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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

Letter received by the Unidroit Secretariat from Mr Stephen McGairl, Partner, Freshfields, Paris on the text of the preliminary draft uniform rules on international financial leasing as this emerged from the second session of governmental experts

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Vos références

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Dear Mr Stanford,

I am replying to your letter of 20 February 1987 which was received here on 23 March.

I am afraid that having read the draft Convention I am not very hopeful of it finding great acceptability among lessors. It is noticeable that, while the delegates who took part in the last session appear to be a distinguished group of academics and civil servants, there is very little representation of practitioners in the leasing industry.

I am not entirely sure to what extent it is intended that the Convention would replace the detailed contractual agreements which are normally to be found between suppliers, lessors and lessees. In some places the Convention seems to be aiming at overriding domestic laws which would otherwise frustrate the intention of lessors (for example Article 5). In other cases the Convention appears to be setting out some contractual provisions between the parties to the transaction, although typically the contractual provisions used between parties to such transactions are much more detailed than those contained in the Convention, and not necessarily to the same effect. Here are a few comments on the draft.

Article 5

Article 5 of the Convention deals with the status of a lessor's interest in leased equipment. However, it is not clear to me precisely what this article is intended to achieve. The first part of the article says that the lessor's "real rights" in equipment shall be valid against the lessee's trustee in bankruptcy and creditors. This is an issue which I think is useful for an internation convention to deal with, but it is full of difficulties. The laws of some European countries (I believe that Belgium and the Netherlands are in this category) provide very feeble rights for lessors, particularly when a purchase option is contained in the agreement and the lessee become bankrupt before the purchase option has, by the terms of the agreement, become exercisable.

However, what is the intended effect of this Article in circumstances where the rights of the lessor may be suspended by the operation of an administration order in the UK, or by a redressement judiciare in France, or by Chapter 11 bankruptcy proceedings in the U.S.?

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Paragraph 4 of this Article is very worrying. The Article appears to recognise that the lessor has rights of ownership which should be protected against creditors of the lessee, but in paragraph 4 it is apparently envisaged that the lessee can create security interests in the equipment. This appears to be in complete conflict with the concept of the lessor as owner.

Article 7

Article 7 also appears to start with a useful statement of principle which is substantially curtailed by the last sentence of the article. Where a lessor is merely a financial institution providing money in the form of a lease rather than a loan, the financial institution will expect to have the greatest possible protection against liabilities relating to the equipment. Because the lessor's ownership is really only a quasi security interest, it will be appropriate for any liabilities which would otherwise fall on an owner to be transferred to the lessee. This is in fact what happens under UK law in relation to aircraft (Civil Aviation Act 1982 Section 76); a provision in the Convention similar in effect to Section 76 (4)(*), but applying to equipment generally, would be a good idea. The distinction drawn at present in the article between the lessor's capacity as lessor, and his capacity as owner does not seem to me to be very logical.

Paragraph 2 of Article 7 dealing with quiet possession does not conform with the usual practice for finance leases. One can divide the risks of quiet possession into three categories: those relating to act or omissions of the lessor, those relating to acts or omissions of the lessee, and those relating to third parties. Both the alternatives suggested in the draft Convention put the risk of a disturbance of quiet possession by third parties on the lessor. If you regard the lessor as a mere provider of finance who acquires title for the purpose of enabling finance to be provided, then this is not a logical division of responsibilities. The principle underlying most finance leases is that, while a lessor has title for security reasons, for tax reasons, for balance sheet reasons or sometimes for other reasons, the lessee, being the company which selected the equipment, decided that it needed it for its business, and which actually has possession and control of the equipment throughout the lease term, is the party who should bear all the risks which it would have borne if the finance had been arranged by way of loan and mortgage. This will include the risk of third parties, for whatever reason, disturbing quiet possession of the equipment.

It does not appear that the principle of the lessor as a mere provider of money is accepted in the Convention.

(*) Note by the Unidroit Secretariat:
Section 76(4) of the Civil Aviation Act 1982 provides as follows:

"(4) Where the aircraft concerned has been bona fide demised, let or hired out for any period exceeding fourteen days to any other person by the owner thereof, and no pilot, commander, navigator or operative member of the crew of the aircraft is in the employment of the owner, this section shall have effect as if for references to the owner there were substituted references to the person to whom the aircraft has been so demised, let or hired out."

Article 8

If the lessor is relying on the value of the equipment as security for the transaction then, depending on the type of equipment involved, Article 8 may need considerable expansion.

Article 9

Article 9 would be of concern to a supplier of equipment, since it appears to creat a double liability for equipment defects. In practice where manufacturer's warranties are important, detailed agreements are sometimes entered into, to define which of the lessor and the lessee may have recourse to the manufacturer in various different circumstances.

Article 10

Article 10 again put responsibilities and potential losses on the lessor which are inconsistent with the lessor's position as a mere financier. The lessee should only have a right of rejection as against the lessor to the extent that there is a right of rejection available against the supplier.

If there are disputes as to the suitability of the equipment they should take place between the lessee and the supplier, and any losses arising should fall either on the lessee or the supplier, not on the lessor. As a matter of drafting, I cannot understand how a lessor is to receive anything in these circumstances where the obligation of the lessee is expressed as an obligation to pay a reasonable sum "for the benefit the lessee has derived from the equipment". This paragraph only applies where the supplier had failed to deliver the equipment, in which case it is difficult to see how the lessee could have derived any benefit from it.

In my view the paragraph ought to say that the lessee should keep the lessor indemnified for the cost of funding the transaction, but without prejudice to the rights of the lessee to recover any such indemnity payments from the supplier, if the reason for the rejection of the equipment or the non-delivery of the equipment was within the supplier's responsibility under its supply contract.

Article 11

The provisions for default do not reflect usual practice for financial leases. The fact that recovery of possession of the equipment is only possible where the lessee's default is "substantial" means that in practice no recovery can take place unless some judicial procedings have occurred to determine the question whether the default is substantial or not. A finance lease normally identifies the events which the lessor and the lessee have agreed are sufficiently substantial to justify repossession so that, if there is no doubt that one of those events had occurred, the lessor can proceed to repossess straight away.

The provisions for payment on default set out a general contractual principle relating to breaches of contract, whereas in the case of a financial agreement much greater precision as to the payments to be made is both usual and desirable. One of the provisions which is sometimes, although not always, found in finance leases is that the lessee should pay the rental which would otherwise have fallen due during the balance of the lease period, but discounted to reflect its acceleration. This is one method of establishing "the position in which the lessor would have been had the lessee performed the leasing agreement in accordance with its terms". It is usually accompanied by a provision allowing the lessee credit for any value recