject for unification, as regards first the feasibility of disentangling the private law aspects of leasing from its fiscal aspects, given the generally agreed unsuitability of the latter for an attempt at unification, all the more so in the same text as its private law aspects, and, secondly, the desirability of dealing with leasing separately from the general body of security interests in movables, a subject then being studied by the United Nations Commission on International Trade Law (UNCITRAL). In order to clarify these doubts the Governing Council set up a restricted exploratory working group⁽²⁾ drawn from amongst its own membership but assisted by consultant experts from the

(2) The Chairman of this group was Mr László RECZEI, Ambassador, Professor of Law in the University of Budapest, member of the Unidroit Governing Council (Hungary). Its members were: Mr Jean Georges SAUVEPLANNE, Professor of Law in the University of Utrecht, member of the Unidroit Governing Council; Mr Detlev F. VAGTS, Professor of Law in the University of Harvard, Counsellor on International Law to the Department of State of the United States of America, representative of Mr Richard D. Kearney, member of the Unidroit Governing Council (see above, footnote 1). Mr Fritz PETER, Honorary Chairman of Leaseurope, served as expert consultant to the group, which was moreover assisted by: Mr Paolo CLAROTTI, Head of the Banking Division at the Commission of the European Communities, and Mr Augusto FANTOZZI, Professor of Revenue Law in the University of Rome.

world of leasing practice. The working group gave positive answers to both questions when it met in Rome from 16 to 18 March 1977. As regards the first problem, it was of the opinion that, notwithstanding the considerable importance of fiscal considerations in specifically international leasing transactions, there was a *sui generis* derivation of private law in tripartite financial leasing which merited the framing of special rules cast with its particular characteristics in mind and that it would be possible in the drafting of such rules to steer clear of those aspects of leasing which rather fell within the competence of the revenue authorities, the philosophies underlying revenue law and private law being quite distinct. As regards the second problem, the group felt that it was perfectly feasible to formulate a legal framework around the *sui generis* leasing transaction without such a definition bringing the transaction automatically under the scope of Article 9 of the Uniform Commercial Code of the United States of America and similarly inspired security interest legislation. In particular, security interests being closely tied to an underlying sale contract, the only potential security interest in the *sui generis* type of financial leasing would be the purchase money security interest relating to the sale contract between supplier and lessor. The relationship between lessor and lessee under the leasing agreement itself, on the other hand, did not establish a security interest so long as no transfer of title took place.

5. - The working group accordingly recommended to the Governing Council that a study group should be set up with the assignment of drafting international uniform rules on the *sui generis* type of leasing transaction. It was felt that international uniform rules would realise a dual advantage in making it possible to leave the choice of the final form which the rules would take until a later stage, leaving open both the possibility that they be used to clarify the situation at the domestic level and the possibility that they be addressed to specifically international situations. The group also made a preliminary examination of the ground to be covered in the uniform rules, concluding with a number of policy recommendations to the Governing Council, among which the following may be singled out as being worthy of special mention:

(i) Clear concepts should be employed in the uniform rules so as to avoid an *a posteriori* classification of a lease as contemplated by the uniform rules under some quite different schema.

(ii) The principal aim of the uniform rules should be to regulate the tripartite leasing transaction in view of its *sui generis* characteristics in relation to the existing schemata with one or other of which it had hitherto generally been assimilated. Bipartite leasing operations should only find a place in the uniform rules to the extent that such operations

did not fit within the schema of a nominate contract.

(iii) Leasing could be defined negatively for the purposes of the uniform rules as neither a credit transaction nor a sale nor a financing transaction, but rather a special form of rental providing for the use of goods. The definition of leasing to be devised in such uniform rules could be based either on an identification of those characteristics which differentiated leasing from the existing contractual schemata with which it had hitherto been bracketed or on an enumeration of the requirements to be fulfilled before a transaction could be considered a leasing transaction for the purposes of the uniform rules, in the manner of the definition of "bill of exchange" in the 1930 Geneva Convention on Bills of Exchange and Promissory Notes, or else on an amalgam of the two.

(iv) The scope of the uniform rules should be limited to capital goods, thus to the exclusion of consumer transactions.

(v) The parties to the transaction should be professional parties and the item leased should have been leased for professional purposes only.

(vi) There was a case for excluding the leasing of aircraft, ships and rolling stock from the scope of the uniform rules, on the basis of the arguments advanced in the previous small working group of the Governing Council.

(vii) The leasing agreement to be addressed in the uniform rules should cover the use of an item leased for a length of time corresponding to its economic working life.

(viii) The lessor should remain the owner of the item leased, whatever agreements might be made with regard to the termination of the leasing agreement.

(ix) The lessee should not be obliged to purchase the item leased at the expiry of the leasing agreement, whereas equally the parties should be left free to include an option to purchase the item leased in the leasing agreement.

(x) Unless the contract provided otherwise, the lessee should have a direct right of action against the supplier in the event of the item leased not proving to be in conformity with the specifications given by the lessee.

(xi) The lessee should bear the physical risks arising in connection with the item leased, in view of the special situation obtaining in tripartite

financial leasing. The general rule of the law of products liability according to which a lessor would be liable *qua* owner for any damage caused to a third party by the item leased should not apply to the special situation of the lessor in tripartite financial leasing.

(xii) Some means of protection of third party creditors of the lessee should be found, be it only in the form of a minimum requirement laying down the principle of registration but leaving the modalities of registration to be established by each country.

6. The working group's recommendation that a study group should be set up was endorsed by the Governing Council at its 56th session in May 1977. This study group, manned by eminent experts from legal and economic systems as diverse as those of Belgium, Brazil, France, Hungary, Italy, the Netherlands, Nigeria, Switzerland, the United Kingdom, the United States of America and Yugoslavia, held four sessions in Rome, from 17 to 19 November 1977, on 1 and 2 February 1979, from 30 September to 2 October 1980 and from 27 to 30 March 1984. The Study Group elected Mr László Réczei, Professor of Law in the University of Budapest and at that time a member of the Unidroit Governing Council, as its chairman.⁽³⁾ Mr Réczei chaired all four sessions of the Study Group.

(3) The members of the Study Group, with the sessions they attended indicated in brackets, were: Mr Luiz Olavo BAPTISTA, President of the São Paulo Bar Association and Professor of International Commercial Law at the Getulio Vargas Foundation, São Paulo(3); Mr El Mokhtar BEY, Directeur juridique et du contentieux juridictionnel with the Locafrance Group, Paris(1)(2)(3)(4); the late Mr Peter F. COOGAN, of Counsel, Messrs Murphy, Weir and Butler, San Francisco(1)(3)(4); Mr Ronald M. DEKOVEN, Attorney, Messrs Shearman and Sterling, New York(3)(4); Mr Giorgio DE NOVA, Professor of Civil Law in the University of Pavia(4); Mr Christian GAVALDA, Professor of Commercial and Banking Law and Director of the Business Law Research Centre in the University of Paris I, Panthéon-Sorbonne(1)(3); Mr Royston M. GOODE, Crowthor Professor of Credit and Commercial Law and Director of the Centre for Commercial Law Studies in Queen Mary College, University of London(1)(2)(3)(4); Ms Tinuade OYEKUNLE, Director, International and Comparative Law Division, Federal Nigerian Ministry of Justice, Lagos(2)(3)(4) and Mr Fritz PETER, Chairman of the Board of Directors of Industrie-Leasing AG, Zürich and Honorary Chairman of the European Federation of Equipment Leasing Company Associations (Leaseurope)(1)(2)(3)(4), who also served as consultant expert to the Study Group. The following observers also attended one or more sessions of the Study Group: Mr Massimo ALDERIGHI, Attorney, Studio Legale Tributario A. Fantozzi-L. Biscozzi, Rome(3); Mr Sergio BIANCONI, Deputy Head of the Legal Service, Italian Banking Association, representing the Banking Federation of the European Community(3); Ms Caroline BILLIQUET DE NUZILLET, Attaché, Legal Secretariat, International Chamber of Commerce, Paris(2); Mr Jesús BLANCO CAMPANA, Legal Adviser to the Spanish Ministry of Justice and Professor of Law in the University of Madrid(1); Mr Franco CAVALLARI, Branch Deputy Director, Banca Nazionale del Lavoro,

7. - The first session of the Study Group was devoted to consideration of a list of questions drawn up by the Unidroit Secretariat and the definition of equipment leasing agreed upon after many years of debate by Leaseurope at its annual working meeting in Oslo that same year. The list of questions was designed to pinpoint the matters to be dealt with in the uniform rules. On the basis of the Leaseurope definition the Study Group was moreover able to draw up a provisional draft definition of the *sui generis* form of equipment leasing generally known as financial leasing, on which it has decided to concentrate its attention. Two other significant policy decisions were taken at this first session, to wit, first, that the Study Group should seek to provide rules for leasing operations in general rather than address specifically international leasing situations, given that there could be no solution to the problems bedevilling the development of international leasing so long as there remained no solution to the problems bedevilling leasing at the national level, and, secondly, that aircraft, ships and rolling stock should be included in the general scope of the uniform rules.

8. - The provisional draft definition agreed at the first session of the Study Group provided the starting point for the tentative draft uniform rules on the *sui generis* form of leasing transaction that were drawn up subsequently by the Unidroit Secretariat in tandem with the Chairman of the Study Group. For the other articles of this tentative draft the drafters sought to follow the general lines of the answers given by the Study Group to the aforementioned list of questions which it had considered at its first session. The provisions on public notice were, on the other hand, modelled on the equivalent provisions of the Uniform Commercial Code and the similarly inspired Personal Property Security Act of Ontario of 1967.

Direzione Generale, Ufficio Studi, Rome(3); Mr Renato CLARIZIA, Professor of Law in the University of Urbino and Secretary-General of the Italian Leasing Association (Assilea), Rome(3)(4); Ms Mireille DUSSEaux, Principal Administrator, Directorate-General XV (Financial Institutions and Fiscal Matters), Commission of the European Communities(1)(2)(3)(4); Mr Augusto FANTOZZI, Professor of Revenue Law in the University of Rome(1)(2); Mr Paolo FERRO LUZZI, Professor of Commercial Law in the University of Perugia(3); Mr Mario GIOVANOLI, representing the Bank for International Settlements(4); Mr Sanford G. HENRY, international leasing consultant, London(2)(3)(4); the late Mr Matthius H. van HOOGSTRAten, then Secretary-General of the Hague Conference on Private International Law(1); Mr Salvatore MACCARONE, Legal Adviser to the Italian Banking Association, representing the Banking Federation of the European Community(3); Mr Michel PELICHET, Deputy Secretary-General of the Hague Conference on Private International Law(3)(4); Ms Jelena VILUS, Professor of International Commercial Law in the University of Novi Sad, Yugoslavia(2).

9. - This tentative draft was considered by the Study Group at its second session. Various proposals were put forward for its amendment at that session, notably regarding what was considered to be too detailed a public notice requirement for an intended international instrument. These proposals provided the inspiration for the subsequent work of revision carried out by the Unidroit Secretariat.

10. - This revised text was then the subject of consultation both among the members of the Study Group and within a working group set up by Leaseurope. This process of consultation yielded alternative revised texts, on the one hand, from two members of the Study Group and, on the other hand, from the Leaseurope working group. A third alternative revised text was then drawn up by the Unidroit Secretariat in tandem with the Chairman of the Study Group in an effort to reconcile the different trends evidenced in these various alternatives. A preamble was added to the original draft in accordance with the wish expressed by the Study Group at its second session that it should be made clear that the uniform rules were only designed to deal with the private law aspects of leasing and did not presume to invade the specific competence normally reserved by the legislator in respect of the fiscal and accounting aspects of leasing.

11. - The alternative revised drafts were considered by the Study Group at its third session. At this session the Group was able, subject to some drafting improvements which it was agreed could be worked out between the different members of the Study Group, to adopt a set of preliminary draft uniform rules on the *sui generis* form of leasing transaction. While the title of the draft still referred to uniform rules, underlining the original intention of the drafters to approach the problem from the angle of seeking to remove the differences in legal treatment existing from one jurisdiction to another, seen as one of the major obstacles to international leasing's realisation of its full potential, the preamble and the scope of application provisions were couched in the form of a draft international Convention and the uniform rules addressed specifically international leasing situations. This change of approach was prompted, on the one hand, by recognition of the reluctance of certain States to become parties to international instruments in respect of any other than international transactions and, on the other hand, by the desire to indicate the Study Group's opinion that the uniform rules' greatest chance of success lay with their embodiment in an international Convention, the feeling being that a model law would not greatly improve the present situation of considerable differences of legal treatment of leasing from one jurisdiction to another.

12. - The Study Group, in adopting the text of preliminary draft uniform rules, recommended that, instead of following the usual course of transmitting the text prepared by the Study Group directly to a committee

of governmental experts for the hammering out of a final text for adoption at a diplomatic Conference, the Unidroit Governing Council should rather first give the uniform rules maximum exposure along the business and legal practitioners familiar with the everyday realities of leasing, *inter alia* by the organisation of symposia in different parts of the world. The purpose of these symposia would be to enable the text to be presented to and discussed by practitioners. The unripeness of the uniform rules for consideration by governmental experts pending such time as they had been given such exposure among practitioners was considered to flow principally from two, not wholly unrelated factors: first, the continuing sparseness of attempts at the domestic level to legislate in this field and, secondly, the continuing evolution of the leasing mechanism in view of its well proven flexibility to meet constantly newly appearing market needs. Since this continuing process of evolution was largely the work of the denizens of the financial and business world, it was considered desirable to sound first the opinion of those responsible for this ongoing evolutionary process, in order to ascertain whether and to what extent the solutions advanced by the preliminary draft uniform rules were consonant with the realities of leasing practice.

13. - The Unidroit Governing Council at its 60th session in April 1981 endorsed this recommendation of the Study Group for the holding of symposia designed to give exposure to the uniform rules and the first in what was envisaged as a programme of symposia was held in New York on 7 and 8 May 1981. This symposium was sponsored by the American Law Institute-American Bar Association Committee on Continuing Professional Education. The audience assembled in New York was essentially composed of bankers, businessmen and practising lawyers having expertise in international leasing, mostly from the United States but also including some who had journeyed from Europe. Invitational in character, the symposium was structured in such a way as to permit a panel of speakers, largely made up of members of the Study Group,⁽⁴⁾ to introduce the provisions of the preliminary draft uniform rules and the audience to raise questions and indicate any criticism.

(4) In New York the panel of speakers was made up as follows: Co-chairmen: Mr Peter F. COOGAN, member of the Study Group; Mr Ronald M. DEKOVEN, member of the Study Group; Members: Mr E. Allan FARNSWORTH, Professor of Law, Columbia University, New York, member of the Unidroit Governing Council; Mr Roy M. GOODE, member of the Study Group; Mr Kraig KLOSSON, Chairman, International Committee, American Association of Equipment Lessors; Mr Peter H. PFUND, Assistant Legal Adviser for Private International Law, Department of State of the United States of America; Mr László RECZEI, Chairman of the Study Group; Mr Martin J. STANFORD, Secretary to the Study Group; Mr Detlev F. VAGTS, member of the restricted working group of the Unidroit Governing Council on the leasing contract.

14. - The second in the programme of symposia, sponsored by Industrie-Leasing AG, the leasing subsidiary of the Swiss Bank Corporation and held in Zürich on 23 and 24 November 1981,⁽⁵⁾ was addressed essentially to an audience of Western and Eastern European bankers, businessmen and practising lawyers, although some participants came from further afield, from Egypt for instance.

15. - Presentation of the uniform rules to, and discussion thereof among a numerous Far Eastern audience was also possible at the First World Leasing Convention, organised by Leasing Digest Conferences in conjunction with the Hong Kong Equipment Leasing Association in Hong Kong from 10 to 12 January 1983.⁽⁶⁾

16. - Further presentation and discussion of the uniform rules was also possible at the seminar on international equipment leasing organised for French-speaking African lawyers by the International Development Law Institute in Rome from 6 to 17 February 1984.⁽⁷⁾

17. - The Unidroit Secretariat in the meantime employed its best offices to ensure that the uniform rules received the maximum exposure world wide by the publication of regular articles thereon in the annual editions of the World Leasing Yearbook from 1980 onwards and, where possible, in the press.⁽⁸⁾ Regular and close ties of co-operation have at all stages of Unidroit's work on this subject been maintained with the national, supranational and regional associations and federations representative of the leasing industry, most notably Leaseurope,⁽⁹⁾ the Asian

(5) The panel of speakers in Zürich was made up as follows: Chairman: Mr Fritz PETER, consultant expert to the Study Group; Members: Mr El Mokhtar BEY, member of the Study Group; Mr Tom M. Clark, then Chairman of Leaseurope; Mr Peter F. COOGAN (see above); Mr Ronald M. DEKOVEN (see above); Mr Roy M. GOODE (see above); Mr Michel PELICHET, observer of the Study Group; Mr László RECZEI (see above); Mr Peter SEIFFERT, lawyer with Deutsche Anlagen-Leasing GmbH, Mainz; Mr Martin J. STANFORD (see above).

(6) Presentation of the uniform rules in Hong Kong was in the hands of Mr Ronald M. DEKOVEN (see above), with additional information being supplied by Mr Martin J. STANFORD (see above).

(7) Presentation of the uniform rules was this time in the hands of Mr Martin J. STANFORD (see above) as Technical Coordinator of, and Visiting Instructor at the seminar.

(8) Thus articles on the uniform rules appeared in the Swiss daily the Neue Zürcher Zeitung on the occasion of the symposium organised in Zürich on 23 and 24 November 1981: "Diskussion um internationales Leasingrecht" N.Z.Z. 21.XI.1981; "Neue Rechtsgrundlagen für internationales Leasing?" N.Z.Z. 27.XI.1981.

(9) Unidroit was twice, in 1976 in Munich and in 1982 in Amsterdam, given the opportunity to address annual working meetings of Leaseurope on the subject of the uniform rules.

Leasing Association, the American Association of Equipment Lessors and the Federacion Latino Americana de Leasing (Felalease). On 12 June 1984 the Italian Finance Houses Association (Associazione Tecnica delle Società Finanziarie di Leasing e di Factoring), in conjunction with the law journal "Nuovi Investimenti", organised a one-day seminar on the Unidroit draft in Milan. The audience, made up of Italian leasing specialists, was thus able to hear presentation of the draft and make such criticism and comments as they saw fit.⁽¹⁰⁾

18. - At its fourth session the Study Group considered the case for the amendments proposed during the course of the programme of symposia and gave especial attention to the improvement of the drafting of the text. It had before it a revised version of the text adopted in October 1980 which had been prepared in Budapest in December 1983 by the Unidroit Secretariat in tandem with the Chairman of the Study Group. The aim of this revision was to give effect to the proposals for the amendment of the uniform rules made during the programme of symposia and other meetings. The major decisions taken at the final session of the Study Group were, apart from that of rejecting a proposal made at the New York symposium for the widening of the scope of the uniform rules to embrace bilateral leasing arrangements, in particular operating leases, first, to reintroduce that provision which had maintained its place right through the Study Group's work prior to the symposia and which sought to highlight the financial nature of the *sui generis* type of lease by indicating that the duration of the leasing agreement took account of the period of amortisation of the leased asset (Article 1 (2)(d) of the text adopted in October 1980); secondly, the deletion of Article 2 of the text adopted in October 1980,⁽¹¹⁾ a provision that had aroused much criticism on the occasion of the symposia, mainly on account of what was considered to be its obscure drafting, but which sought to ensure that once a given transaction was regarded as subject to the uniform rules under the law of the State in which the leasing agreement was

(10) On this occasion presentation of the uniform rules was in the hands of Mr Riccardo MONACO, then Secretary-General of Unidroit; Mr Giorgio DE NOVA, member of the Study Group and Mr Martin J. STANFORD (see above).

(11) The text of Article 2 as adopted by the Study Group in October 1980 with subsequent modifications incorporated, with the agreement of the members of the Study Group, in the text published in March 1981 read as follows:

"Where a transaction is regarded as being subject to this Convention according to (a) the law of the State in which the leasing agreement was concluded or (b) the proper law of that agreement as determined by the rules of private international law of the forum, such a transaction shall also be regarded as being subject to this Convention in any other Contracting State."

concluded or under the proper law of that agreement, then it was automatically subject to the uniform rules in any other Contracting State; thirdly, the deletion of Variant II of Article 4 of the text adopted in October 1980⁽¹²⁾ following much criticism of that variant during the symposia on the ground that it would put the risk of loss of title too heavily on the lessor; fourthly, the introduction of a clause requiring the lessor to elect between the exercise of the remedies given it under the then Article 12 (1) of the uniform rules and the benefit of a clause accelerating its entitlement to all or any of the lease rentals upon the lessee's default; fifthly, the introduction of an article by now common in international commercial law Conventions designed to ensure, on the one hand, that the uniform rules are interpreted in accordance with their international uniform character and not on the basis of the legal principles and traditions of the legal system of the judge or arbitrator called upon to decide a given case and, on the other hand, the observance of good faith.

19. - The preliminary draft uniform rules on international financial leasing as adopted by the Study Group at its fourth session were then, in accordance with Unidroit tradition, submitted for approval to the Governing Council at its 63rd session held in May 1984. This approval was given and the Council accordingly authorised the convening of a committee of governmental experts to hammer out the text of a draft Convention suitable to be submitted for adoption to a diplomatic Conference.

20. - Three sessions of this committee were held in Rome from 15 to 19 April 1985, from 14 to 18 April 1986 and from 27 to 30 April 1987. 40 Unidroit member States, five non-member States, six intergovernmental organisations, two international non-governmental organisations, three international professional associations and five national professional associations were represented in the committee's work.⁽¹³⁾ Mr László Réczei, the representative of Hungary, was again elected chairman. Mr Royston M. Goode, a representative of the United Kingdom, was elected deputy chairman and chairman of the drafting committee. A drafting com-

(12) The text of Article 4, Variant II as adopted in October 1980 read as follows:

"The lessor's title to the equipment shall be enforceable against all third parties provided that the lessor has complied with such rules (if any) as to public notice as may be prescribed by the law of the State of the lessee's principal place of business. [Where the lessor has not so complied or where there are no such rules, its title is not enforceable against a person acquiring an interest in the equipment, by attachment or otherwise, unless the lessor proves that this interest was acquired in bad faith.]

(13) A full list of those who took part in this committee's work is set out in the Appendix to this report.

mittee was set up at the first session of the committee of governmental experts. At the first session this drafting committee was manned by the chairman of the committee of governmental experts and the representatives of France and the United Kingdom, whereas at the second and third sessions it was enlarged to take in also one representative each from the delegations of Belgium, China, Finland and the United States of America. The committee of governmental experts gave the text adopted by the Study Group three readings as a result of which, at its final sitting on 30 April 1987, it was able, subject to reservations regarding certain provisions which it was agreed should be placed in square brackets for decision at the diplomatic Conference, to adopt the text of the draft Convention on international financial leasing set out *supra*. This text, together with its sister draft Convention on international factoring, will now be laid before a diplomatic Conference to be hosted by the Government of Canada. This Conference will be held at the Government Conference Centre in Ottawa from 9 to 28 May 1988.

II. - GENERAL CONSIDERATIONS

Growth of Leasing

21. - Leasing, notwithstanding the comparatively recent emergence of the technique at present known by this term, in fact has a long history. Historical evidence suggests its widespread use by the ancient Sumerians circa 5000 B.C. Its modern development, though, as a generally acceptable alternative to the outright purchase of equipment, is rather to be traced back to the development of the railways in the middle of the 19th century. The United Kingdom wagon leasing companies of the late 1850's were among the very first registered limited liability companies to avail themselves of the new corporate form. Though their activity only spanned a relatively short period, the wagon leasing companies made a vital contribution to the rapid development of railway freight. A similar pattern occurred in the United States of America where railroad companies pushing ahead with new routes concentrated their financial resources on the provision of track and facilities and obtained their rolling stock on leases known initially as "car trusts" but which later became known as "equipment trusts". Certain manufacturers of specialized machinery, starting with the Bell Telephone Company in 1877, subsequently found another application of leasing as a means of protecting their monopoly or near-monopoly position by limiting the use of their products to lessees.

22. - It was in the post-World War II period, however, that the spectacular growth of leasing really got underway. This can be seen as one aspect of the more general phenomenon of the movement towards a credit

economy and the acceptance of debt financing by the business community. The initial impetus to the growth of leasing in the wake of World War II was given by those businesses needing to replenish their equipment. The conventional means of responding to this need in the United States, the conditional sale, was simply not suitable, requiring almost invariably as it did a down-payment of 15-20%, a sum which many businesses did not then have. Until the 1960's the use of leasing was thus principally confined in the United States to capital-poor, high-risk companies, and the total annual volume of new equipment leases over that period in the United States probably did not exceed U.S.\$ 1 billion. It was in the late 1950's and with the advent of the 1960's that leasing came of age with its acceptance by large industrial corporations, utilities, national banks and Governments, as well as the establishment of the first independent leasing companies, playing a role analogous to that of banks and other financial institutions, from which they nevertheless differed in that they aimed to buy and then lease equipment to their clients, rather than simply loaning them the necessary money to buy it. The first such company was founded in 1952 in San Francisco: the United States Leasing Corporation. It was through the expansion into Europe and the Far East of the first American leasing companies, and notably U.S. Leasing, that the first non-American leasing companies were established: Mercantile Leasing in the United Kingdom in 1960, Deutsche Leasing in the Federal Republic of Germany in 1962 and Orient Leasing in Japan in 1962. Manufacturer links provided the early impetus for these operations but leasing companies, whether or not linked to domestic financial institutions, soon began cultivating direct links with equipment users and leasing an ever wider variety of equipment to them.

23. - The 1970's and the beginning of the 1980's are generally considered to mark the most rapid period of growth in leasing world-wide. Thus in the United States the amount of new equipment on lease rose from U.S.\$ 15 billion in 1975, to U.S.\$ 37 billion in 1980, to more than U.S.\$ 61 billion in 1983, and to an estimated U.S.\$ 100 billion in 1987. On the basis of these figures, the leasing industry's contribution to total plant and equipment acquisition by commercial businesses in the United States now stands at 29%. As regards Western Europe, the more than 600 leasing companies represented in the European Federation of Equipment Leasing Company Associations (Leaseurope), a federation which covers about 80% of the financial leasing industry in Western Europe and encompasses 16 countries, in 1972 purchased equipment for leasing to their customers costing some ECU 2.1 billion; by 1980 the total value of new equipment leased in the member countries of Leaseurope had climbed to ECU 12.2 billion. By 1985 Leaseurope member companies leased equipment to the value of ECU 29.1 billion (U.S.\$ 24.7 billion). The pioneer of leasing in Asia has been Japan. In 1970 Japan's 31 largest leasing companies signed

contracts worth a total of U.S.\$ 726 million. By 1976 this figure had grown to U.S.\$ 1,938 billion and by 1981 to U.S.\$ 7.5 billion. During the 1983 fiscal year ending on 31 March 1984, the total value of new leasing contracts concluded by member companies of the Japan Leasing Association amounted to U.S.\$ 12.6 billion. This figure had grown to U.S.\$ 25 billion by the 1986 fiscal year. Leasing has achieved roughly a 10% to 20% annual rate of growth over the last few years in Japan. Leasing's share of total private sector capital expenditure in Japan has grown from 3.03% in 1980 to 6.9% in 1986.

24. - Developments elsewhere in the world have mirrored this trend of rapid growth, albeit from more recent beginnings. The Far East has seen some of the most startling figures in this regard. The setting up of the first leasing company in the People's Republic of China dates back only to 1981. By 1985 Chinese leasing companies were concluding business for a value of U.S.\$ 800 million, the volume of their business having grown 65 times since 1981. The first leasing company in India was set up in 1973: by the end of 1986 there were probably more than 500 leasing companies operating in India. The business written by Indian leasing companies at the end of 1986 was estimated to be about U.S.\$ 370 million, nearly 75% of which was written by the 30-40 leaders of the market. Where there were only five leasing companies in Indonesia in 1980, 65 such companies are now registered there. This expansion was reflected in the increase in the total value of new Indonesian leasing contracts on a purchase-cost basis from Rp. 0.7 billion in 1975 to Rp. 368.6 billion in 1985. Some of the most startling figures of all, however, are those for the Republic of Korea which show an increase in the total value of new leasing contracts on an acquisition-cost basis from U.S.\$ 203 million in 1982 to U.S.\$ 1,027 million in 1985. From the establishment of the first leasing company in Malaysia in 1973, the Equipment Leasing Association of Malaysia by July 1986 counted 147 member companies. The value of assets leased by Malaysian leasing companies now stands at M\$ 1 billion, representing probably over 20% of total annual capital expenditure on equipment in Malaysia.

25. - In South American markets too leasing has grown apace, particularly in the early 1980's. By the end of 1982 approximately U.S.\$ 3.5 billion were invested in leasing in South America, more than two-thirds of this sum - U.S.\$ 2.6 billion - being concentrated in Brazil. This rate of growth dipped in the years 1982 to 1984, in common with that in other sectors of the economy, but has now picked up again to such an extent that the Brazilian leasing industry had by 1986 once again caught up with its 1982 investment figure of U.S.\$ 2.6 billion.

26. - The world leasing business is estimated to have grown from U.S.\$ 53 billion in 1979 to U.S.\$ 200 billion by 1986. The July 1984 News

Bulletin of the American Association of Equipment Lessors (AAEL) reported the results of an informal survey carried out by the AAEL which showed that American lessors financed U.S.\$ 8-10 billion of equipment outside the United States during 1983. Mr Tom M. Clark in his address to the September 1984 Copenhagen annual working meeting of Leaseurope, entitled "International leasing in practice", made the first attempt, on the basis of the AAEL survey, to estimate the extent of cross-border leasing activity. On his assumption that the international activities of leasing groups of other countries, principally the United Kingdom and France in Europe together with Japan and Australia elsewhere, were roughly comparable in overall size to those of American lessors, he concluded that, just as United States domestic leasing represented about 50% of the world market, so the total figure for new international leasing business in 1983 could be put at upwards of U.S.\$ 15 billion, that is more than the total new domestic business of members of Leaseurope's 16 national associations in 1983.

The need for a uniform legal treatment of financial leasing

27. - The technique known as financial leasing was developed by the financial community to respond to newly perceived market needs for which the existing range of financing techniques had shown itself to be inadequate. In common with other techniques developed by the business community it has tended for its contractual documentation to draw quite heavily, albeit at times indiscriminately, on existing contractual models. It has thus borrowed features from the traditional bailment contract just as it has also taken over concepts commonly associated with the conditional sale or hire purchase transaction. However, in fusing these different characteristics financial leasing ultimately outgrew its relationship with its original contractual models and developed a separate, albeit hybrid legal personality of its own. For a long time the significance of this phenomenon seemed to be lost on the courts of the various countries which invariably sought to resolve legal problems arising in connection with the new technique by reference to the conceptual armoury of those classical contractual schemata to which it owed its origins.

28. - To take but one example, in the United States of America the argument for a long time ran that leases could be adequately dealt with either under the law of bailment (the "true" lease) or under the provisions of Article 9 of the Uniform Commercial Code governing security interests (the lease by way of security). Only the isolated voice was to be heard arguing for the inappropriateness of the remedies provisions of Article 9 to those leases which did not closely approximate to transactions traditionally handled as security devices and in any event such voices were still not willing to recognise the existence of a category of lease that

was amenable neither to classification within the category of bailment contracts nor to classification within the category of conditional sale/security interests. Admittedly this thinking has now undergone a radical transformation with the approval on 9 August 1985 of the Uniform Personal Property Leasing Act by the National Conference of Commissioners on Uniform State Laws.

29. - The nefarious consequences flowing from this longstanding failure to recognise the inadequacy of the legal treatment of leases resulting from the indiscriminate application to them of the conceptual framework of the classical contractual schemata were compounded by the piecemeal nature of the attempts made over the years by the legislator to grasp the nettle of the legal nature of leasing. At times the legislator addressed itself to the fiscal aspects of leasing, at others it regulated the accounting aspects of leasing, at other times again it established the necessary conditions for leasing companies to operate in certain countries, but only rarely did it get fully to grips with the legal nature of leasing.

30. - The international potential of financial leasing was certainly not enhanced by the conspicuous failure to adopt a consistent attitude to its legal treatment from one jurisdiction to another. What started life in the Anglo-Saxon world as a form of bailment lease was, for instance, absorbed into countries with a civilist tradition as something more in the nature of a conditional sale. This proved to be a source of legal uncertainty in cross-border transactions, ownership for example being differently attributed according to the jurisdiction seized.

31. - Unidroit's thinking in embarking on the preparation of uniform rules on the leasing contract was at one and the same time to bestow on the atypical leasing transaction known as financial leasing a separate legal infrastructure of its own conceived with its particular characteristics in mind rather than on the pattern of the traditional contractual schemata and thereby to remove those elements of legal uncertainty bedevilling the realisation of anything like financial leasing's full potential at the cross-border level.

Some general remarks about the draft Convention

32. - In distinguishing this atypical lease from those neighbouring legal concepts to which it had previously almost invariably been assimilated, the authors of the draft Convention singled out two factors as being of crucial importance: first, the dynamic, pivotal role played in the transaction by the lessee who selects the equipment and supplier on its own with a concomitant reduction in the role of the lessor whose ownership is

stripped of virtually all the normal attributes of that quality and whose interest in the transaction is the purely financial one of recouping its capital investment; secondly, the leasing agreement between lessor and lessee is concluded for a term which takes the period of economic amortisation of the equipment into consideration, whence the essentially financial nature of the transaction for the lessor, in that the lessee's payment of its rentals is not merely consideration for its right to use of the equipment, as would be the case with a typical bailment, but also guarantees the lessor the amortisation of its capital investment.

33. - It was around a core made up of these twin characteristics that the authors of the draft Convention set about building a distinct legal framework for the *sui generis* type of lease. Whilst it was true that in so far as the constituent elements of this novel transaction were a sale and a bailment the *basic* rules to be applied in regard to this transaction would be those of the law of sale and the law of bailment, it was equally true that to the extent that this novel institution had in fusing these two contracts into a complex new transaction to meet new market needs rendered certain concepts of the law of sale and the law of bailment inappropriate to, and inadequate for the resolution of legal issues arising in connection with this legal hybrid, these basic rules would have to be suitably adapted in fashioning this new legal framework. Reflecting the origins of the new institution in the creativity of the denizens of the financial world it was the opinion of the authors of the draft Convention that in shaping this legal framework it would be more profitable to have foremost in one's mind the economic finality of the transaction, as reflected by the parties in their respective agreements, than simply slavishly to try to force the new transaction into the conceptual framework of the classical contractual schemata out of which it had evolved.

34. - The very circumstances which had called into being the new transaction, that is the inadequacy of the existing range of financial techniques to meet newly perceived market needs, moreover provided a clear signal to the authors of the draft Convention to be on their guard against in any way seeming to impose a legislative straitjacket on the object of their attentions. Its dynamic, hybrid nature, forever sprouting new varieties to respond to changing market conditions, made the authors of the draft Convention keenly aware of the need to safeguard its inherent creative potential by leaving the parties maximum freedom in their contractual relations with one another. Moreover, this convinced the authors of the draft Convention that their efforts would be better employed in clarifying a limited number of fundamental points, capable of bringing out the atypical nature of financial leasing, than in endeavouring to achieve a systematic unification of all legal aspects of the subject, all the more so as the more one went into detail the more likely was one to

become embroiled in aspects of the law governing the traditional sale and bailment contracts and the greater the differences between the manner in which these aspects would be regulated from one legal system to another. Concentration on such a limited number of fundamental aspects of financial leasing could, moreover, for the same reason be reasonably expected to enhance the chances of the acceptance of the end-product of this exercise by a large number of Contracting Parties.

35. - One preliminary issue which fell to be resolved in delimiting the ambit of the draft Convention was whether to restrict one's efforts to the tripartite lease commonly known as financial leasing or whether to broaden the area of inquiry also to encompass the type of leasing generally referred to as operating leasing. The major factor which determined the decision of the authors of the draft Convention in this respect has already been adverted to above, namely the idea that the draft Convention should confer a separate legal status on the atypical lease capable of distinguishing it once and for all from those neighbouring legal concepts with which it had previously been the tendency to confuse it. Whereas there is undoubtedly a good deal of operating leasing engaged in by lessors operating in exactly the same manner as they would in a full-pay-out financial lease, notably in container leasing, and whilst it is true that there are many cases where it is only possible to determine with certainty whether the type of lease being used is a financial lease or an operating lease depending on what finally happens to the 20% or 30% residual factored in by the lessor at the outset of the lease, the fact is that the operating lease does not typically present the hallmarks of atypicality, referred to above in §32, commonly found in the financial lease, to wit the leading, dynamic role played by the lessee in the selection of the supplier and the equipment and the correspondingly subsidiary, purely financial role played by the lessor, on the one hand, and the link between the leasing term and the period of economic amortisation of the equipment, on the other. As such the operating lease does not present the same problems of awkwardness of fit in the classifical contractual schemata and is indeed generally amenable to treatment as a bailment.

36. - In particular the restriction of the ambit of the draft Convention to the tripartite financial lease was essential to the draft's whole underlying philosophy, in that the reason for insulating the lessor in most cases from liability for the condition of the equipment was because its role was purely financial in character, a consideration which would not apply in the typical operating lease, particularly in that type of operating lease where the lessor produces the equipment itself. Likewise, one of the principal reasons for focussing on financial leasing was precisely to deal with those special legal problems that arise out of the complex, tripartite nature of financial leasing, in particular the absence

of contractual nexus between the supplier and the lessee, problems which do not arise with the typically bipartite operating lease. There was not the same need for an international instrument, indeed for any legislation at all, where all the parties had to do was to write their own contract, as was the case with the typically bipartite operating lease.

37. - Recent developments in the leasing world have nevertheless contributed to blur considerably the lines of demarcation between financial leasing and operating leasing. Thus for economic reasons leases entered into with airlines in developing countries are now frequently termed "operating leases", while seeming nevertheless in substance to remain within the contours of the draft Convention. The aircraft is purchased from the manufacturer by a financial intermediary who in turn leases it to a national airline. Furthermore, the Draft Operational Regulations adopted by the preparatory committee of the signatory States of the 1985 Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) contained certain recommendations to MIGA's Board the effect of which would be to allow for MIGA coverage of leasing arrangements on condition, *inter alia*, that the lease was an operating lease. However, this requirement should again be seen more as a question of terminology than of substance, the underlying intention being to distinguish an eligible investment from a transaction that is nothing more than an export credit substitute. Article 12 (a) of the MIGA Convention provides that "eligible investments shall include equity interests ... and such forms of direct investment as may be determined by the Board" of MIGA.

38. - While the draft Convention was originally conceived as uniform rules designed to clarify the situation with regard to the *sui generis* type of leasing in general, albeit in particular with a view to facilitating and promoting cross-border transactions, this idea soon had to be sacrificed in view of the well-known reluctance of certain States to become parties to international instruments the effect of which will be to impinge on their domestic law and for this reason the draft Convention's application is limited to *international* financial leases. However, the authors of the draft Convention never lost sight of the fact that for the vast majority of States that have no legislative infrastructure specifically addressing the atypical leasing transaction the greatest usefulness of the body of uniform rules contained in the draft Convention may well prove to be as the basis of domestic law designed to fill this legislative vacuum.

39. - The provisions of the draft Convention have been divided up into three parts, although it is important at this stage to bear in mind the limited objective of the authors of the draft Convention in making this decision, namely to enable them better to situate the problem raised by the provisions of Article 14, to wit which provisions of the draft Convention

should be amenable to derogation. A first series of articles (Chapter I: Articles 1-3) delimits the future Convention's sphere of application, both substantive and geographic. This is followed by the main body of substantive uniform rules contained in the draft Convention (Chapter II: Articles 4-13) dealing with the rights and duties of the parties to the financial leasing transaction. These provisions can be further sub-divided into those dealing with the parties' rights and duties *inter se* (Articles 4, 7, 8, 9, 10, 11) and those dealing with the rights and duties of the parties with regard to third parties or outsiders (Articles 5, 6, 7 (1)(b) and (c)). The other two articles at present contained within Chapter II (Articles 12 and 13) are in fact more concerned with the draft Convention's sphere of application. The main purpose of Article 12 is to extend the application of the draft Convention to those financial leasing transaction, commonly known as leveraged leases, in which in return for putting up a large part of the investment represented by the transaction, one or more lenders will receive an assignment from the lessor of the stream of rentals provided for under the leasing agreement. Article 13, on the other hand, seeks to extend the application of the draft Convention to sub-leasing arrangements. The proper place for these provisions as such may accordingly finally be found to be in a revamped Chapter I encompassing, on the line of other recent international instruments adopted in the commercial law field, both "sphere of application and general provisions", although this would probably not be appropriate for Article 12 (2), dealing with the lessee's right of assignment. Such a revamped Chapter I would also be able to absorb the third group of provisions at present contained in the draft Convention (Chapter III: Articles 14 and 15), which are general provisions traditionally found in international instruments of this ilk.

III. - COMMENTARY ON THE BODY OF THE DRAFT CONVENTION

Title

40. - In common with other texts emanating from Unidroit committees of governmental experts, this text is styled a draft Convention. Its title indicates that it is concerned essentially with that type of leasing commonly known as financial leasing and with only the international manifestations of that phenomenon. As we have already had occasion to note, the delimitation of the ambit of the draft Convention by reference to international transactions is in no way intended to prevent those States the primary concern of which would be for legislation to govern domestic financial leasing transaction so to extend the draft Convention's application. Its delimitation by reference to financial leasing goes back to the same occasion, namely the fourth session of the Unidroit Study Group

when it was decided that the previous denomination of the subject-matter of the draft Convention, as the *sui generis* type of leasing transaction, was less felicitous than the name by which it had generally become known. The idea also was that the qualification of a legal institution as *sui generis* was not normally something that one would expect to find in a statute, let alone an international instrument, being a matter more appropriate for debate among legal scholars. It nevertheless remains true that the inclusion of the words "*sui generis*" in the title, and indeed also in the preamble up until the first session of governmental experts, had the advantage of alerting the reader straight away to the fundamental idea behind the draft Convention, namely to enshrine therein the recognition of a new legal category that should no longer be confused with those neighbouring legal concepts from which it traced its origins. This concern has once again become topical, as alluded to earlier in this report, in view of the increasing blurring of the distinction between financial and operating leases. The specific expression "financial leasing" employed in the title should, accordingly, not be read as anything more than a term of art to encompass that particular type of transaction which is subsequently defined in Article 1 (2).

41. - Differences of opinion emerged as to the most suitable French title for the draft Convention. The Unidroit Study Group had come up with the appellation "location financière", drawing inspiration from the titles of legislation passed in several jurisdictions belonging to the Latin linguistic tradition (notably the Belgian 1967 legislation which spoke of "location-financement", the Spanish legislation of 1977 which employed the term "arrendamiento financiero", the Colombian legislation of 1979 which also spoke of "arrendamiento financiero", the Portuguese legislation of 1979 which spoke of "locação financeira", the Venezuelan legislation of 1982 which again employed the term "arrendamiento financiero", not to mention all Italian legislation on this subject which speaks of "locazione finanziaria"). However, certain French-speaking representatives attending the first session of governmental experts took exception to this appellation in view of what they considered to be the primacy of the term "crédit-bail" to denote this activity in the French language, after its use in the French legislation of 1966 and subsequent hallowed usage in France, notably in an "arrêté" on the Frenchification of terminology imported into France from abroad.

Preamble

42. - Enshrined in the preamble, in particular in the second and fourth clauses thereof, is the basic philosophy underlying the draft Convention, namely that, in order to foster the wider use of financial leasing at a cross-border level, it is important to remove the impediments to such

cross-border transactions deriving from legal factors, and pre-eminent among such legal impediments must be counted the inadequacy of the legal treatment at present generally meted out to such transactions. The inadequacy of this legal treatment, as we have already had occasion to note, consists essentially in financial leasing being generally forced this way or that into one or other of the traditional contractual schemata, most notably the contract of bailment, to which it owes its origins and within the comfortable logic of which it has hitherto therefore almost invariably been the tendency to try to accommodate it. The authors of the draft Convention adjudged that it was time that the distinctive set of triangular relationships created by the financial leasing transaction should receive an appropriate legal treatment of their own cast with their particular characteristics in mind.

43. - At the same time the authors of the draft Convention recognised the continuing relevance of the rules governing the traditional contract of bailment to the financial leasing transaction. Indeed in the fourth clause of the preamble they acknowledge that these rules had been the starting point, the foundation for the rules embodied in the draft Convention. The draft Convention had, in taking over many of the rules, concepts and terminology of the law of bailment, had to adapt this regulatory, conceptual and terminological framework so as adequately to reflect the novel economic reality of financial leasing.

44. - It did not escape the attention of the authors of the draft Convention that not only have some of the most outstanding recent growth figures for leasing been recorded in developing countries but also that financial leasing has undoubtedly proven its worth in meeting just those capital investment needs which are at present so sorely felt among developing countries. In the third clause of the preamble the draft Convention accordingly proclaims its authors' commitment to the need to make international financial leasing more available to developing countries. Clearly this idea follows on from and is intimately connected with those ideas expressed in the previous clause of the preamble, that is that in order to make international financial leasing more available to developing countries it is especially vital to remove those legal impediments at present standing in the way of greater cross-border leasing traffic with such developing countries, on the one hand, and to ensure that a fair balance is maintained between the interests of the different parties to the transaction, one of which may well be in a developing country, on the other.

45. - Striking an equitable balance between the interests of the different parties to the leasing transaction was an objective ever in the forefront of the minds of the authors of the draft Convention. This search

was conducted both in the context of the two contracts making up the complex financial leasing transaction and in that of the mutual relations of the parties *inter se*. The structure of the draft Convention is cast in the image of the economic reality of the transaction. Whilst it accordingly reflects the central, dynamic role played by the lessee, it nevertheless also seeks to achieve an overall apportionment of the rights and duties of all parties to the transaction that mirrors their different roles and levels of responsibility in relation to the transaction.⁽¹⁴⁾

46. - From the very beginning the authors of the draft Convention, bearing in mind the different philosophies underlying the treatment of financial leases for accounting and revenue purposes, on the one hand, and for strictly private law purposes, on the other, intended that the ambit of the draft Convention should be delimited by reference to the private law aspects of financial leasing alone, judging that it would be both unrealistic and presumptuous to endeavour to address such divergent concerns in one and the same text. This is not to preclude the possibility of the provisions of the draft Convention impacting indirectly, albeit involuntarily, on such non-private law aspects of the subject as its accounting and revenue treatment. In expressing this idea in the fifth clause of the preamble, the authors of the draft Convention in the event found the term "civil and commercial law aspects" preferable to "private law aspects" in the interest of accommodating those legal systems, notably the Socialist legal systems, which do not recognise the existence of a category of private law relations.

47. - Another fundamental feature of the draft Convention proclaimed in the preamble has already been alluded to, namely the realisation by the authors of the draft Convention that its chances of success could only be enhanced by its concentration on a limited number of basic points capable of bringing out the atypical nature of the financial leasing transaction rather than by its attempting to achieve a systematic unification of all

(14) One writer has already commented on the equitable distribution made under the draft Convention of the liability for product defects under a financial leasing transaction. Cf. Amelia H. BOSS, *Products Liability and International Leasing Transactions: The Unidroit Draft Convention*, in *Journal of Products Law* 1982, 143 at 147, where she writes:

"The Convention defines the tripartite transaction as consisting of both the leasing agreement between the lessor and lessee and the supply agreement between the lessor and supplier. This broad coverage allows the Convention to consider both relationships together in fashioning its rules to achieve symmetry and equity between the parties. For example, the liability of the lessor for defective products may be limited while the supplier's liability is expanded; the lessee is still allowed recovery for product defects but the liability is more equitably distributed between the parties."

legal aspects of the subject. This idea is intended to be conveyed in the fifth clause of the preamble by the employment of the word "certain" before the words "uniform rules". The corollary of this idea is that whole areas of the law relating to financial leasing will be left outside the draft Convention. The authors of the draft Convention were therefore at the same time aware of the need to ensure that its avowedly limited scope did not jeopardise its basic underlying purpose, namely to ensure that the atypical leasing transaction which it addresses is henceforth treated separately from those neighbouring legal concepts to which it has hitherto tended to be assimilated. This concern is echoed in the provisions of Article 15 (2).

48. - Special importance attaches to the preamble by virtue of the incorporation in Article 15 (1) at the final session of governmental experts of a reference to the "object and purpose" of the draft Convention "as set forth in the Preamble". It would thus be incumbent upon those called upon to interpret the future Convention to have special regard to the objectives of the Contracting Parties as proclaimed in the preamble.

Article 1

49. - The opening article of the draft Convention delimits its substantive sphere of application. The subject-matter of the draft Convention already having been generically defined in the title and the preamble as "international financial leasing", this article sets out what may be regarded in substance as a definition of "financial leasing", leaving Article 2 to set forth the conditions that have to be met for a given financial leasing transaction to be regarded as "international" for the purposes of the draft Convention.

50. - As has already been mentioned above, the definition adopted in Article 1 is closely modelled on the definition of "equipment leasing" adopted after protracted negotiations by Leaseurope in 1977. The fact that the reaching of agreement on this definition of the activities pursued by its members caused Leaseurope such difficulty is eloquent testimony of the often widely differing conceptions of leasing from one country to another, even within the relatively limited geographical confines of Western Europe.

51. - Whereas the provisions of Article 1 present many of the characteristic traits of a legal definition, this is deceptive. The contents of Article 1 are not so much a legal definition of "financial leasing" in the broad, loose sense in which that term is employed and understood in everyday parlance, for to embrace in one definition all the possible variations on the hybrid mechanism generically referred to as

"financial leasing" would probably be not only to attempt the virtually impossible but also unnecessarily, to restrict its future pattern of evolution, as a description in the first place of the mechanics of a financial leasing transaction and secondly of those ingredients of the financial leasing transaction that establish its atypical credentials in relation to those neighbouring legal concepts with which by virtue of its provenance it has so much in common and with which it has accordingly in the past all too often been bracketed.

52. - The combined effect of paragraphs 1 and 2 is *prima facie* to exclude various types of leasing transaction from the ambit of the draft Convention. Foremost among the types of leasing that are not intended to be covered by the draft Convention are operating leasing and short-term leasing, sometimes known as renting. This exclusion is implicit in the provisions of Article 1 (2)(c) which make it a necessary ingredient of the type of lease governed by the draft Convention that there is a link between the rentals payable under the leasing agreement and the period of economic amortisation of the leased asset, a link which would not normally exist under an operating lease or a renting agreement. However, bearing in mind the increasing blurring of the distinction between "financial leases" and "operating leases" of late,⁽¹⁵⁾ the authors of the draft Convention took the view that it would not be appropriate to exclude its application merely by virtue of the fact that the transaction in question is denominated an "operating lease" rather than a "financial lease." This intention is conveyed by their inclusion of the words "as defined in paragraph 2 of this article" featuring in the chapeau of Article 1 (1). The definitional ingredients listed in Article 1 (2) are accordingly not so much definitional ingredients of the financial leasing transaction as that term is understood at any given moment in time as definitional ingredients of the type of transaction singled out for treatment under the draft Convention.

53. - By virtue of the basically tripartite nature of the transaction addressed in the draft Convention bipartite leasing transactions are also excluded from its scope of application. It is moreover primarily the special financial role played by the lessor in the transaction addressed by the draft Convention that determines its atypicality. Where there are only two parties to the transaction, a supplier and a user, the case for a derogation from the traditional rules of the law of bailment becomes that much more difficult to justify.

54. - That type of financial lease, above all practised in the real estate field, known as "sale and lease-back" is excluded from the ambit of

(15) Cf. above §37

the draft Convention by virtue of its opening article's reference to the fact that the equipment to be leased is acquired by the lessor from the supplier: in the typical sale and lease-back situation the acquisition of the item to be leased to the lessee is effected between lessee and lessor.

55. - Another *prima facie* exclusion from the draft Convention results from the type of property singled out for treatment thereunder. The delimitation of the substantive sphere of application of the draft Convention by reference to "plant, capital goods or other equipment" is meant to exclude real estate leasing and to restrict its application to personal property leasing. The reasons underlying the decision not to tackle real estate leasing were essentially two-fold: first, the limited incidence of real estate leasing at the cross-border level and, secondly, the enormous difficulties that would inevitably arise in any attempt to unify principles of the law of real property and the law of personal property in the same text.⁽¹⁶⁾

56. - Article 1 (3) excludes another category of leasing from the draft Convention and this is consumer leasing. In view of the different philosophies generally applied to consumer transactions, on the one hand, and to non-consumer transactions, on the other, it was considered politic to limit the application of the draft Convention to the latter. This decision was clearly additionally justified by the decision to restrict its sphere of application to international transactions, consumer transactions not generally being international in character. The language employed for the purpose of achieving this exclusion was modelled on the corresponding provision (Article 2 (a)) of the 1980 United Nations Convention on Contracts for the International Sale of Goods (hereinafter referred to as "the Vienna Sale Convention"). The significance of the addition of the word "primarily" in Article 1 (3) of the draft Convention to the formula employed in Article 2 (a) of the Vienna Sale Convention lies in the fact that otherwise, the criterion for determining whether a given transaction is or is not to be considered a consumer transaction for the purposes of the draft Convention being not the nature of the equipment as such but rather the use to which it is intended to be put, namely "the lessee's personal, family or household purposes", there would be a risk that the future Convention might apply in certain cases to goods which ordinarily were not intended to be used for specifically business or professional purposes and could just as well be used by a consumer but which, by reason of the party making use of them, namely a business, would become subject to the draft Convention.

(16) Cf. also §63 below.

57. - Two types of leasing transaction that are intended to be within the purview of the draft Convention, on the other hand, are that species of financial lease known as a leveraged lease and financial sub-leasing arrangements. The application of the draft Convention is specifically extended to these types of financial lease, to the former by the provisions of Article 12 (1) and to the latter by the provisions of Article 13.

58. - The first feature of the atypical financial lease to which we are introduced in Article 1 is that it is a complex, basically tripartite transaction embracing two agreements, a supply agreement between the supplier and the lessor and a leasing agreement between this same lessor and the lessee. One of the prime objectives of the authors of the draft Convention has all along been to ensure that the type of lease addressed in the draft Convention should no longer be treated as two separate contracts but rather as a single, complex transaction setting off the interaction of two mutually interdependent agreements. The factual connection between the two constituent agreements of this transaction is brought out in that provision of the draft Convention (Article 1 (1)(a)) which states that the supply agreement is concluded on terms approved by the lessee. The previous treatment of this transaction as two distinct agreements has proved to be the source of much distortion of the economic reality underlying the parties' intentions. The purely financial nature of the lessor's interest in the transaction and the case for its consequent insulation from that liability in contract and tort that would normally flow from its capacity of lessor would not, for example, emerge from the leasing agreement viewed in isolation: they only make sense when the motives of the parties to the two agreements are seen in the overall context of the single complex transaction that provides the link between the mutual rights and duties of the different parties.

59. - This formulation of the type of lease addressed in the draft Convention in terms of a complex, triangular relationship enables the draft Convention to bring out, and at once to focus on the fundamental element of its originality, that is that element which justifies the atypical legal regulation that follows: the essentially financial nature of the transaction. As one commentator on the draft Convention has noted, this means that "the lessor's role is that of lender, the lessee's role is that of borrower. Instead of lending money directly for the purchase of equipment and then securing repayment of the debt through the pledge of the equipment as collateral, the lessor purchases the equipment, takes title in its own name, and then grants the use of it to the lessee in return for a promise to pay rentals."⁽¹⁷⁾

(17) Cf. Walter E. MAY, *International Equipment Leasing: The Unidroit Draft Convention*, in Columbia Journal of Transnational Law 1984, Vol. 22, 333 at 341.

60. - The other side of the coin, as it were, to the lessor's purely financial role in the transaction is the lessee's dynamic, pivotal role. This provides the other principal hallmark of the originality of the atypical leasing transaction spelled out in Article 1, namely that it is on the specifications of the lessee that the lessor acquires the equipment to be leased from the supplier. The reality of financial leasing is indeed that the technical specifications of the equipment, the terms of payment and delivery are worked out directly between the lessee and the supplier, with delivery being made direct by the supplier to the lessee. It is thus a relationship effectively beyond the contractual pale that underpins to a large extent the logical basis of the atypical chain of rights and duties generated by the financial leasing transaction, in the sense that the lessee and the supplier are never at any stage co-contractants but are essentially responsible through their dealings with one another for the selection, with a view to the subsequent use, of a particular item of equipment, the lessor's role being confined to the injection of the necessary capital for the acquisition of the equipment. It is this quasi-contractual relationship between lessee and supplier which was felt to merit not only the shifting in the draft Convention of many of the rights and duties normally associated under a lease with the lessor onto the lessee but more specifically the recognition, in Article 9 (1), of the lessee's right to sue the supplier directly for the latter's breach of the terms of the supply agreement. The recognition of this right apart, the only legal link between the lessee and the supplier in the context of the financial leasing transaction lies through the lessor. The lessor indeed is the contracting party common to both legal relationships underlying the complex financial leasing transaction, bound as it is both to the supplier under the supply agreement, providing for the acquisition of the asset to be leased, and to the lessee under the leasing agreement, granting the lessee the right to use the asset acquired under the supply agreement.

61. - Up until the first session of governmental experts the opening article of the draft Convention had specifically referred to the "tripartite" nature of the transaction addressed by the draft Convention. This was, however, considered inaccurate in so far as, as has already been mentioned, the future Convention also encompasses that special type of financial lease known as a leveraged lease, in which there will be more than three parties. Moreover, the basic tripartite pattern of the transaction singled out for treatment under the draft Convention is already clear enough from its description in Article 1 (1).

62. - Originally, moreover, the authors of the draft Convention had sought to drive home the distinctiveness of the type of lease addressed therein by the employment of distinctive indicia to denote the three parties to the transaction. Thus, instead of the traditional appellations

"manufacturer", "lessor" and "lessee" the Study Group had at one time preferred the terms "supplier", "financier" and "user" respectively. This choice of labels was designed to reflect the essential role played by each party in the transaction. The term "financier" was however considered to be dangerous as a label and, while maintaining the term "supplier", for the other two parties the authors of the draft Convention reverted to the traditional appellations of "lessor" and "lessee", preferring to distinguish these parties from the classical lessor and lessee by their description of their atypical functions in the context of the financial lease.

63. - The subject-matter of the draft Convention is further delimited by reference to the types of equipment which are subject to the draft Convention. For the reasons expounded above,⁽¹⁸⁾ the authors of the draft Convention decided to leave real property outside the scope of the future Convention and to concentrate their attention on what is generally known as equipment leasing. In defining the "equipment" covered by the draft Convention Article 1 (1)(a) adopts the definition employed in the aforementioned Leaseurope definition, to wit plant, capital goods or other equipment. This definition must clearly be interpreted in the light, first, of the additional delimitation of the substantive sphere of application of the draft Convention introduced in Article 1 (3), namely that the equipment must be of a type that will not be used primarily for the lessee's personal, family or household purposes, the intention here, as has already been explained, to exclude consumer movables, and, secondly, of the decision to exclude real estate leasing from the ambit of the draft Convention. While the authors of the draft Convention were clear in their own minds that the draft Convention was principally designed to cover the leasing of movables, they nevertheless rejected the idea of spelling this out more explicitly, on the ground that this would probably involve introducing terms like "movables" and "immovables" into the draft Convention with the considerably differing meanings attributed to these notions from one legal system to another. The principal source of difficulty on this score was the reference in the draft Convention to "plant".⁽¹⁹⁾ While there was no doubt that plant leased as a chattel which subsequently became annexed to land would qualify as equipment and accordingly fell within the scope of the future Convention in Common law jurisdictions, the same was not necessarily felt to be true where the chattel leased began life as a fixture. The authors of the draft Conventions were not in the end convinced of the desirability of adding the

(18) Cf. §55 above.

(19) "Plant" is defined in the Shorter Oxford English Dictionary as "the fixtures, implements, machinery, and apparatus used in carrying on any industrial process".

qualification "movable" before the word "plant", for the reason adduced earlier in this paragraph, and decided accordingly to leave the matter open. Thus, while the draft Convention was never specifically intended to apply to real estate, its accidental application thereto cannot be ruled out in those cases where this follows from the interpretation given to "plant" by the courts of a given country. The disadvantages inherent in this approach were considered by the authors of the draft Convention to outweigh the aforementioned advantages of not having to introduce the slippery notions of "movables" and "immovables" into the text of the draft Convention.

64. - As regards three particular classes of equipment, aircraft, ships and rolling stock, a change of thinking by the authors of the draft Convention means that, whereas there was originally, from 1975 to 1977, a feeling that it might be better to exclude the leasing of these special classes of equipment from the scope of the draft Convention,⁽²⁰⁾ in the generally accepted interest of ensuring the draft Convention as broad a scope of application as possible these items of equipment have since then definitely been intended to be covered by the future Convention, notwithstanding the undeniable difficulty of classifying aircraft, ships and rolling stock in the same category as the general body of capital goods. Their inclusion was never felt to require any specific mention in the text, as, failing their express exclusion, their inclusion would follow implicitly under the umbrella of the term "capital goods".

65. - Article 1 (2) sets out those essentialia, those characteristic traits of financial leases which must be present for a given financial leasing transaction to be subject to the draft Convention. However, it is important to bear in mind that the characteristics listed in this paragraph are merely intended as features illustrative of the type of lease singled out for attention by the authors of the draft Convention, as indeed prefigured by the words "as defined in paragraph 2 of this article" in the chapeau to Article 1 (1), and are not therefore intended to be exhaustive definitional ingredients.⁽²¹⁾ The importance of this paragraph lies in its spelling out of those elements which determine the *sui generis* credentials of the type of lease addressed in the draft Convention and thus provide the logical premise from which the subsequent articles of the draft Convention can then draw the original consequences.

66. - These characteristics formerly numbered six. Of those that have been lost en route, one was relocated in Article 3. The reason for this

(20) Cf. §§2,5 (vi) above.

(21) But cf. §52 above.

relocation was that while the inclusion in the leasing agreement of an option to purchase was a *sine qua non* of a financial leasing transaction under certain legal systems, under others its inclusion would alter the nature of the transaction, changing it instead into a hire-purchase or conditional sale transaction. Another, providing that the lessor was owner of the leased asset throughout the term of the leasing agreement, was dropped because it would not necessarily correspond to all financial leasing transactions, some of which used sub-leasing arrangements. The other, specifying that the type of leasing transaction addressed by the draft Convention embodied "one or more agreements", was considered by some to be a pleonasm, in so far as it was true of any contract that it could be expressed in one or more contractual documents, and by others to be misleading in that the fact that many financial leasing transactions were laid down in one document did not alter the fact that it was still made up of at least two contracts, a supply agreement and a leasing agreement. The committee of governmental experts adjudged that the idea behind this clause was moreover already conveyed in Article 1 (1).

67. - The first of the surviving characteristics of the financial leasing transaction covered by the draft Convention is set out in Article 1 (2)(a). Especial importance within the scheme of the draft Convention, notably as the basis of the shifting of the normal disposition of so many of the rights and duties of the parties under a traditional bailment contract, attaches to this clause. The lessee it is that is responsible for specifying the equipment, in the light of and with a view to its own operational requirements, and selecting the supplier, with whom it will work out directly such matters as the conditions of, and the time to be allowed for delivery, alterations, improvements, the conditions of, and the time to be allowed for payment. The lessee may in making these choices rely on the advice of third party experts but will essentially conduct negotiations with the supplier on its own as a reasonably informed user of the type of equipment it requires. The lessor's interest in the transaction being purely financial, its technical involvement will normally be correspondingly nil. It follows from this that it would be morally indefensible for a lessee that has had ample opportunity to check on the technical suitability of the equipment required by it prior to delivery to be able to blame the lessor for its own bad choice when the equipment upon delivery proves to be unsuited to its requirements. This clause accordingly provides the logical premise for that general insulation of the lessor from that liability towards the lessee that would normally attach to its capacity as lessor of the equipment (Article 7 (1)). It also furnishes the justification for the lessee being made a third party beneficiary of the duties assumed by the supplier under the supply agreement (Article 9 (1)). The technical specifications regarding the equipment are, as we have just seen, worked out directly between lessee and supplier but this factual

link is not reflected in any contractual nexus, the result of which, failing the provisions of Article 9 (1), would be to make it difficult for the lessee to seek adequate redress from the supplier for its failure to deliver, late delivery or delivery of equipment that failed to measure up to that stipulated.

68. - However, just as the authors of the draft Convention recognised that it would be morally indefensible to make the lessor responsible for the lessee's bad choice, in Article 7 (1), so they also acknowledged that there would nevertheless be cases, notably in international financial leasing transactions, where the large sums of money involved might at times necessitate some abandonment of the lessor's technical neutrality in relation to the equipment. For instance, in the construction of a tanker it would be common for the lessor and the lessee to agree to have a team of engineers on the spot to monitor the changes of design that would regularly be called for. The lessor as owner and as the party contracting with the supplier would clearly be anxious to have the necessary technical expertise at its disposal to enable it to gauge the impact of any important change on its financial commitment under the supply agreement as well as on its potential liability towards third parties (in respect of rules of safety). In accordance with the general intention of the authors of the draft Convention to ensure it as broad a sphere of application as possible, it was recognised that it would be undesirable to create an inference that, where and to the extent that the lessor intervened in the sphere of autonomy reserved to the lessee under Article 1 (2)(a), the nature of the transaction would change to such an extent as to make it no longer amenable to treatment under the draft Convention. Accordingly Articles 1 (2)(a) and 7 (1)(a) are intended to have the combined effect that, in cases where the lessor's technical neutrality in relation to the equipment is less than absolute - the justification for the word "primarily" in Article 1 (2)(a) - the transaction will still fall within the scope of the draft Convention but the general immunity from liability conferred upon the lessor vis-à-vis the lessee is to be reduced by the extent to which the lessor has intervened in the selection of the supplier or the specifications of the equipment.

69. - The provisions of Article 1 (2)(b) underline the fact that the complex financial leasing transaction addressed by the draft Convention will ordinarily comprise two contracts and brings out once more the link between these two contracts, the lessor acquiring the equipment from a supplier in pursuance of the agreement it has made with the lessee. The somewhat vague wording "in connection with" is designed to indicate that the lessee's selection of the equipment is neither necessarily contemporaneous with, nor necessarily subsequent to the making of the leasing agreement, but may in fact precede the conclusion of this

agreement, further testimony of the flexibility the authors of the draft Convention sought to build into the text. The fact that this provision, in common with Article 1 (1)(a), speaks of the equipment being "acquired" rather than being "purchased", as at an earlier stage, reflects the feeling of the authors of the draft Convention that to say that the equipment was "purchased" by the lessor would not be entirely accurate to describe the case, frequent in the leasing of plant, where the land on which the plant was to be built was indeed purchased by the lessor but where the plant was then constructed on this land by a third party builder. The words "to the knowledge of the supplier" are intended to ensure that the draft Convention should only apply where the supplier is aware that the equipment in question is to be held on lease. This is particularly important in view of the provision in Article 9 (1) extending the duties owed by the supplier to the lessor under the supply agreement also to the lessee.

70. - More than any other provision in the draft Convention, it is Article 1 (2)(c) which brings out the financial nature of the transaction addressed in the draft Convention. It does so by positing a necessary link between the duration of the leasing agreement and the period of the useful working life of the leased asset. It is a hallmark of the type of lease addressed by the draft Convention that the rentals payable under the leasing agreement are not calculated in function of the use-value of the equipment, as with a traditional bailment, but in function of what is necessary to amortise the lessor's capital investment. The measure of the lessor's capital investment in this regard is expressed in Article 1 (2)(c) in terms of the whole or at least a substantial part of the cost of the equipment. However, aware as they were of the incidence of other factors in the calculation of the lessee's rentals and with a view to ensuring the future Convention as broad a sphere of application as possible, the authors of the draft Convention introduced the qualificatory expression "in particular" into the equation between the notion of the rentals payable by the lessee under the leasing agreement and the notion of the amortisation of the whole or a substantial part of the cost of the equipment. The addition of these two words, for instance, indicates that the calculation of the lessee's rentals will also normally reflect the cost of the transaction to the lessor. It would also facilitate the extension of the application of the future Convention to those leasing arrangements at present under consideration for coverage under MIGA: among the Draft Operational Regulations adopted by the preparatory committee of the signatory States of the MIGA Convention in September 1986 was one recommending the coverage under MIGA of leasing arrangements under which the rentals payable are "substantially dependent on the production, revenues or profits from the investment project".

71. - Doubts nevertheless lingered in the minds of one or two delegations to the final session of governmental experts as to the felicitousness of the formulation of this provision. One suggestion was that a more accurate formulation would be to refer not only to the rentals payable under the leasing agreement *but also all other financial obligations for which the lessee was liable under the leasing agreement* as being calculated so as to take into account in particular the amortisation of *the whole* of the cost of the equipment. What was had in mind by the reference to other financial obligations incumbent upon the lessee under the leasing agreement apart from its rentals was the price at which the lessee would be entitled to exercise any purchase option that might be included in the leasing agreement. The aim of bringing this price into the equation of the lessor's amortisation of its capital investment in Article 1 (2)(c) was, by enabling the text to refer to the lessor's amortisation of the whole of the cost of the equipment, to avoid those difficulties that were felt to be implicit in referring to a "substantial" part of the cost of the equipment, notably any inference that a part of the cost of the equipment did not have to be amortised under the draft Convention.

Article 2

72. - This article delimits the geographic sphere of application of the draft Convention. It basically sets forth the conditions to be met before a given financial leasing transaction may be regarded as "international" and subject to the regimen of the draft Convention. The reasons behind the decision taken by the authors of the draft Convention to restrict its sphere of application to *international* transactions have already been rehearsed above.⁽²²⁾ In drawing up this article the authors of the draft Convention followed closely the basic structure and terminology of the corresponding provisions of the Vienna Sale Convention (Articles 1 (1) and 10 (a)) and the 1983 Unidroit Convention on Agency in the International Sale of Goods (hereinafter referred to as "the Geneva Agency Convention") (Articles 2 (1) and 8 (a)).

73. - Once it had been decided to tie the draft Convention to specifically international transactions, it became necessary to decide which should be the criteria for determining whether a given financial leasing transaction is to be regarded as international for the purposes of the draft Convention. The criterion normally employed to determine the international character of a legal relationship in recent international commercial law Conventions is that of the place of business of each of the

(22) Cf. §38 above.

parties to the relationship in question.⁽²³⁾ This criterion was basically followed in the draft Convention. However, the difficulty with applying this principle in the case of the draft Convention was that, whereas in most of the cases addressed by such Conventions the relationship covered is basically a two-party relationship, the transaction addressed by the draft Convention is basically tripartite. Of the three possible places of business the Study Group elected to take those of lessor and lessee and to exclude the impact of that of the supplier. The reasoning behind this decision was that the leasing agreement was the fundamental legal relationship contained within the complex financial leasing transaction⁽²⁴⁾ and that it was undesirable unnecessarily to restrict the future Convention's sphere of application. However, this decision was overturned by the committee of governmental experts which considered that the impact of certain of the provisions of the draft Convention on the supplier's position, notably Article 9 (1), meant that some account had to be taken in the provisions determining the future Convention's sphere of application of the supplier's place of business. Otherwise there was a very real risk that the effectiveness of the lessee's remedies against the supplier under Article 9 (1) might be jeopardised in those cases where the law applicable to the supply agreement was not that of a State Party to the future Convention, thus enabling the supplier to invoke in its defence the argument that there was no contract between it and the lessee and thus defeat the lessee's exercise of its remedies under Article 9 (1). In Article 2 (1)(a) the draft Convention therefore, while still taking the fact that the places of business of the lessor and the lessee are in different States and that these States are Contracting States as the fundamental criterion for the application of the future Convention, also requires that the place of business of the supplier be in a Contracting State before the future Convention can apply. However, in recognition of the fact that the leasing agreement is undoubtedly the fundamental legal relationship in the complex financial leasing transaction, the place of business of the supplier, it should be noted, does not also need to be in a State different from those in which the lessor's and lessee's places of business are located: it simply has to be in a Contracting State.

74. - A traditional alternative connecting factor employed for the application of international commercial law Conventions is that the rules of private international law of the forum lead to the application of the law of a State which has adopted the future Convention. This additional

(23) Cf. for example Article 1 (1) of the Vienna Sale Convention and Article 2 (1) of the Geneva Agency Convention.

(24) Cf. El Mokhtar BEY and Christian GAVALDA, *Problématique juridique du leasing international* in *Gazette du Palais* 1979, 1^{er} sem., 143 at 144.

ground for the application of the future Convention is founded on the premise that, once it has been adopted by a State, then its rules should govern all financial leasing transactions of an international character as defined in the chapeau of Article 2 (1) in preference to its domestic law which was conceived with only internal financial leasing transactions in mind. Thus, when by the operation of the rules of conflict the law of a Contracting State is found to be applicable by the judge seized of the case, then it is the future Convention which, by virtue of this principle, should apply to the transaction. The major difficulty in applying this principle to the financial leasing transaction arose, as with Article 2 (1)(a), from the fact that the relations governed by the draft Convention are not bipartite but tripartite. For the same reason as has been expounded in the previous paragraph in respect of the solution reached in Article 2 (1)(a), namely that, while the fundamental legal relationship in the complex financial leasing transaction is undoubtedly the leasing agreement, it is essential that account should also be taken in the sphere of application provisions of the future Convention of their impact on the supplier, the authors of the draft Convention in Article 2 (1)(b), whilst aware that such an additional criterion would necessarily restrict the cases in which the future Convention would be applicable, concluded that for the future Convention to be applicable by virtue of the operation of the rules of private international law it would have to be necessary not only for the leasing agreement to be governed by the law of a Contracting State but also for the supply agreement to be governed by the law of a Contracting State. It follows that it does not matter whether the law applicable to the leasing agreement is the same as, or differs from that applicable to the supply agreement: the only requirement is that these two laws should be the laws of one or more Contracting States. This alternative connecting factor for the application of the future Convention is, it should be noted, intended to include those cases where the parties themselves designate the law of a Contracting State to govern their respective contractual relations.

75. - In line with Article 95 of the Vienna Sale Convention and Article 28 of the Geneva Agency Convention, it should be noted that Article F of the draft final provisions capable of embodiment in the draft Convention drawn up by the Unidroit Secretariat, ⁽²⁵⁾ however, allows States to declare at the time of becoming Parties to the future Convention that they will not be bound by Article 2 (1)(b).

76. - The provisions of Article 2 (2) follow closely those of other recent international commercial law Conventions (notably Article 10 (a) of the Vienna Sale Convention and Article 8 (a) of the Geneva Agency

(25) Cf. Study LIX - Doc. 49.

Convention). They are designed to indicate the relevant place of business for the purpose of determining the applicability of the future Convention under Article 2 (1) where one or more of the parties to the transaction has more than one place of business. The relevant place of business is stated to be that which has the closest relationship to the agreement in question, that is the supply agreement or the leasing agreement, and its performance. In determining the closeness of this relationship the draft Convention invites those called upon to apply it to have regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the agreement in question.

Article 3

77. - This article seeks to resolve the difficulties that arise out of the fact that, whereas the inclusion in the leasing agreement of an option to purchase the leased asset in favour of the lessee is in some jurisdictions, notably Civil law systems, an essential ingredient of the atypical leasing transaction addressed in the draft Convention,⁽²⁶⁾ under other legal systems, notably Common law jurisdictions, the inclusion of such an option would prevent the agreement being qualified as a lease at all and would lead instead to its requalification as a hire-purchase or conditional sale transaction. The purpose of Article 3 is thus essentially to preserve the application of the draft Convention in those jurisdictions in which the inclusion of a purchase option would otherwise destroy the transaction's characterisation as a lease. Equally in those jurisdictions which would normally regard the inclusion of such a purchase option as an essential ingredient of its domestic financial leases its effect is that such a jurisdiction would have to recognise that a transaction could still be a financial leasing transaction for the purposes of the draft Convention even in the absence of any purchase option in the leasing agreement.

78. - There was a time when those among the authors of the draft Convention who were more accustomed to a compulsory purchase option in the leasing agreement argued that this provision went to the essence of the transaction addressed by the draft Convention and as such should feature among the characteristic traits of the transaction set forth in Article 1 (2). However, given the width of the gulf separating the attitude of the different legal systems on this question of purchase options, it was acknowledged that to elevate the stipulation of such a purchase option to the

(26) In these countries such a purchase option represents an important part of the financial bargain for both lessor and lessee, the pre-negotiated price at which the option is exercisable reflecting the amount paid by the lessee in rentals; cf. also §71 above.

status of a definitional ingredient of the type of transaction addressed by the draft Convention would be seriously to jeopardise the acceptability of the future Convention in those jurisdictions where the inclusion of such a purchase option would destroy the leasing agreement's characterisation as a lease altogether. Likewise to attempt to introduce a clause in Article 1 (2) that would encompass the position taken by both groups of legal systems on this point would, it was felt, be to introduce an intolerable degree of legal uncertainty into the applicability of the future Convention. As it stands under Article 3, the inclusion of an option to purchase in the leasing agreement amounts to an optional ingredient of the type of leasing transaction addressed by the draft Convention. The future Convention is intended to apply whether or not a purchase option is included in the leasing agreement in question. The authors of the draft Convention concluded there was no good reason why the draft Convention should not apply regardless of the particular solution adopted on this subject in the individual country. The draft Convention is after all specifically addressed to *international* transactions and accordingly does not purport to impinge on the varied situation existing in this regard from one country to another regarding wholly domestic transactions.

79. - The words "has or subsequently acquires" are intended to indicate that this provision covers both the case where the purchase option is conferred under the leasing agreement itself - the word "has" is the appropriate word here - and those cases where it is either conferred under a separate agreement, reached say at the end of the lease term, or under a variation of the original leasing agreement - the appropriate words for these cases are "or subsequently acquires". The question also came up during the drafting of this provision as to whether it would be appropriate to be more explicit as regards the time when the purchase option, where granted, should be exercisable. In practice such options are made exercisable either during or at the end of the lease term. However, it was adjudged better not to lay down any specific time for the exercising of purchase options in the draft Convention so as to leave the parties maximum flexibility in this regard: the lessee is therefore free to acquire the asset at the moment in time most favourable to its interests.

80. - At one stage this provision referred to the lessee's "right" to buy the leased asset. In the end, however, the term "option" was judged more opportune with a view to making it clear that this provision did not purport to cover the situation where the lessee's right derived from an obligation to purchase the leased asset, since such an agreement would constitute a sale contract.

81. - Apart from the purchase option, where this is exercisable, there are of course two other possible courses of action open to the lessee at

the end of the lease term. One of these is stated in this article, namely "to hold" the equipment "on lease for a further period", usually at a much reduced and in some cases a peppercorn rental. It was not judged necessary to spell out the lessee's other possible course of action in this provision, first because it is already stated elsewhere, in Article 8 (2), and secondly because it is not in the nature of a special right conferred on the lessee by the leasing agreement but is simply the lessee's duty where it either has not exercised a purchase option, if exercisable, or has not taken the equipment on lease for a further period, to wit to return the leased asset to the lessor, who will then normally dispose of it on the second-hand market. When Article 3 speaks of the lessee deciding to hold the equipment on "lease" for a further period, this raised the question whether the second lease had necessarily to be a leasing agreement of the kind contemplated by the draft Convention or whether it would be sufficient for it to be a traditional bailment contract. Here again the authors of the draft Convention, anxious to leave the parties the maximum freedom of contract, agreed that both possibilities were intended to be encompassed.

82. - The words "and whether or not for a nominal price or rental" at the end of Article 3 were designed to deal with the controversy that rages in some jurisdictions over what constitutes a sale. An economic test is applied in these jurisdictions whereby if the option fee or renewed rental is purely nominal then the transaction is characterised as a sale, with the concomitant risk that in these jurisdictions the cases for the future Convention's application might end up being substantially narrowed in respect of such transactions. These words accordingly serve two purposes. First, they indicate that the mere fact that the option fee or renewed rental is nominal does not take the transaction in question outside the future Convention. Secondly, they serve as an indication to those called upon to apply the future Convention that they should not apply general economic tests with a view to excluding from the future Convention what it was intended to cover, namely those transactions which whilst in form leases might in some jurisdictions be regarded as sales.

Article 4

83. - This article deals with the extent to which, once the financial leasing transaction has been concluded, the lessor and the supplier should be free to vary the supply agreement. The basic idea behind this article is that, while there can be no harm in the parties negotiating better terms for themselves, in order to safeguard the interests of the lessee, any attempt to vary the supply agreement once the leasing agreement has been made must be sanctioned by the lessee. Given that it is the lessee who is to use the equipment, it is vital that there should be no room for

collusion between the supplier and the lessor to the detriment of the lessee.

84. - Up until the final session of governmental experts the authors of the draft Convention had considered it important that this rule should be balanced by another, making the lessor's consent necessary for any variation, subsequent to the making of the supply agreement, in the specifications given by the lessee to the supplier. They had taken the view that, just as it is legitimate for the lessee to want to have access to the best equipment available for its particular needs, it is equally legitimate that the lessor should first be given an opportunity to declare its opinion on any consequential variation in the terms of the specifications given by the lessee to the supplier, for instance during the ongoing construction of the item to be leased, that might have the effect of increasing its responsibilities. However, the committee of governmental experts at its final session decided to delete this rule, basically on the ground that it was hard to conceive how the lessee could affect the terms of the supply agreement, once this had been made, in so far as it was not a party to that agreement but also because, in so far as the lessor was a party to the supply agreement, it was merely stating the obvious to require the lessor's consent to any variation of the specifications given by the lessee to the supplier. The authors of the draft Convention accordingly concluded that the whole question of whether the lessee should have the right to vary the terms of the supply agreement should not be governed by the future Convention, but should rather be left to be settled by the terms of the parties' own agreement and in accordance with the applicable law.

85. - As has been mentioned above, this article is in no way intended to interfere with the parties' right to negotiate better terms for themselves, all the more so as the effect of the negotiation of better terms by supplier and lessor could well be to improve the terms of the leasing agreement for the lessee, principally in the shape of lower rental payments. Thus the lessor and the supplier might well agree to vary their original agreement by the terms of a buy-back arrangement, enhancing the lessor's guarantee and enabling it to pass this onto the lessee in the form of lower rentals. Such private arrangements between the parties are to be expected, given that they will often be dealing with one another on a continuing basis over a number of years. On the other hand, whereas the rule contained in Article 4 is designed to prevent the variation of the supply agreement by the lessor and the supplier inasmuch as the result of such variation would be to worsen the situation of the lessee, it was not considered feasible or worthwhile to formulate a distinction between the positive and negative impact of individual variations on the position of the lessee.

Article 5

86. - One of the thorniest problems arising in connection with leases as indeed with all transactions involving the separation of ownership and possession in respect of property concerns how best to inform innocent third parties coming into contact with leased property, through their dealings with the lessee, that it is subject to a reservation of title, since failing such notification appearances, that is the fact of the lessee's possession of the asset, would normally induce third parties, notably creditors of the lessee, to believe they were dealing with the owner, rather than the lessee, of the asset in question. This problem was particularly acute in the case of financial institutions contemplating lending to the lessee on the security of its assets, as a physical inspection of all the equipment of the potential debtor of the financial institution would simply not be feasible.

87. - Consideration was given within the Study Group to the use of a whole range of systems of public notice, from the simple affixing of a plaque on the equipment, as required under the law of more than one country, to the highly sophisticated computerised system of registration against the lessor already in use in more than one jurisdiction. Experience has revealed the limitations of the affixing of plaques as the basis of a foolproof public notice system, such plaques being so relatively easy to remove. Balance-sheets were also considered but rejected as inadequate for this purpose, in view of the fact that they served a quite different function, that of a general public notice, from the function that was required here, namely a notice to a specific kind of third party. The vast majority of opinion within the Study Group recognised the ultimate desirability of a system of registration as the most effective means of giving notice of the lessor's title to third parties. However, apart from the fact that in many countries registration was only considered feasible for large unit goods that were easily identifiable, such as ships, aircraft and motor vehicles, the greatest single difficulty recognised as obtruding with the embodiment of however minimal a public notice requirement in the future Convention was seen as the very limited number of jurisdictions that had such public notice systems in place at the present time. The organisational and financial implications of a public notice requirement based on registration were accordingly seen as making such a solution a no-starter.

88. - The Study Group was nevertheless anxious that the future Convention should give some expression of its conviction that a public notice system of some sort was the only real answer to this problem, and thus perhaps give some momentum to the future institution of such systems in the various countries. The solution with which the Study Group came up

was a rule whereby, where there were rules as to public notice for financial leasing transactions of the type contemplated in the future Convention in the country where the lessee had its principal place of business, then the lessor's title would only be good against third parties if the lessor had complied with such rules. The corollary of this rule was that, if there were no rules as to public notice for financial leasing transactions under the law of the country where the lessee had its principal place of business, the lessor's title would automatically be good against third parties.

89. - This rule, while recognised as a key provision of the future Convention in so far as it set out to regulate conflicts over the leased asset which could not simply be regulated in the agreements of the parties, nevertheless attracted much criticism at the first session of governmental experts. This criticism essentially reflected the very different philosophies underlying the methods of resolving conflicts between the dispossessed owner of property and a third party who had acquired that property in good faith in, on the one hand, Common law jurisdictions and, on the other hand, Civil law jurisdictions. Whereas the former, under the *nemo dat quod non habet* rule, recognised the dispossessed owner's general right to assert its title against third parties, application of the Civil law principle that *en fait de meubles possession vaut titre* meant that in Civil law jurisdictions an innocent third party would take free of the dispossessed owner's title. Civil law jurisdictions proved unwilling to depart from such a fundamental principle of their legal systems for the sake of financial leasing transactions alone. The committee of governmental experts accordingly concluded that it would have to discontinue its efforts to regulate conflicts between the lessor, on the one hand, and both third parties acquiring the equipment from the lessee in good faith and the lessee's ordinary creditors, on the other. The scope of its efforts was therefore narrowed down to the regulation of those conflicts that arise between the lessor and the ordinary creditors of a lessee that had been declared bankrupt. In any case, the committee was convinced that the incidence of cases involving a dishonest lessee disposing of the leased asset to a third party would be extremely rare in practice and that the area where real difficulties would arise in this connection was precisely that where the lessee had been declared bankrupt, and that it would be more fruitful for the draft Convention to address this practical problem rather than becoming embroiled in the extremely delicate issue of third parties in good faith.

90. - Another area where the solution of the Study Group attracted considerable criticism from the committee of governmental experts was over the connecting factor to be employed for the purpose of determining the public notice requirement to be incorporated in the future Convention. The

Study Group had made this the law of the State where the lessee had its principal place of business. However, concern was expressed in some quarters at the prospect of the lessor's rights as against third parties being subordinated to a public notice requirement imposed by the law of a State other than that where the equipment was located. The task of third parties in seeking to comply with such a requirement could well, it was argued, be most arduous. They might well not know that the lessee was holding the equipment on lease, let alone that the lease in question was a cross-border lease governed by special international rules. The country where the lessee's principal place of business was located might well, moreover, be a quite different country from that where the equipment was physically located, thus creating problems for the third parties in question in knowing which country's public notice records to search. The reason why the Study Group had decided to depart from the generally accepted connecting factor for determining questions of title to property or proprietary rights, that is the *lex rei sitae*, was that an important category of leased assets, particularly in international leases, was mobile and by its very nature liable to move from one jurisdiction to another. As an example of the problems inherent in taking the *lex rei sitae* as the appropriate connecting factor for the public notice requirement in respect of this category of equipment, the committee considered the case of construction equipment on lease to a construction firm that regularly moved all round the world. It concluded that it would be unrealistic to expect such equipment to have to be registered in each of the countries where it happened to be used for a shorter or longer period of time.

91. - Only a small number of countries had passed legislation on this subject and it was accordingly felt that instruction might usefully be sought in the solutions proposed under these statutes. The French legislator in its 1972 decree on the public notice formalities to be complied with in respect of financial leasing transactions, for instance, had selected the place where the lessee had its principal place of business in preference to the place where the equipment was located as the appropriate place for registration. The reasons underlying this choice were as follows. First, given that this article was concerned more with possible conflicts between the lessor and third party creditors of a bankrupt lessee than with the unlikely case of a conflict between the lessor and innocent third parties to whom the lessee had fraudulently disposed of the leased asset, the lessee's principal place of business was particularly appropriate as a connecting factor in so far as it would normally be in the country where the lessee had its principal place of business that its bankruptcy would be declared. Secondly, the law of the State where the lessee had its principal place of business had the advantage over the *lex rei sitae* that the places to which a third party would have to look would be concentrated in one country. Thirdly, in the

case of the arrest of a leased ship or the attachment of a leased aircraft carried out in respect of a debt owed by the lessee's principal place of business while the ship or the aircraft was abroad, provided that the State where the arrest or the attachment was carried out was a Party to the future Convention the advantage of having the lessee's principal place of business as the appropriate connecting factor would be that, once the lessee's representative had informed the person carrying out the arrest or the attachment that the ship or the aircraft, as the case might be, was on lease, this person would simply have to check against the public registry of the place where the lessee had its principal place of business.

92. - Under Article 9 of the Uniform Commercial Code of the United States of America and under the Saskatchewan Personal Property Security Act, S.S. 1978-79 a distinction was drawn for registration purposes between equipment of a type likely to be used in more than one jurisdiction, that is equipment that is intrinsically mobile, and equipment that is likely to be used in only one jurisdiction. For the former category of equipment the law of registration was the law of the lessee's place of business and for the latter it was the *lex rei sitae*.

93. - The foregoing considerations were reflected in the final solution with which the committee of governmental experts came up in Article 5. Their text only essays a solution to those conflicts between the lessor and third party creditors of the lessee arising in the limited context of the latter's bankruptcy. It does not attempt to deal with conflicts between the lessor and those third parties acquiring the leased asset in good faith from the lessee. It should be noted that this article speaks not of the lessor's *title* to the equipment but rather of the lessor's *real rights* in the equipment, reflecting the decision of the authors of the draft Convention to encompass situations, such as sub-leasing arrangements, where the lessor will not necessarily be owner of the equipment. Under the terms of Article 5 (1) the lessor's real rights in the equipment are stated to be valid against the lessee's trustee in bankruptcy and unsecured creditors, including creditors who have obtained an attachment or execution. The reason why it was deemed appropriate to insert a special reference to creditors of the lessee who have obtained a judicial attachment or execution was that simply to make the lessor's rights valid against unsecured creditors of the lessee would in itself achieve nothing in so far as an unsecured creditor will only seek to overreach the lessor's rights at such time as it seeks to obtain the leased asset by some judicial process.

94. - The general rule enunciated in Article 5 (1) is, however, subject to a special rule set out in Article 5 (2). This covers the case where under the applicable law the lessor's real rights against the lessee's trustee in bankruptcy and unsecured creditors are only valid upon

compliance with a public notice requirement. Where this is the case Article 5 (2) provides that the lessor's real rights shall only be valid against the lessee's trustee in bankruptcy and unsecured creditors under the future Convention where the lessor has complied with such a requirement. Where the lessor fails to comply with such a requirement of the applicable law, then the lessor's real rights in the equipment are as a result no longer valid against the lessee's trustee in bankruptcy and unsecured creditors under the draft Convention.

95. - In the light of the various problems alluded to above in respect of the choice of connecting factor for the determination of the public notice requirement laid down in Article 5 (2), the committee of governmental experts at its final session hit upon a new formula for establishing the relevant connecting factor. Article 5 (3) in fact establishes a three-tier system for this purpose, equipment being divided into three different categories. In respect of the generality of equipment the applicable law is, in line with the traditional conflicts rule in this field, the *lex rei sitae* (Article 5 (3)(c)). On the other hand, this law was not judged to be appropriate for that class of equipment which, by virtue of being mobile, would normally be used in more than one jurisdiction. Under Article 5 (3)(b) the applicable law for this class of equipment is accordingly made the law of the State where the lessee has its principal place of business. Anxious to avoid creating any inference under Article 5 (2) of a double registration requirement for that special class of mobile equipment, such as ships and aircraft, already subject to registration - the term "registration" in this context being used not in the sense of registration of rights in, ownership of, or of a security interest in an asset but in the sense of registration of a particular type of asset - pursuant to the law of a State, the committee proposed in Article 5 (3)(a) that the applicable law for this special class of equipment should be the law of the State of registration. However, the committee of governmental experts was only too aware of its limited expertise in the specialist field of ship and aircraft registration and of the complexities inherent in the subject, notably the different purposes for which registration may be required, and therefore requested the Unidroit Secretariat to sound out technical experts in advance of the diplomatic Conference with a view to ascertaining whether the solution it had come up with in Article 5 (3)(a) would be workable in practice. This enquiry was underway at the time this report was being written. In the meantime Article 5 (3)(a) is presented in square brackets indicating that it is a matter that will have to be settled at the diplomatic Conference. It should be noted that two delegations to the final session of governmental experts took the view that a better solution to the problem which the draft Convention sought to deal with in Article 5 (3)(a) was to exclude ships and aircraft from the application of the provisions of Article 5 altogether.

96. - Square brackets were also inserted around the words "mobile" and "normally used in more than one State" in Article 5 (3)(b). The term "mobile" aroused much criticism within the committee of governmental experts, on the ground that virtually all equipment apart from fixtures could be considered to be mobile. As a result it was proposed either clarifying it by the addition of the words "normally used in more than one State" along the lines of the formula employed in Article 9 of the Uniform Commercial Code and similarly inspired Canadian legislation or replacing it by these words altogether. As it proved difficult to reach a decision on this point within the committee of governmental experts, it was felt wiser to forward both expressions to the diplomatic Conference for decision.

97. - Article 5 (4) is designed to indicate that all questions of priority as between the lessor and a lien creditor or secured creditor of the lessee are not intended to be dealt with in Article 5 and are accordingly left to be dealt with by the applicable law.

Article 6

98. - This article deals with the situation, frequent in practice, where the leased equipment becomes a fixture of real property. The text of this article as adopted by the Study Group sought to regulate eventual conflicts of interest arising in respect of the leased asset as between the equipment lessor and the real estate lessor or an encumbrancer of the realty. It was agreed that, as with the eventual conflicts of interest addressed in Article 5, these conflicts would in practice only arise where the lessee had gone bankrupt. The solution proposed by the Study Group was, along the lines of Article 9-313:5 of the Uniform Commercial Code and Section 36(4) of the Ontario Personal Property Security Act of 1967, to recognise the equipment lessor's right to enter upon the property of the owner or encumbrancer of the realty to sever its equipment, subject only to it having priority under the *lex rei sitae* over the claim of any person having an interest in the realty concerned and to its duty to reimburse the owner or encumbrancer of the realty for any damage occasioned by the act of severance.

99. - This rule, however, proved unacceptable to the representative of a Civil law system attending the first session of governmental experts. He saw it as proposing a radical departure from what he considered to be a fundamental tenet of his legal system, namely that the owner of realty has priority over the owner of personalty, and he could not see the case for making such an exception for the sake of financial leasing transactions alone. The drafting committee, unable to make any headway with the various compromise solutions put forward, accordingly proposed the deletion of

Article 6 at the conclusion of the committee of governmental experts' first reading. However, on second reading, while there was agreement that it would be unwise to attempt to reinstate any substantive rule on this subject, support emerged for a limited restoration of this article designed to put parties to financial leasing transactions on notice that all conflicts arising as between the equipment lessor and the owner or encumbrancer of the realty to which the leased equipment has become a fixture are referred to the *lex rei sitae* and that the applicable rules may accordingly differ depending on the location of the equipment. This proposal was accepted by the committee of governmental experts and incorporated in the new Article 6. The conflicts of interest referred under this rule to the *lex rei sitae* are spelled out in this provision as, first, the whole question of whether the leased equipment has or has not become a fixture to, or incorporated in realty and, secondly, the question of the rights of the equipment lessor and the owner or encumbrancer of the realty *inter se* in relation to the equipment.

Article 7

100. - At first sight the provisions of Article 7 might appear to involve a fairly radical departure from the law of most countries. In fact, they do little more than reflect the situation existing in practice, in that financial leases invariably contain detailed provisions absolving the lessor from responsibility for defective or non-conforming equipment and requiring the lessee to indemnify the lessor against claims brought by third parties. It reflects the general philosophy underlying the draft Convention, that is the special nature of financial leasing, seen both in the lessor's role and in that of the lessee, in excluding the lessor's liability in contract or tort in most situations in which it would otherwise normally have been held liable in its capacity of lessor of the equipment. The finance lessor will in most cases have no technical expertise with regard to the equipment's specifications, will never take delivery of the equipment and normally will not even have any reason to see it. Its role is limited to supplying the capital needed for the acquisition of the equipment. It is the lessee, we have seen in Article 1 (2)(a) above, who relies primarily on its own skill and judgment in selecting both equipment and supplier, and who typically conducts negotiations with the supplier on its own as a reasonably informed user. If there is any reliance on the knowledge and representations of another party in this context, indeed it is the lessee's reliance on the supplier's knowledge of the equipment and its representations in this regard, so much so indeed that it is the supplier rather than the lessor who in effect under the draft Convention is in many ways treated as the party who places the equipment into the stream of commerce. In Article 9, moreover, the

draft Convention recognises that in most cases it is the supplier, rather than the lessor, who is the appropriate party from whom the lessee should seek redress where the equipment turns out to be defective or otherwise not in conformity with the terms of the supply agreement.

Exceptions to the general principle of the lessor's immunity

101. - Before analysing the extent of the immunity granted the lessor under this article, it is important to be clear about what is not intended to be included in this immunity. It is an exoneration that is confined to those liabilities that would flow as a matter of law from the lessor's notional delivery of the equipment under the leasing agreement, from the lessor's being treated as the legal supplier of the equipment in relation to the lessee under most jurisdictions. It is not therefore intended to affect those liabilities that would be imposed by contract, whether by express terms of the leasing agreement or by terms implied in fact. This restriction of the lessor's immunity is spelled out in the opening words of Article 7 (1)(a) ("Except as otherwise provided by ... the leasing agreement"). Equally the lessor's immunity in relation to the lessee is clearly not intended to affect those liabilities imposed upon the lessor elsewhere in the draft Convention. This is notably the case with the provisions of Article 10. This limitation on the lessor's immunity is also spelled out in the opening words of Article 7 (1)(a) ("Except as otherwise provided by this Convention"). Equally the general immunity conferred upon the lessor under Article 7 is not intended to extend to breaches of statutory duty, in that it is questionable whether States would be prepared to accept an exclusion of those special duties imposed by statute over and above those imposed by the general law of tort.

102. - The fact that the immunity conferred under Article 7 (1)(a) is stated to be commensurate with the lessor's non-intervention in the selection of the supplier or the specifications of the equipment means, as a corollary, that where the lessor does so intervene, then it will be liable to the lessee to the extent of its intervention. This follows from the logical premise upon which the immunity conferred upon the lessor under Article 7 is founded, namely the lessor's technical neutrality in relation to the equipment. We have already seen, in Article 1 (2)(a), that this technical neutrality of the lessor has been made a definitional ingredient of the type of lease addressed by the draft Convention. The question of the degree of the lessor's intervention in the sphere of autonomy normally reserved exclusively to the lessee under the draft Convention needed to defeat the lessor's right to raise its immunity under Article 7 (1)(a) was considered a matter best left to be resolved by the applicable national law.⁽²⁷⁾

(27) Regarding this provision cf. also §68 above.

103. - It follows from the fact that the immunity in tort conferred upon the lessor under Article 7 (1)(b) is stated to extend only to that liability for personal injury or damage to property caused by the equipment that would flow from its *capacity of lessor* that it is not the intention of Article 7 (1) of the draft Convention to affect any liability that might be imposed on a finance lessor in some other capacity, notably as owner of the leased asset. Whereas there are under most jurisdictions relatively few liabilities that would in this context flow from ownership as such, most liabilities being imposed on the lessor as legal supplier of the equipment, there is special international legislation, notably the International Convention on Civil Liability for Oil Pollution Damage adopted in Brussels in 1969 and amended in London in 1984, which would have the effect of imposing liability on a finance lessor as owner. The authors of the draft Convention were at all times conscious of the need to avoid the embodiment in the future Convention of a rule that would run counter to such special international legislation to which States that might otherwise have wished to become Parties to the future Convention might already be Contracting Parties. Article 7 (1)(c) accordingly makes it clear that the immunity from liability conferred upon the lessor under Article 7 (1)(a) and (b) is without prejudice to any liability it might incur as owner of the equipment but that the question of such liability is not governed by the draft Convention.

104. - The fact that the provisions of Article 7 (1)(c) speak not only of the lessor's liability as owner but more generally of its liability in any capacity other than as lessor, including that of owner, indicates that the authors of the draft Convention contemplated that there might well be capacities other than that of owner in which the lessor's immunity under Article 7 might be forfeited. This might, in particular, be the case with the 1985 E.E.C. Directive on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products, Article 3 (2) of which provides that any person importing a product into a Community country with a view to *leasing* it is to be deemed a producer for the purposes of the Directive and is to be liable to the same extent as if it were a producer. The authors of the draft Convention, however, took the view that it was more practical and allowed for greater flexibility to refrain from seeking to enunciate an exhaustive list of all the capacities in which the lessor might be found liable, their primary objective being rather to ensure that the lessor would not henceforth be treated, simply by virtue of letting out the equipment, as the notional legal supplier of the equipment.

105. - The other exception to the lessor's immunity under Article 7 proved rather more troublesome for the committee of governmental experts. This concerns the lessor's duty to ensure the lessee's quiet possession

under the lease. The division of opinion that emerged within the committee of governmental experts as to the appropriate measure of the lessor's liability for disturbances of the lessee's quiet possession is reflected in the presentation of alternative solutions, Alternative I and Alternative II, to Article 7 (2). It also reflects the inherent contrast between, on the one hand, the idea expressed by certain delegations to the committee of governmental experts that it was appropriate to extend the notion that quiet possession goes to the essence of a lease to the atypical leasing transaction addressed by the draft Convention and, on the other, the reality that, in view of the lessor's purely financial role in such transactions, the lessor's warranty of quiet possession is invariably excluded in finance leases.

106. - Up until the second session of governmental experts this provision had attracted no controversy, the idea all along having been simply to ensure that the lessor remain liable for any disturbance of the lessee's quiet possession resulting from the lawful act of a third party having a superior title or right not derived from any act or omission of the lessee, that is where the lessor did not have the right to dispose of the equipment or where its right to do so was qualified in some way and because of that a third party was entitled to claim possession by virtue of a paramount title, for example where its use was in breach of a patent or trademark. At the second session of governmental experts, however, a body of feeling emerged that favoured the extension of the lessor's warranty of quiet possession under Article 7 (2) to cover a disturbance resulting from the lawful act of a third party not necessarily having a superior title or right but *laying claim* to such a superior title or right. The committee, however, was divided on the advisability of agreeing to such an extension and accordingly forwarded alternatives to the final session of governmental experts. At this session the committee, albeit still divided, accepted the principle that the lessor's liability for any disturbance of the lessee's quiet possession resulting from the lawful act of a third party having a superior title or right should be extended to cover any disturbance of the lessee's quiet possession resulting from a third party laying claim to such a superior title or right. It was, however, the committee's opinion that the lessor could not be made liable for all claims to a superior title or right made by third parties and that the category of claims for which the lessor could be held liable under Article 7 (2) would have to be narrowed down. The committee took the view that the lessor's warranty of quiet possession in relation to such claims would have to be limited to claims that were serious and therefore not merely vexatious. The criterion it adopted for ascertaining the seriousness or otherwise of such claims was to require that the person asserting such a claim was acting under the authority of the court, for instance under an interim order for the return of the property to the claimant. Where what in the event turned out to be

an unsurmountable division of opinion emerged within the committee at this final session was over whether the lessor had to have been at fault in a third party being able to disturb the lessee's quiet possession for it to be liable under this provision. On the one hand, there was a body of feeling that the lessor should incur liability under this provision *regardless of whether or not it had been at fault* in the third party being able to disturb the lessee's quiet possession, the only circumstances in which it would be relieved from such liability being where the disturbance had been caused by the lessee's own fault. This broader measure of the lessor's liability is expressed in Alternative I. On the other hand, there was a body of feeling which maintained that *the lessor had actually to have been at fault* in the third party being able to disturb the lessee's quiet possession for it to incur liability under Article 7 (2). This narrower measure of the lessor's liability is expressed in Alternative II, which, it should be noted, includes an extra paragraph, Article 7 (3), the effect of which would be to preserve any broader warranty of quiet possession guaranteed under the applicable law. The division of opinion on this provision was so marked that, when the committee of governmental experts came to discuss which provisions of the future Convention should be made mandatory under Article 14, certain representatives, admittedly reflecting a minority opinion, again took the view that the lessor's right to quiet possession was of the essence of a finance lease and that Article 7 (2) should therefore be made a mandatory provision of the future Convention. This was a matter on which, the committee being unable to reach agreement, it was therefore judged best to leave the making of a decision to the diplomatic Conference and hence the reference to Article 7 (2) as a mandatory provision of the draft Convention is presented in square brackets.

107. - Being clear in our minds about the cases not meant to be covered by the general immunity in contract and tort conferred upon the lessor under Article 7, we now have to address ourselves to the content of this immunity. This immunity is examined below, first, as regards its impact on the liability that would ordinarily attach to the lessor vis-à-vis the lessee and, secondly, in its impact on that liability in tort that might otherwise attach to the lessor vis-à-vis third parties.

Lessor's liability to lessee

108. - Article 7 (1)(a) has the effect of excluding those contractual terms implied by law from the supply of equipment, notably the duty to ensure that the equipment supplied is of merchantable quality and fit for its known purpose. The need to exclude the lessor's liability in respect of these duties arises, as we have seen, from the fact that most

jurisdictions treat the lessor as the legal supplier in relation to the lessee, even though it does not physically deliver the equipment. Breach of these duties would usually entitle the lessee to damages as against the lessor and might give it a right to reject the equipment and withhold payment of its rentals or even terminate the leasing agreement completely. As such the immunity in contract conferred upon the lessor under this clause has, of course, to be read in conjunction with, and is correspondingly limited by the lessee's right to reject the equipment, terminate the leasing agreement and in certain limited circumstances withhold the payment of its rentals under Article 10.

109. - The provisions of Article 7 (1)(a) are also intended to exclude those liabilities in tort that the lessor would normally incur towards the lessee in its capacity of lessor. This would, for example, be the case with any liability in tort that the lessor might incur through the equipment proving not only to be defective but also unsafe and causing death or personal injury to the lessee, or damage to property of the lessee, although most jurisdictions would make such liability dependent in any event on proof of negligence on the part of the lessor. The immunity from liability in tort conferred upon the lessor under Article 7 (1)(a) would, however, probably have its greatest impact in those jurisdictions, in particular the United States of America, in which the lessor might in certain circumstances find itself exposed to a suit alleging strict liability on the ground that it was to be considered as having introduced the defective equipment into the stream of commerce. This immunity has, however, to be interpreted in conjunction with what has already been said⁽²⁸⁾ regarding any liability that the lessor might incur as a producer under the aforementioned 1985 E.E.C. Directive. The lessor's general immunity in tort would, however, in principle preclude the lessee from claiming contribution or indemnity from the lessor in respect of liability incurred by the lessee to a third party as a result of a defect in the equipment.

110. - The basic reasons underlying the decision of the authors of the draft Convention to exclude the lessor's liability in contract and tort towards the lessee in most situations have already been rehearsed above.⁽²⁹⁾ It suffices to recall here, by way of justification of the specific exclusion of the lessor's liability towards the lessee in respect of the implied warranty of merchantable quality, that the lessor will not normally be a merchant as to the type of equipment leased: it will generally only be a merchant in the extension of credit. With regard to

(28) Cf. §104 above.

(29) Cf. §100 above.

the exclusion of the lessor's liability towards the lessee in respect of the implied warranty of the equipment's fitness for its known purpose, on the other hand, it has to be remembered that the lessor will not normally have shown any skill or exercised any judgment upon which the lessee has relied in its selection of the equipment. The case for the lessor's immunity from liability in tort towards the lessee is founded on its non-involvement in the selection of the supplier and the specifications of the equipment and on the fact that it will normally at no stage profess any technical expertise with regard to the equipment's physical characteristics.

Lessor's liability to third parties

111. - A finance lessor will not as a rule incur liability to third parties who sustain injury or damage to their person or property as a result of defects in the equipment. There being by definition no contractual nexus between the lessor and such third parties, such a claim would only lie in tort and most jurisdictions would require the third party to show that the lessor had been guilty of negligence, for instance in leasing equipment that it knew or ought to have known was unsafe. Given the finance lessor's technical neutrality in most financial leases, the burden of proving such negligence on the part of a finance lessor is usually a heavy one. Moreover, in most Common law jurisdictions such liability would attach to the lessee as being the party in possession of the equipment. The major impact of the immunity from liability in tort vis-à-vis third parties conferred upon the lessor under Article 7 (1)(b) is therefore once again likely to be in those jurisdictions, such as the United States of America, with an ever expanding concept of strict products liability as a result of which the lessor might find itself being exposed to a suit alleging such strict liability merely by virtue of the fact that the lessor is to be treated as notionally delivering the equipment under the leasing agreement and therefore as notionally putting it into the stream of commerce. As we have already indicated in respect of the immunity in tort vis-à-vis the lessee conferred upon the lessor under Article 7 (1)(a), this immunity must, however, be interpreted in conjunction with what we have already said⁽³⁰⁾ regarding any liability that the lessor might incur as a producer under the aforementioned 1985 E.E.C. Directive.

Article 8

112. - This article spells out the lessee's duty of care in relation to the equipment from the moment that it is delivered into the lessee's hands

(30) Cf. §104 above.

up until the time that it has to be returned to the lessor at the end of the lease term. Paragraph 1 details the lessee's duty of care during the lease term, while paragraph 2 specifies the condition in which the equipment must be returned to the lessor at the end of the lease term, in the event that it does not exercise any purchase option that it may have or decides not to seek a renewal of the lease.

113. - The duty of care imposed on the lessee under Article 8 (1) is that of a "normal user". The standard of care that must be displayed by the lessee to this end is specified to be "proper care". This standard of care is further clarified by the additional requirement that the lessee must keep the equipment in the same condition as it was in at the time of delivery, after allowance has been made for fair wear and tear. In effect this means that the lessee is under a duty to keep the equipment in good working order. This is made even more explicit by Article 8 (2) which specifies that when the lessee comes to return the equipment to the lessor at the end of the lease term, then the equipment must be in "the condition specified in the previous paragraph", in other words still in a state of good working order. It is true that individual leasing agreements may regulate these matters differently. In some countries it may, for instance, be unusual for there to be an exception in the leasing agreement for fair wear and tear. However, whilst it is also true that leasing agreements invariably contain detailed provisions as to possession, care and use of the equipment, the authors of the draft Convention considered that the provisions of Article 8 could serve a useful purpose in those cases where the lease was silent on some or all of these matters, all the more so as this was *par excellence* a provision that they intended to be subject to the parties' agreement.

114. - There was discussion within the Study Group of whether the draft Convention should cover the question of what should happen where the equipment was accidentally destroyed at some stage during the leasing agreement. While the value of the equipment would normally be covered by insurance, this still left the problems of how the insurance monies should be applied and what should be the effect of destruction of the equipment on the leasing agreement: if the insurance monies were to be applied in restoring the equipment, the question arose as to whether a new contract came into existence between the parties to the original leasing agreement or whether the original agreement should go on applying to the restored equipment. It was the opinion of the authors of the draft Convention that this was a matter best left to be settled by the parties in their contract.

Article 9

115. - The problem addressed by this article is that of the lessee's remedies against the supplier where the latter has failed to tender delivery in conformity with the terms of the supply agreement. The wide terms of the immunity from liability vis-à-vis the lessee conferred upon the lessor under Article 7 (1) presuppose an alternative avenue of redress for the lessee for the deleterious consequences which it sustains through such a breach of the terms of the supply agreement by the supplier. The authors of the draft Convention took the view, as we have seen above, that since it is the lessee and the supplier who typically conduct negotiations on their own regarding the equipment's specifications and since if the lessee relies on the knowledge and representations of another party in this context it is upon the supplier's, the most appropriate party from whom the lessee should seek redress in the event of such a breach of the supply agreement by the supplier is the supplier itself. However, the conversion of this principle into an effective right of action exercisable directly by the lessee proved to be the source of some difficulty.

116. - In effect, unless some form of collateral contract can be deduced in the circumstances from the negotiations between lessee and supplier, there is no contractual nexus between these two parties. This has not surprisingly hitherto created problems for the lessee wishing to bring proceedings against the supplier. The techniques employed to get round this problem have varied. Some jurisdictions have treated the supply agreement as creating stipulations for the benefit of a third party, in this case the lessee. This technique was recently given the legislative stamp of approval when it was embodied in Section 2A-209 ("lessee under finance lease as beneficiary of supply contract") of the proposed final draft (6 April 1987) of Article 2A (Leases) of the Uniform Commercial Code. The techniques generally employed have, however, rather involved the lessor agreeing either to assign its claims against the supplier under the supply agreement to the lessee or to enforce its own rights as buyer against the supplier for the lessee's benefit, or else the lessor, when placing the order for the equipment, contracting as agent for the lessee as well as on its own behalf. Both these techniques were adjudged by the Study Group to be inadequate inasmuch as the claim pursued by or in the right of the lessor can only be for such loss as would have been recoverable by the lessor, whereas the lessee will naturally enough be wanting to recover its own measure of loss. This may well differ from the lessor's. To take the example of equipment which upon delivery proves to be *partially* unfit for the purpose for which it was intended, the lessor will, under the hell and high water clause customarily included in financial leasing agreements, be entitled to recover its rentals come what may. The supplier could accordingly with reason assert in its defence to any claim brought by the

lessor that the latter has not sustained any financial loss, save to the extent that the value of the equipment for re-leasing or re-sale purposes has depreciated in proportion to the extent to which it had proved to be partially unfit for the purpose for which it was intended. The lessee's measure of loss will, on the other hand, be quite different from that of the lessor. Its loss will be essentially consequential in nature, in the shape of the loss of production and trading income that it will sustain through the equipment's partial unfitness for its purpose, not to mention the negative impact that its loss of production will probably also have on its trading image.

117. - The lessee might, however, find itself entitled to nothing more than nominal damages if restricted to recover against the supplier only as the lessor's assignee. It was to meet the foregoing problems, notably that posed by the lessee's lack of privity of contract with the supplier, that the Study Group proposed that the future Convention should create a new statutory direct right of action exercisable by the lessee against the supplier. This solution, however, proved to be the source of misgivings among some members of the committee of governmental experts at its first session. They feared lest their legal systems might be reluctant to accept the introduction of such a direct right of action when the same result could already be achieved under their legal systems by the lessor's assignment of its rights under the supply agreement. These jurisdictions, it transpired, did not have the problem experienced by so many legal systems discussed above, namely that a lessee would be restricted as assignee to the measure of loss recoverable by its assignor. Under the principle of the *Drittschadensliquidation*, in Austria and the Federal Republic of Germany, for example, it was possible for one party to recover in respect of the loss of another party who, while not a party to the contract in question, has a close connection thereto.

118. - The assignment solution nevertheless continued to pose many problems for the jurisdictions which did not have this possibility. Moreover, the measure of loss recoverable by the lessor against the supplier might be subject to qualification for some reason, for instance by virtue of a right of set-off in favour of the supplier, which would result in the lessee's remedies under an assignment from the lessor being also correspondingly limited. Another problem with the assignment solution resided in what was seen as the impossibility for the lessor to have to assign *all* its rights under the supply agreement. Some of the lessor's rights, it was argued, the lessor could not reasonably be expected to abandon. This was in particular the case with its right to terminate the supply agreement, since this would have the effect of revesting title to the equipment in the supplier, whereas for the lessor its title was an essential element of its security and under many jurisdictions the basis of

its receiving those tax indemnification benefits which enabled it to offer the lessee more advantageous rental terms. This in turn raised the whole question of which of the rights of the lessor under the supply agreement would, under the assignment solution, have to be assigned to the lessee.

119. - Once it became clear that neither the assignment solution nor the direct right of action solution was going to prove acceptable, the committee looked at different compromise solutions. One of these proposed that, where the supplier knew the purpose for which the lessee required the equipment and the loss sustained by the lessee was therefore reasonably foreseeable by the supplier, the lessee should be entitled to require the lessor to bring legal proceedings to recover both its loss as well as any additional loss sustained by the lessor itself. This would, in particular, have met one of the objections raised to the direct right of action solution, namely that the supplier would face the likelihood of two different claims being brought by two different parties in respect of the same damage on two separate occasions.⁽³¹⁾ However, other compromise solutions, essentially based on the lessee being for the purposes of this provision treated as an additional party to the supply agreement, fared better.

120. - Indeed the solution which the committee of governmental experts finally hit upon in Article 9 (1) was to extend the benefit of the supplier's duties under the supply agreement to the lessee as if the latter were a party to that agreement and as if the equipment were to be supplied directly to the lessee. This solution, it should be noted, has much in common with that of paragraph 1 of the proposed new Section 2A-209 of the Uniform Commercial Code.⁽³²⁾ Originally the authors of the draft Convention proposed making the benefit of this provision available only where the supplier knew the purpose for which the lessee required the equipment, that is for the purpose of being held on lease, but subsequently

(31) This argument rested on the premise that the supplier would normally expect to find the lessor as its only interlocutor but this reasoning may be criticised as in practice the specifications regarding the equipment are negotiated directly between lessee and supplier and it is accordingly not unreasonable for the latter to expect to find the lessee as its adversary in the event of litigation.

(32) This provides as follows:

"(1) The benefit of the supplier's promises to the lessor under the supply contract and of all warranties, whether express or implied, under the supply contract, extends to the lessee to the extent of the lessee's leasehold interest under a finance lease related to the supply contract, but subject to the terms of the supply contract and all of the supplier's defenses or claims arising therefrom."

they adjudged this specification to be superfluous in that it followed automatically from the terms in which the sphere of application provisions of the future Convention were drawn, in particular the words "to the knowledge of the supplier" incorporated in Article 1 (2)(b), that the future Convention would only apply where the supplier knew that the equipment was to be held on lease. Prior to the final session of governmental experts the words "for its professional or business purposes" featured at the end of Article 9 (1) but these too were finally adjudged to be superfluous in view of the fact that, by virtue of Article 1 (3), the future Convention was in any event only intended to apply to transactions in which equipment was to be used primarily for such business or professional purposes.

121. - As a rider to the rule set out in Article 9 (1), Article 9 (2) makes it clear, however, that, for the reasons expounded above, ⁽³³⁾ the rights conferred upon the lessee vis-à-vis the supplier under Article 9 (1) do not include the right to terminate or rescind the supply agreement, rights which remain vested in the lessor alone. There was a proposal that the right to vary the supply agreement should also be specifically excluded under this provision from those rights conferred upon the lessee vis-à-vis the supplier under Article 9 (1). We have already had occasion to comment ⁽³⁴⁾ on the fate reserved to this proposal in the context of Article 4.

122. - The authors of the draft Convention were at all times conscious of the need to avoid the supplier being exposed to liability in respect of the same loss or damage twice over, that is to both lessor and lessee. Indeed the Study Group essayed a solution to this problem the effect of which would have been to require both lessor and lessee to be joined as parties to any proceedings against the supplier for the latter's breach of the terms of the supply agreement. This proposal had to be dropped because in the event it was feared lest it might unduly encroach on domestic procedural law. A similar proposal, for an additional paragraph to Article 9, was made within the forum of the committee of governmental experts. This proposal would have had the effect that, once the lessee had acquired rights of action as against the supplier under Article 9 (1), then these rights would no longer have been exercisable by the lessor against the supplier. However, this proposal was also found unacceptable, on the ground that the interests of the lessor and the lessee were quite distinct. Whilst in the event unable to agree on a provision on this matter, it was nevertheless the committee's feeling that the draft Convention should be understood on the basis that the supplier could not be held liable to two parties for the same loss or damage.

(33) Cf. §118 above.

(34) Cf. §84 above.

Article 10

123. - This article treats of the lessee's remedies against the lessor in the event of the supplier's failure to tender delivery in conformity with the terms of the supply agreement. It should be borne in mind that this is a matter normally exhaustively regulated in the leasing agreement and as such the provisions of this article are intended to be subject to the parties' agreement under Article 14.

124. - The first of the lessee's remedies against the lessor under this article is detailed in paragraphs 1 and 2. This is the right to reject the leased equipment. It is stated to arise either where the equipment upon delivery proves to be not in conformity with the terms of the supply agreement, which basically means that it is either wholly or partly defective (Article 10 (1)(a)) or where delivery is not tendered within a reasonable time of the date fixed for delivery or, where no delivery date was fixed, within a reasonable time of the making of the leasing agreement (Article 10 (1)(b)). The logic behind this provision is that it would be wrong to require the lessee to wait for delivery indefinitely or to have to make do with non-conforming equipment. It will be noted that in determining the relevant delivery date for the purpose of calculating the "reasonable" time to be allowed for delivery, Article 10 (1)(b) accords priority to the date set in the leasing agreement. Thus if a date for delivery is set in both the leasing agreement and the supply agreement, it is that fixed in the leasing agreement that provides the starting point for the running of the "reasonable" period of time allowed for delivery under Article 10 (1)(b). The due delivery date fixed in the supply agreement provides this starting point only where no such date is stipulated in the leasing agreement. The priority given to the date fixed in the leasing agreement reflects the fact that the remedy being granted to the lessee under these paragraphs is against the lessor. As has already been explained above in the context of Article 9,⁽³⁵⁾ the reason why the authors of the draft Convention considered it appropriate to grant the lessee this remedy vis-à-vis the lessor and not vis-à-vis the supplier stems from the fact that the effect of granting the lessee the right to reject the equipment as against the supplier would have been to divest the lessor of its security in the transaction, namely its title to the equipment.

125. - Paragraph 2 of this article makes the lessee's right to reject vis-à-vis the lessor exercisable by notice. Such notice must be given to the lessor within a reasonable time after the lessee has discovered the non-conformity or ought to have discovered it. This language is clearly

(35) Cf. §118 above.

designed to cover the case of hidden defects which only emerge some time after delivery has been tendered. The lessor is given the right to cure the non-conformity by a fresh tender provided this is made within a reasonable time after the giving of notice to reject. The subject of the "fresh tender" is specified to be either a re-tender of the same piece of equipment as was tendered before, therefore suitably repaired, or else the tender of an alternative item of equipment, corresponding to that stipulated for under the supply agreement. A propos of the lessor's right to make a fresh tender, the view was expressed that it might be desirable to restrict this right to re-tender so as not to subject the lessee to the possibility of an endless series of non-conforming tenders, each made within a reasonable time after notice of rejection of the previous tender. It was feared that this might unfairly limit the lessee's chances of looking elsewhere for the equipment that it required. It was nevertheless explained that this provision sought merely to give the lessor a parallel right to cure a non-conforming tender by making a fresh tender to the corresponding right given to a seller under the Vienna Sale Convention. Moreover, the language employed in Article 10 (2) speaks specifically of a fresh tender.

126. - There was some criticism of the expression "a reasonable time" as employed in this provision. The fear was expressed that it erred too much on the side of vagueness. However, it was explained that this was a notion, drawn from the Common law, that had been imported into other international Conventions in the commercial law sector, such as the Vienna Sale Convention. It afforded a measure of flexibility that was particularly desirable in international transactions in so far as it would be impossible to specify a single period apt for all transactions and all circumstances. Just one example of the way in which circumstances could change from one international transaction to another would be the distances involved. It was accordingly judged that this was a matter best left to be assessed by the judge in the light of the particular circumstances of the case. One factor that the judge might wish, for instance, to take into consideration in this context might, it was felt, be whether the lessor or the supplier had offered to have non-conforming equipment put right.

127. - Article 10 (3) deals with the problem, significant above all in the case of hidden defects in the equipment which the lessee only discovers some time after the equipment has been in operation, of the point in time at which the lessee should lose its right to reject the equipment under Article 10 (1). It is clear that there has to be some cut-off point beyond which the lessor can be sure that there is no longer any risk that the lessee can exercise the right to reject. There was an attempt by a number of representatives within the committee of governmental experts to fix this moment at the time when the lessee intimates acceptance of the equipment to

the lessor or supplier. This solution would have had the advantage of corresponding with the practice current in financial leasing transactions for the lessor only to disburse the purchase price to the supplier at such time as it has been notified by the lessee that the equipment has been delivered and is in good working order. However, this solution was found to be unacceptable, principally on the ground that the remedies granted the lessee against the supplier under Article 9 would not by themselves give the lessee adequate redress in the event of hidden defects emerging only after the initial intimation of acceptance - for instance, the lessee's remedies against the supplier under Article 9 would be considerably limited as a result of the prohibition contained in Article 9 (2) on the lessee terminating or rescinding the supply agreement - but also because of a reluctance to deprive the lessee of its right to reject equipment that it would ordinarily have been supplied with under a standard form of contract. In the event the solution reached by the committee was to equate the lessee with an ordinary buyer for this purpose: the lessee under Article 10 (3) will accordingly lose its right to reject where it would have lost this right if the equipment had been supplied to it as a buyer. It was felt that it was right that if, as a buyer, the lessee would have been treated as against the supplier as having decided to retain the equipment, it should also be so treated as against the lessor.

128. - Article 10 (4) gives the lessee a further remedy as against the lessor. This is the right to terminate the leasing agreement and to recover any rentals and other sums it may have paid in advance. This right is exercisable by the lessee once it has rejected the equipment under Article 10 (1) and the supplier has still failed to make a conforming tender even after the further reasonable time permitted under Article 10 (2). The reason why the lessee's right to reject, on the one hand, and its right to terminate the leasing agreement and recover any rentals and other monies paid in advance, on the other hand, are set forth separately in Article 10 is that the authors of the draft Convention basically adopted the line that it would not be right to allow the lessee, who had after all selected the supplier and given the specifications for the equipment, to terminate the leasing agreement and recover any rentals and other monies it may have paid in advance from the lessor, who had only gone into the transaction to finance the lessee's acquisition of the use of an asset chosen by that same lessee without any technical role in relation to the equipment's characteristics having been played by itself, so long as there was still an opportunity under Article 10 (1) and (2) for the making of a conforming tender.

129. - While the authors of the draft Convention were not prepared to give the lessee a general right to withhold the payment of its rentals in the event of a non-conforming tender, taking the view that the lessee

basically had a straight choice, either to retain the equipment and assert its rights against the supplier for non-conformity under Article 9 (1) or to reject it and recover whatever rentals and other monies it may have paid to the lessor, they nevertheless did in the end recognise a temporary right - the temporary nature of this right being brought out in the text of Article 10 (4) by employment of the word "meanwhile" - for the lessee to withhold payment of its rentals, during that limited period of time necessary for it to make up its mind, following the tender of non-conforming equipment, whether to reject or not.

130. - However imperfect may be the use that the lessee may be able to make of such non-conforming equipment, admittedly probably at a lower capacity than that foreseen by the parties in their agreement, the authors of the draft Convention were of the opinion that the lessor should be entitled to reasonable compensation in respect of such beneficial use, if any, of the equipment as the lessee may have had. This right of the lessor is spelled out in the second sentence of Article 10 (4).

131. - Under Article 10 (5) the lessee's right to reject the equipment, to terminate the leasing agreement and to recover any rentals and other monies that it may have paid in advance and temporarily to withhold payment of its rentals while deciding whether or not to reject a non-conforming tender are in effect stated to be the limit of the lessee's remedies against the lessor in the event of the supplier's failure to deliver the equipment in accordance with the terms of the supply agreement, save in one set of circumstances: this is where the non-delivery, late delivery or tender of non-conforming equipment is the lessor's own fault, which would normally mean where the lessor had failed to settle the purchase price with the supplier. In such a case Article 10 (5) leaves open the possibility for the lessee to sue the lessor for any additional loss, over and above the compensation represented by its recovery of any rentals and other sums it may have paid in advance, that it may sustain through the supplier's failure to deliver the equipment in accordance with the terms of the supply agreement.

Article 11

132. - This article deals with the consequences of a lessee's default in the performance of its duties under the leasing agreement, notably detailing the range of remedies this opens up for the lessor. As such it may be considered as constituting those elements of a liquidated damages clause which local law should not cut down. It is in no way intended to limit the parties' freedom to stipulate a liquidated damages clause of their own in the leasing agreement, and as such was, with the exception of paragraphs 3 and 4, intended to be open to derogation under Article 14.

133. - The lessor's remedies are divided for the purposes of this article into two categories, those that it may exercise in the event of any default by the lessee and those that it may only exercise where the lessee's default is "substantial". The former are treated in Article 11 (1) and the latter in Article 11 (2). The draft Convention did not essay a definition of either "default" or "substantial default" on the ground that, given the limited objectives of both this article and the draft Convention in general, namely the establishment of a basic rather than an exhaustive legal framework for the atypical leasing transaction, these were matters best left to the parties in their agreement, all the more so since consumer transactions were excluded from the ambit of the draft Convention by Article 1 (3) so that both parties to the type of leasing agreement envisaged here could safely be considered to be professionals. In the type of leasing done at the international level, moreover, the rule as regards what is to be considered as an event of default differs considerably from contract to contract. The essential factor behind this differentiation lies in the degree of creditworthiness of the individual lessee. Thus the better the lessee's creditworthiness, the more the lessor will be prepared to restrict the circumstances deemed under the lease to constitute default, whereas the weaker the economic situation of the lessee the more the lessor is going to be inclined to press for a more extensive interpretation of the events constituting default. It should moreover be borne in mind that a lessor will not press for the enforcement of its contractual rights and remedies upon the mere first occurrence of an event deemed in the leasing agreement to constitute default: leasing agreements customarily provide for the lessor to give the lessee notice in such circumstances that an event has occurred which with the passage of time will nevertheless become a default justifying its invocation of the rights and remedies set forth in their agreement.

134. - The first remedy, set out in Article 11 (1), is for the lessor to recover accrued unpaid rentals, together with interest, in the event of a default by the lessee in the performance of its duties under the leasing agreement.

135. - In the event of a "substantial" default by the lessee, on the other hand, the lessor may also, according to Article 11 (2), terminate the leasing agreement. However, by virtue of Article 11 (5), this right to terminate is only exercisable following the giving of notice by the lessor to the lessee to remedy its default to the extent that the same may be remedied. Article 11 (5) provides that the lessee must be given a "reasonable" opportunity of remedying its default. This restriction on the lessor's right to terminate the leasing agreement is clearly designed to meet just that concern alluded to in paragraph 133 above, namely that the lessee's mere failure, for instance, to pay one of its rentals right on

time should not automatically bring down on it the full force of the sanctions laid down in the leasing agreement. Article 11 (5) recognises that there will, of course, be some cases where the lessee will be unable to remedy its default, in particular following its bankruptcy, and in such cases it may reasonably be inferred from the language of Article 11 (5) that the serving of notice on the lessee and the subsequent need to await a further reasonable period of time may be dispensed with. We have had occasion elsewhere to comment on the word "reasonable" as employed in the draft Convention.⁽³⁶⁾ It suffices to recall here that it was considered inappropriate to set specific time-limits in an instrument designed to be of international application.

136. - Once the lessor has terminated the leasing agreement, but not before, it also becomes entitled, under Article 11 (2)(a), to recover possession of the equipment and, under Article 11 (2)(b), to recover such compensation as may be necessary to place it in the position in which it would have been had the lessee duly performed its part of the leasing agreement and not defaulted. The fact that the lessor's right to repossess is made contingent on its first having terminated the leasing agreement again reflects the concern adverted to above,⁽³⁷⁾ namely that repossession should not be used by the lessor as a means of exerting pressure on the lessee to pay its rentals⁽³⁸⁾ but should only be possible where the lessor has already terminated the leasing agreement. The right to repossess can be quite important for the lessor where the lessee is unwilling to part with possession and given the reluctance of Common law jurisdictions to entertain applications for specific performance. Where a lessee is in default, repossession may often represent for the lessor, notwithstanding the fact that it is not a merchant and does not ordinarily deal in such equipment, its best guarantee of salvaging some of its investment, as the straitened circumstances that will probably have determined the lessee's default are just as likely to affect its ability to meet a claim in damages.

137. - The other remedy granted the lessor following its termination of the leasing agreement, to wit the recovery of such compensation as may be necessary to place it in the position in which it would have been had the lessee duly performed its duties under the leasing agreement, illustrates

(36) Cf. §126 above.

(37) *idem*.

(38) However, while such a concern might in some cases be justified in the context of a domestic leasing transaction, it would seem to be somewhat less likely in that of an international leasing transaction. Quaere whether a French lessor would go to the lengths of seeking to repossess equipment leased in Ecuador for a fortnight to exert such pressure.

the basic attitude of the authors of the draft Convention regarding what should be considered as a reasonable computation of the lessor's measure of loss in such circumstances. The lessor's role in the transaction, as we have seen, is at all times a narrowly financial role. It is accordingly a very serious upset for the lessor's financial calculations when, upon the lessee's default, that is through no fault of its own, it finds itself from one minute to the next obliged to repossess at an unforeseen moment during the term of the leasing agreement. This upset will, moreover, be compounded by various other factors, responsibility for which cannot reasonably be attributed to the lessor. For instance, the equipment will frequently have been constructed specially to the lessee's specifications, rendering the lessor's task of finding someone willing to take it off its hands all the more difficult, particularly at a price that will bear some relation to its calculations when it embarked on the transaction. Moreover, once there has been a breach of the leasing agreement by the lessee constituting "substantial default" and thus entitling the lessor to repossess the leased asset, the lessee, in the absence of an additional agreement providing for the lessee's safekeeping of the asset pending its collection by the lessor, would no longer be liable for any damage sustained by the equipment after such time. The aim of the authors of the draft Convention was to ensure that the net effect of the compensation to be paid under Article 11 (2)(b) would be to place the lessor in the position in which it would have been had it received the total number of rentals stipulated under the leasing agreement. They refrained from attempting to spell this out in greater detail, although their basic idea was that the lessor should be able to recover an amount equivalent to the discounted value of the lost future rentals, after giving credit against that sum for the sum it would have received from disposing of the repossessed asset in a commercially reasonable manner. Finally in connection with Article 11 (2)(b) it should be noted that the authors of the draft Convention considered it worthwhile to spell out that the compensation recoverable by the lessor under this clause is subject to its duty to take all reasonable steps to mitigate its loss.

138. - The law governing minimum payment clauses is in many countries considered a matter of public policy and in recent years legislation has been passed, both at the national and the supranational level, giving the courts a wide measure of discretion in revising the sums fixed by the parties in their agreement. Article 11 (3) is to be understood in this light. It in no way seeks to oust the manifest right of the courts to review the bargain struck between lessor and lessee: it merely states that, in recognition of the current practice of lessors in attempting to articulate their measure of damage in the form of such a liquidated damages clause, the court should, in the event of a dispute arising, have regard, in the first place at least, to the provisions agreed between the parties

on the manner in which the compensation to be paid by the lessee upon default under Article 11 (2)(b) is to be computed, subject always to its finding that in the circumstances the compensation provided for is disproportionate. Clearly the factors involved in the court making such an evaluation will be complex. For instance, the economic conditions may well have changed by the time that the lessor comes to repossess its asset following the lessee's default so that the lessee's rental obligations as stipulated under the leasing agreement may be either higher or lower than the current market price for a similar period of time. The difficulties involved in proving the fairness of a given liquidated damages clause in the light of such imponderables were considered to strengthen the case for recognising the parties' right to negotiate a remedy in anticipation of default. The fact that Article 11 (3) provides that the parties' agreement on this matter is to be enforceable between them "unless such compensation is disproportionate" was designed to remind the parties, in particular a lessor in a powerful bargaining position, not to overreach in their negotiation of such a remedy. Given the difficulties alluded to above regarding the computation of fair compensation in the wake of default rather than in anticipation of the same, the court in finding as to the disproportionateness or otherwise of the individual liquidated damages clause stipulated by the parties was intended by the authors of the draft Convention to have regard to the situation obtaining at the time when the leasing agreement was entered into, rather than the situation as it had developed by the time of default.

139. - The effect of Article 11 (4) is to alter the range of remedies exercisable by a lessor upon the lessee's default in those cases where the leasing agreement includes, as it often will, an acceleration clause entitling the lessor upon the lessee's default to require immediate payment by the lessee of all the outstanding rentals due under that agreement. In recognition of the injustice that would be wrought by allowing the lessor both to benefit from such an acceleration clause and to terminate the leasing agreement - thus opening the way for it also to repossess the equipment, which it could then sell or re-lease - Article 11 (4) requires the lessor in such a case to elect between the exercise of one or the other of these remedies. Thus where the lessor elects to terminate the leasing agreement, it is thereby debarred from seeking to enforce such an acceleration clause. Moreover, it was the opinion of the authors of the draft Convention that, since the fact of suing for rentals presupposes that there is a current leasing agreement on foot, the fact that the leasing agreement has been terminated means that there is no longer any justification for the lessor to be able to sue for such rentals. Finally it should be noted that the same protection as that given the lessee in respect of the lessor's termination of the leasing agreement referred to earlier⁽³⁹⁾ is also given to the lessee under Article 11 (5) in respect of the lessor's

(39) Cf. §135 above.

enforcement of an acceleration clause. Accordingly, the lessor can only enforce such a clause after it has given the lessee notice of its duty to remedy its default and allowed it a further reasonable time in which to do so. As with the provision relating to the lessor's termination of the leasing agreement, the lessor's duty to give the lessee notice of its duty to remedy its default and to allow it a further reasonable period of time in which to do so is made contingent on it being possible for the lessee in the circumstances to cure its default,⁽⁴⁰⁾ the inference being that the lessor is otherwise dispensed of the need to give the lessee such notice and allow it such an additional period of time.

Article 12

140. - This article deals, in its first paragraph, with the question of the lessor's assignment of all or part of its real rights in the equipment or all or part of its contractual rights under the leasing agreement and, in its second paragraph, with that of the lessee's right to assign its right to use the equipment or any other rights it may possess under the leasing agreement. As such it seeks to facilitate matters for those jurisdictions that place legal restrictions on the transfer of rights.

141. - The question of the lessor's assignment of all or part of its rights is particularly critical in those jurisdictions where a particular species of financial lease, the leveraged lease, is common. In leveraged leases, whereas legal title to the equipment and hence entitlement to the tax indemnification benefits associated with ownership, vest in the lessor, the latter will, by reason of the huge amounts of money involved, put up only a part of the capital cost represented by the purchase of the equipment. For the remainder it will have recourse to one or more lenders who will assure their position by requiring an assignment to themselves of the stream of rentals provided for under the leasing agreement. It was feared lest, without a provision on the lines of Article 12 (1), there was a risk that such transactions might, by virtue of involving more than the three parties specified in Article 1 (1), fall outside the scope of the draft Convention, whereas for those countries for which leveraged leasing was important it was vital that such transactions should come under the draft Convention, all the more so given the high incidence of leveraged leasing transactions among those countries' international financial leasing operations.

142. - Such transfers by the lessor of its rights in the equipment or under the leasing agreement are accordingly permitted under Article 12 (1).

(40) idem.

The words "or otherwise deal with", coming after the word "transfer" in the first sentence of this provision, were added because of what was feared to be the inadequacy of the term "transfer" to cover the case of the Civil law "hypothec". Such a transfer by the lessor can clearly only affect its rights, and not also its duties under the leasing agreement, as is specified in the second sentence of this provision. This clause was also by extension intended to indicate that neither can such a transfer affect the lessee's rights under the leasing agreement.

143. - The lessor's transfer of its rights under Article 12 (1) is not, however, to be used as a means of circumventing the application of the future Convention: the second sentence of Article 12 (1) thus goes on to provide that such a transfer may alter neither the nature of the leasing agreement nor its legal treatment as provided in the draft Convention. Thus where, prior to the assignment, the draft Convention was already applicable, say, by virtue of the lessor and the lessee having their places of business in different States and both these States and the State where the supplier's place of business was located being Contracting States (Article 2 (1)(a)), the draft Convention would not cease to be applicable merely because, subsequently to the assignment, both the lessor and the lessee found their places of business to be in the same State. This result reflected the considered opinion of the authors of the draft Convention that it was not possible to legislate for fraud at the international level. Likewise, a financial lease not subject to the draft Convention as originally concluded, that is a wholly domestic transaction, could not, merely by virtue of the lessor's transfer of its rights under Article 13 to a party having its place of business in another State be transformed into an international transaction subject to the draft Convention. It should be noted that in those States, like France and Senegal, which require lessors to have the status of either a bank or a financial institution, the transferee from a lessor would have to have the same status as the transferor.

144. - The fundamental idea behind Article 12 all along having been to bring leveraged leases explicitly within the scope of the draft Convention, the authors of the draft Convention never considered the question of the lessor's assignment of its duties under the leasing agreement. The fact that this question was not as a result addressed in the draft Convention should, however, in no way be seen as prohibiting such assignments: rather it is yet another example of a matter left to be settled by the parties in their agreement and the applicable law.

145. - Article 12 (2) balances the right of assignment given to the lessor under Article 12 (1) by recognition of the lessee's right to assign its right to use the equipment or any other rights it may possess under the

leasing agreement. Enshrinement in the draft Convention of this right of assignment for lessees is particularly important for those countries with planified economies. Circumstances might change during the currency of the leasing agreement as a result of which the original lessee might drop out of the picture. However, the person of the lessee is obviously a matter of primordial concern to the lessor and this is why Article 12 (2) makes the lessee's right of assignment subject to the lessor's consent. The lessee's right of assignment is furthermore specified to be subject to the rights of third parties.

Article 13

146. - It had all along been the intention of the authors of the draft Convention that its application should extend to those sub-leasing arrangements so common in international financial leasing transactions. Evidence of this intention was to be found, for example, in the employment of the term "real rights" rather than "title" in Article 5 (1) and (2). At its final session the committee of governmental experts nevertheless judged it opportune to include a provision in the future Convention expressly extending its application to sub-leases. An alternative formula, involving an amendment to the sphere of application provisions of the draft Convention, was rejected as making those provisions over cumbersome, although it was recognised that the rightful place of this provision might well finally be in the sphere of application provisions of the future Convention.

147. - The effect of paragraph 1 is that, in the case of a financial sub-leasing transaction, the sub-lessor is to be treated as the lessor for the purposes of the draft Convention, the sub-lessee as the relevant lessee and the supplier from whom the lessor acquired the equipment as the relevant supplier. Article 13 (2) deals with the situation where there is a series of transactions involving the same equipment including more than one financial leasing transaction. It provides that in respect of such a series of transactions the last financial lessor is to be treated as the relevant lessor and the party who supplied the first financial lessor as the relevant supplier.

Article 14

148. - This article is a provision found in most international commercial law Conventions. It reflects the idea that Conventions in the commercial law field should not as a rule deprive the parties of their freedom to choose alternative rules to govern their transaction. While no

decision was taken on which provisions, if any, of the future Convention should be mandatory, the committee of governmental experts made a preliminary examination of the issues involved. Some representatives felt that, given the commercial nature of all the parties to the transaction and the need to allow for further evolution of the leasing technique, the entire text should be amenable to exclusion. Others felt that the application of certain provisions at least needed to be guaranteed. It was the unanimous feeling of the committee, on the other hand, that the parties should not be free to contract out of the sphere of application provisions of the future Convention, even though it was not felt that this needed to be stated explicitly in Article 14. The authors of the draft Convention were at all times conscious of the risks inherent in the effect of these provisions being able to be changed at will, in particular in view of the delicate balance between the interests of the parties to the transaction established throughout the draft Convention as a whole.

149. - The committee of governmental experts accordingly drew up two rules, one (Article 14 (1)) permitting the total exclusion of the future Convention and the other (Article 14 (2)) guaranteeing the application of certain of its provisions. That allowing for total exclusion was placed in square brackets to indicate that this was a matter which the committee of governmental experts judged involved a policy decision, which was better left to be taken at the diplomatic Conference. In Article 14 (2) the committee, on the other hand, made an attempt to identify those provisions which it felt should be made mandatory. The effect of this provision would be, subject to some uncertainty as to the precise status of Article 7 (2) in this regard, to leave the parties free, *in their relations with each other*, to derogate from or vary all provisions of the future Convention save Article 11 (3) and (4), that is the provision dealing with the enforceability of minimum payment clauses, a question considered to be a matter of public policy in certain jurisdictions, and that precluding the lessor from both terminating the leasing agreement and enforcing an acceleration clause. There was also, as we have had occasion to note elsewhere,⁽⁴¹⁾ a certain body of feeling within the committee of governmental experts that the lessor's warranty of quiet possession was of the essence of a finance lease and that Article 7 (2) should accordingly also be made mandatory. This point of view did not, however, command more than minority support, the point being made that it was invariably the practice in financial leasing transactions for the lessor's warranty of quiet possession to be excluded. It was eventually judged wise to leave the decision on this question to be taken at the diplomatic Conference, a reference to Article 7 (2) accordingly being inserted in Article 14 (2) in square brackets. Finally a propos of Article 14 (2) it should be noted that

(41) Cf. §106 above.

it only proposes to give the parties the right to contract out of those provisions which concern their relations with one another and that as a result the provisions of Articles 5, 6, 14 and 15 are also clearly not intended to be subject to the parties' agreement.

Article 15

150. - This is another provision which has now become a common feature of international Conventions in the commercial law field. It is addressed principally to those called upon to decide cases involving the interpretation of the future Convention, that is judges and arbitrators. If the objectives of the authors of the draft Convention in seeking to establish an international uniform legal infrastructure for financial leasing transactions are not to be thwarted by those called upon to interpret its provisions, it is clearly essential, as proclaimed in Article 15 (1), that they have regard to the international character of the draft Convention and to the need to promote uniformity in its application, in other words that they avoid the first opportunity to interpret it in the light of the principles and traditions of their own legal system. The provisions of Article 15 (1) furthermore exhort those called upon to interpret the future Convention to have regard to the need to ensure the observance of good faith in international trade. "International trade" in the sense which the authors of the draft Convention wished to give it in this provision is to be read as including international investment.

151. - The other factor to which those called upon to interpret the future Convention are exhorted to have regard under the terms of Article 15 (1) is its object and purpose as set forth in the Preamble. This reference to the Preamble in the provisions on interpretation clearly underscores the draft Convention's commitment to maintaining a fair balance of interests between the different parties to international financial leasing transactions.

152. - Article 15 (2) seeks to ensure that the special distinct status conferred on the particular type of leasing transaction addressed by the draft Convention will not be jeopardised as regards all those many issues which have not, both consciously and unconsciously, been specifically dealt with in the draft Convention. It would again be undesirable if the objectives of the authors of the draft Convention were to be thwarted by judges and arbitrators filling in these gaps on the basis of the solutions of their domestic law, all the more so given that it was precisely the inadequacy and inappropriateness of these solutions which provided the starting point for Unidroit's initiative on this subject. Article 15 (2)

accordingly provides that matters not expressly settled in the draft Convention but which are nevertheless governed by the same are to be settled in conformity with the general principles on which it is based and the law applicable by virtue of the rules of private international law. It will be noted that, unlike the Vienna Sale Convention (Article 7) and the Geneva Agency Convention (Article 6), which provide that the applicable law is only to be referred to for the settlement of a given matter where it proves impossible in respect of that matter to glean any general principles on which the Convention in question is based, in the case of the draft Convention such general principles and the applicable law are put on an equal footing. The basic reason underlying this departure was, on the one hand, what was feared might prove to be the difficulty of gleaning general principles from the draft Convention and, on the other, the important role that rules of conflict play in determining the sphere of application of the draft Convention.

APPENDIX

LIST OF THE REPRESENTATIVES OF GOVERNMENTS, INTERNATIONAL ORGANISATIONS AND PROFESSIONAL ASSOCIATIONS WHO ATTENDED ONE OR MORE⁽¹⁾ OF THE SESSIONS⁽²⁾ OF THE UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

UNIDROIT MEMBER STATES

ARGENTINA

Mr Juan Carlos PALMERO,
Secretary of State for Religious Affairs,
Ministry of Foreign and Religious Affairs,
Palacio San Martin,
Arenales esq. Esmeralda,
1061 Buenos Aires (3)

AUSTRALIA

Ms Alison PERT,
Acting Principal Legal Officer,
International Trade Law and Intellectual
Property Branch,
Attorney-General's Department,
Robert Garran Offices,
National Circuit,
Barton, Canberra, A.C.T. 2600 (3)

Ms Alexandra WEDUTENKO,
Principal Legal Officer,
International Trade Law and
Intellectual Property Branch,
Attorney-General's Department,
Robert Garran Offices,
National Circuit,
Barton, Canberra, A.C.T. 2600 (1)(2)

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- (1) The appearance of the number (1) after the name and address of a person indicates that that person attended the first session of the committee; (2) that he or she attended the second session; (3) that he or she attended the third session.
- (2) The committee held three sessions, all at the seat of Unidroit in Rome. The first ran from 15 to 19 April 1985, the second from 14 to 18 April 1986 and the third from 27 to 30 April 1987.

AUSTRIA

Mr Martin ADENSAMER,
Public Prosecutor,
Federal Ministry of Justice,
Neustiftgasse 2,
A - 1070 Wien (1)(2)(3)

BELGIUM

Ms Catherine DEBOYSER,
Secrétaire d'administration,
Ministry of Justice,
Place Poelaert 3,
B - 1000 Bruxelles (2)(3)

BULGARIA

Mr Simeon DJELEPOV,
Professor of Law,
Institut V.M.E.I. Lenin,
Postad Vassilevski 1,
Sofia (2)

Mr Miltcho KRESTEV,
Head of Section,
Supreme Court of Bulgaria,
Ul. Vitocha 2,
Sofia 1000 (3)

Mr Vladimir PENKOV,
Legal Adviser,
Ministry of Trade,
Ul. Sofiiska Komuna 12,
Sofia (3)

Mr Dimitar TADARAKOV,
Director,
Bulgarleasing,
Slavjanska 8,
Sofia 1000 (2)(3)

CANADA

Mr Ronald C. C. CUMING,
Professor of Law,
College of Law,
University of Saskatchewan,
Saskatoon,
Saskatchewan, Canada S7N 0W0 (1)(2)(3)

CHILE

Mr Antonio GARRIDO ACUNA,
Second Secretary,
Embassy of Chile in Italy,
Via Nazionale 54,
00184 Roma (2)

Mr Hernán RIOS DE MARIMON,
Ambassador of Chile in the Netherlands,
Mauritskade 51,
2514 HG Den Haag (3)

PEOPLE'S REPUBLIC
OF CHINA (3)

Mr Liu CHU,
Deputy Director,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (2)

Mr Yubin HUANG,
Legal Adviser,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (1)(3)

Mr Liao JINCHENG,
Division Chief,
Department of Treaties and Law,
Ministry of Foreign Affairs,
Beijing (2)

Ms Li XIAOLIN,
Legal Adviser,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (2)

-
- (3) The delegation of the People's Republic of China to the first session of the committee attended that session as observers, the People's Republic of China not then being a Unidroit member State.

Mr Xiouru XIE,
Legal Officer,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (3)

Mr Zhuang YAO,
Associate Professor,
Foreign Affairs College;
Legal Adviser,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (1)

Ms Yuejiao ZHANG,
Division Chief,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (3)

Mr Yuqing ZHANG,
Legal Adviser,
Department of Treaties and Law,
Ministry of Foreign Economic Relations and Trade,
2 Dong Chang An Jie,
Beijing (1)

COLOMBIA

Mr Manuel LEAL ANGARITA,
Attorney,
Carrera 9 N° 70A - 35, Piso 3,
Apartado Aereo 075792,
Bogotá (3)

Mr Ricardo MARTINEZ MUNOZ,
Chargé d'Affaires *ad interim*,
Embassy of Colombia in Italy,
Via Giuseppe Pisanelli 4,
00196 Roma (3)

DENMARK

Mr. Jeppe SKADHAUGE,
Legal Counsellor,
Permanent Representation of
Denmark to the European Communities,
73 rue d'Arlon,
B - 1040 Bruxelles (2)

EGYPT

Mr Mohamed Zaki Aly RIZK,
Deputy Minister of Justice,
Ministry of Justice,
Laz-Ougly,
Cairo (1)(2)

FINLAND

Ms Pauline KOSKELO,
Legal Adviser,
Ministry of Justice,
Eteläesplanadi 10,
00130 Helsinki (2)(3)

FRANCE

Mr Jean-Paul BERAUDO,
Head of the Office for International
Legal Affairs,
Ministry of Justice,
13 place Vendôme,
75001 Paris (1)(2)(3)

Mr Christian GAVALDA,
Professor of Commercial and Banking Law,
University of Paris I (Panthéon-Sorbonne),
12 place du Panthéon,
75005 Paris (3)

FEDERAL REPUBLIC
OF GERMANY

Mr Eberhard REBMANN,
Legal Adviser,
Federal Ministry of Justice,
Heinemannstr. 6,
D - 5300 Bonn (1)(2)(3)

GREECE

Mr Panayotis MACRIS,
First Secretary,
Embassy of Greece in Italy,
Via Mercadante 36,
00198 Roma (1)

Mr Ioannis VOULGARIS,
Professor of Private International Law
and Vice-Rector,
Democritos University of Thrace,
Dimocritou 17,
691 00 Komotini (3)

HOLY SEE

Mr Pio CIPROTTI,
President of the Court of the Vatican City,
Via Antonio Cesari 8, vill. A, Int. 3,
00152 Roma (1)(2)(3)

HUNGARY

Mr László RECZEI,
Ambassador (retired);
Professor of Law, University of Budapest;
Honorary member of the Unidroit Governing
Council; Chairman of the Committee,
Szerb u. 17,
H - 1056 Budapest (1)(2)(3)

INDIA

Mr Dinkar KHULLAR,
First Secretary (Commercial),
Embassy of India in Italy,
Via Venti Settembre 5,
00187 Roma (3)

Mr Narayanan RADHAKRISHNAN,
First Secretary,
Embassy of India in Italy,
Via Venti Settembre 5,
00187 Roma (2)

Mr K.L. SARMA,
Legal Officer,
Legal and Treaties Division,
Ministry of External Affairs,
Patiala House (Annex B),
Tilak Marg,
New Delhi 110001 (1)

IRAN

Mr Keyvan RAHNAMA,
Second Secretary,
Embassy of the Islamic Republic of Iran in Italy,
Via della Camilluccia 651/657,
00162 Roma (1)

IRELAND

Mr John F. GORMLEY,
Legal Assistant,
Office of the Attorney-General,
Government Buildings,
Merrion St.,
Dublin 2 (3)

ITALY

Mr Guido FERRARINI,
Associate Professor of Banking Law,
University of Genoa,
Via G. d'Annunzio 2/57,
16121 Genova (2)(3)

Mr Antonio GAMBARO,
Professor of Law,
University of Milan,
Via Festa del Perdono 7,
20100 Milano (1)

Mr Giuseppe RANUCCI,
Judge of the Court of Accounts;
Seconded to the Legislation Office of the
Ministry of Industry and Commerce,
Via Molise 2,
00187 Roma (2)

Mr Mario SALVEZZA,
Head of the Legislation Office,
Ministry of Justice,
Via Arenula,
00186 Roma (2)

JAPAN

Mr Norihiko ISHIGURO,
Deputy Director,
Service Industries Office,
Industrial Policy Bureau,
Ministry of International Trade and Industry,
1-3-1 Kasumigaseki,
Chiyoda-ku,
Tokyo (3)

Mr Masahiko YANE,
Chief of Section,
Service Industries Office,
Industrial Policy Bureau,
Ministry of International Trade and Industry,
1-3-1 Kasumigaseki,
Chiyoda-ku,
Tokyo (3)

KOREA

Mr Dai-Hee AHN,
Public Prosecutor,
Office of Legal Affairs,
Ministry of Justice,
Joongang-dong 1,
Kyungkido Kwachum,
Seoul (2)(3)

Mr Eui-Min CHUNG,
First Secretary,
Embassy of Korea in Italy,
Via Barnaba Oriani 30,
00197 Roma (1)

Mr Jin-Soo KIM,
Deputy Director,
Treaties Division,
Ministry of Foreign Affairs,
Jongrokoo Taipyungko,
Seoul (2)

Mr Ki-Chul LEE,
Deputy Director,
Treaties Division,
Ministry of Foreign Affairs,
Jongrokoo Taipyungko,
Seoul (3)

LUXEMBOURG

Mr Jean Mathias GODART,
Attaché de Gouvernement,
Ministry of Justice,
16 boulevard Royal - B.P. 9,
L - 2910 Luxembourg (2)(3)

MEXICO

Ms Maria MARIN-BOSCH,
Second Secretary,
Embassy of Mexico in Italy,
Via Lazzaro Spallanzani 16,
00161 Roma (3)

NETHERLANDS

Ms Maryke REINSMA,
Legal Adviser,
Ministry of Justice,
P.O. Box 20301,
2500 EH - s'Gravenhage (1)(2)

NIGERIA

Mr Ore A. AKERELE,
Third Secretary,
Embassy of Nigeria in Italy,
Via Orazio 14 - 18,
00193 Roma (3)

Mr Ayodeji AYODELE,
Second Secretary,
Embassy of Nigeria in Italy,
Via Orazio 14 - 18,
00193 Roma (2)

Mr Kehinde Basola OLUKOLU,
Assistant Director,
Federal Ministry of Justice,
New Secretariat,
P.M.B. 12517,
Ikoyi,
Lagos (1)

NORWAY

Mr Bernt NYHAGEN,
Legislative Counsellor,
Department of Justice,
Ministry of Justice and Police,
P.O. Box 8005 Dep.,
Oslo 1 (1)

POLAND

Mr Gabriel WUJEK,
Deputy Director,
Legal Department,
Ministry of Foreign Trade,
ul. Wiejska 10,
00-950 Warszawa (3)

PORTUGAL

Mr Rui PINTO DUARTE,
Attorney;
Lecturer in Law at the
University of Lisbon,
Rua Duque de Palmela, 27-5º Esq.,
1200 Lisboa (2)(3)

ROMANIA

Mr Ion ANGHEL,
Minister Counsellor,
Embassy of Romania in Italy,
Via Nicolò Tartaglia 36,
00197 Roma (1)

SAN MARINO

Mr Corrado PECORELLA,
Professor of Law,
University of Rome - II,
Via Molvena 106,
00135 Roma (1)(2)

SOUTH AFRICA

Mr Piet J. BADENHORST,
Acting Registrar,
Financial Institutions,
Department of Finance,
Private Bag X 238,
Pretoria 0001 (3)

Mr Nereus L. JOUBERT,
Associate Professor of Law,
Rand Afrikaans University,
P. O. Box 527,
Johannesburg 2194 (3)

SPAIN

Mr Pablo RUIZ-JARABO,
Legal Adviser (International Affairs),
Ministry of Foreign Affairs,
Plaza de la Provincia 1,
Madrid (3)

Mr Juan GUITARD MARIN,
State Attorney,
Directorate-General for
State Legal Services,
Paseo del Prado 6,
Madrid (3)

SWEDEN

Mr Anders ERIKSSON,
Assistant Under-Secretary,
Ministry of Justice,
S - 103 33 Stockholm (3)

Mr Göran HÅKANSSON,
Legal Adviser,
Ministry of Justice,
S - 103 33 Stockholm (1)(2)

SWITZERLAND

Mr Heinz REY,
Head of the Land Registry,
Federal Office of Justice,
Federal Department of Justice and Police,
Bundesgasse 32,
CH - 3003 Berne (1)

Mr Giacomo RONCORONI,
Head of the "Droit des obligations" Section,
Federal Office of Justice,
Federal Department of Justice and Police,
Bundesgasse 32,
CH - 3003 Berne (2)(3)

TURKEY

Mr Tanju SUMER,
Counsellor,
Embassy of Turkey in Italy,
Via Palestro 28,
00185 Roma (3)

UNITED KINGDOM

Mr Royston M. GOODE,
Crowther Professor of Credit and Commercial Law
and Director of the Centre for Commercial Law
Studies, Queen Mary College,
University of London;
Deputy Chairman of the Committee and
Chairman of the Drafting Committee,
339 Mile End Road,
London E1 4NS (1)(2)(3)

Mr Christopher S. KERSE,
Assistant Solicitor,
Department of Trade and Industry,
10 - 18 Victoria St.,
London SW1H 0NN (2)(3)

UNITED STATES OF AMERICA

Mr Peter F. COOGAN,
Member of the Massachusetts bar;
Member of the Permanent Editorial Board for the
Uniform Commercial Code;
of Counsel, Messrs Murphy, Weir and Butler,
101 California St., 39th floor, P.O. Box 26822,
San Francisco, California 94126 - 6822 (1)⁽⁴⁾

Mr Charles W. MOONEY, Jr.,
Associate Professor of Law,
University of Pennsylvania Law School,
3400 Chestnut St.,
Philadelphia, Pennsylvania 19104 (2)(3)

Mr Peter H. PFUND,
Assistant Legal Adviser for
Private International Law,
Department of State
(L/PIL, Room 5420),
Washington, D.C. 20520 (2)

Mr Detlev F. VAGTS,
Professor of Law,
Harvard University,
Cambridge, Massachusetts 02138 (2)

VENEZUELA

Ms Maria Lourdes VERA MUJICA,
Counsellor,
Embassy of Venezuela in Italy,
Viale Bruno Buozzi 109,
00197 Roma (3)

OBSERVERS

NON-MEMBER STATES

ALGERIA

Mr Ali BENCHENEB,
Professor of Law,
Faculty of Law,
University of Algiers,
83 rue Didouche Mourad,
Alger (3)

(4) Subsequently deceased.

Mr Abdelmadjid BOUKEBOUS,
Directeur des Etudes Juridiques,
du Contentieux et de la Documentation,
Ministry of Finance,
Immeuble Mauretania,
Alger (3)

BRAZIL

Mr Ruy de Lima CASAES e SILVA,
Counsellor (Economic Affairs),
Embassy of Brazil in Italy,
Piazza Navona 14,
00186 Roma (2)(3)

Mr Thomas Benes FELSBURG,
Attorney,
Avenida Paulista 1776-14° andar,
01310 São Paulo (3)

PERU

Mr José Luis GARAYCOCHEA BUSTAMANTE,
Minister Counsellor,
Embassy of Peru in Italy,
Via Po 22, Int. 7,
00198 Roma (2)

Ms Maria Roxana GARMENDIA PELAEZ,
Attorney,
Via Lucania 13, Int. 12,
00187 Roma (3)

PHILIPPINES

Mr Gonzalo SANTOS, Jr.,
Professor of Law in the
University of the Philippines;
Commissioner,
Securities and Exchange Commission,
EDSA,
near Ortigas Avenue,
Mandaluyong,
Metro Manila (3)

SENEGAL

Mr Amadou Moustapha DIOP,
Senior Counsellor,
Embassy of Senegal in Italy,
Via Bartolomeo Eustachio 12,
00161 Roma (1)

Mr Cheikh Tidiane DIEYE,
Counsellor (Cultural Affairs),
Embassy of Senegal in Italy,
Via Lisbona 3,
00198 Roma (2)

INTERGOVERNMENTAL ORGANISATIONS

*BANK FOR INTERNATIONAL
SETTLEMENTS*

Mr Mario GIOVANOLI,
Legal Adviser,
P.O. Box 2258,
CH - 4002 Basel (1)(2)

*COMMISSION OF THE
EUROPEAN COMMUNITIES*

Ms Mireille DUSSEAU,
Principal Administrator,
Directorate-General XV/A/1
(Financial Institutions and Company Law),
8 square de Meüs,
B - 1030 Bruxelles (1)(2)(3)

*COMMONWEALTH
SECRETARIAT*

Mr Stewart W. HALSTEAD,
Barrister-at-Law,
Messrs Ryan & Halstead,
15 Lincolns Inn Fields,
London WC2A 3ED (2)

*EUROPEAN INVESTMENT
BANK*

Mr Luigi LA MARCA,
Attorney,
Member of Legal Directorate,
100 boulevard Konrad Adenauer,
Luxembourg - Kirchberg,
L - 2950 Luxembourg (1)

*HAGUE CONFERENCE ON
PRIVATE INTERNATIONAL
LAW*

Mr Michel L. PELICHET,
Deputy Secretary-General,
Javastraat 2^c,
2585 AM Den Haag (1)(2)(3)

WORLD BANK

Mr Jürgen VOSS,
Counsel,
1818 H Street, N.W.,
Washington, D.C. 20433 (3)

INTERNATIONAL NON-GOVERNMENTAL ORGANISATIONS

*BANKING FEDERATION OF
THE EUROPEAN COMMUNITY*

Mr Sergio BIANCONI,
Head of Legal Division,
Italian Banking Association,
Piazza del Gesù 49,
00186 Roma (2)(3)

*INTERNATIONAL CHAMBER
OF COMMERCE*

Mr Mario QUINTO,
In-house lawyer,
SAFIM - Finanziaria Industria
Manufatturiera S.p.A.,
Via Nazionale 60,
00184 Roma (3)

INTERNATIONAL PROFESSIONAL ASSOCIATIONS

*EUROPEAN FEDERATION OF
EQUIPMENT LEASING
COMPANY ASSOCIATIONS
(LEASEUROPE)*

Mr Fritz PETER,
Honorary Chairman;
Chairman of the Board of Directors,
Industrie-Leasing AG,
Albisriederplatz/Badenerstrasse 329,
CH - 8040 Zürich (1)(2)(3)

Mr El-Mokhtar BEY,
Chairman of the Legal Committee;
Directeur Juridique et du
Contentieux du Groupe Locafrance,
80 avenue de la Grande Armée,
75017 Paris (1)(2)(3)

*FEDERATION OF LATIN
AMERICAN LEASING
COMPANIES (FELALEASE)*

Mr Thomas Benes FELSBERG,
Legal Adviser,
Avenida Paulista 1776-14º andar,
01310 São Paulo (2)(3)

*WORLD LEASING
COUNCIL*

Mr Fritz PETER,
Member;
Chairman of the Board of Directors,
Industrie-Leasing AG,
Albisriederplatz/Badenerstrasse 329,
CH - 8040 Zürich (3)

NATIONAL PROFESSIONAL ASSOCIATIONS

AMERICAN ASSOCIATION
OF EQUIPMENT LESSORS
(AAEL)

Mr Lawrence M. TAYLOR, Jr.,
Vice-President International,
BancNewEngland Leasing Group,
28 State Street, P.O. Box 2332,
Boston, Massachusetts 02107 (3)

ITALIAN LEASING
ASSOCIATION (ASSILEA)

Mr Renato CLARIZIA,
Secretary-General,
Via D'Ara Coeli 3,
00186 Roma (2)(3)

JAPAN LEASING
ASSOCIATION

Mr Yasuo HOSHINA,
General Manager,
Research Department,
Mitsui Leasing & Development Ltd.,
Hibiya Central Bldg.,
2-9, Nishi-Shinbashi 1 - chome,
Minato-ku,
Tokyo 105 (2)

Mr Yuji MORIZUMI,
General Manager,
Business Planning Dept.,
Japan Leasing Association,
Landic Hirakawa-cho Bldg.,
2-6-2 Hirakawa-cho,
Chiyoda-ku,
Tokyo 102 (2)(3)

Mr Osamu NAGANO,
Associate Director and General Manager,
International Department,
Japan Leasing Corporation,
Shinyurakucho Bldg., 4th fl.,
12-1, Yurakucho 1-chome,
Chiyoda-ku,
Tokyo (3)

Mr Hiroshi NAKAMURA,
Assistant Manager,
Credit Department,
Orient Leasing Co., Ltd.,
World Trade Center Bldg. 33F.,
2-4-1, Hamamatsu-cho,
Minato-ku,
Tokyo (2)(3)

Mr Kiichi NISHIZAWA,
Director,
Japan Leasing (U.K.) Ltd.,
107 Cheapside,
London EC2V 6DT (2)

Mr Masaya SUGIMOTO,
Managing Director,
Japan Leasing Corporation,
Shinyurakucho Building 4th fl.,
12-1, Yurakucho 1-chome,
Chiyoda-ku,
Tokyo (2)

*MEXICAN ASSOCIATION
OF FINANCIAL LESSORS*

Mr Mario LUCATERO ALVAREZ,
Attorney,
J. Vasconcelos 208-5° piso,
Mexico, D.F. 06140 (3)

*ITALIAN ASSOCIATION OF
SMALL AND MEDIUM-SIZED
LEASING COMPANIES
(ASS.NA)*

Mr Aldo FRIGNANI,
Legal Adviser,
Via Amedeo Avogadro 26,
10121 Torino (3)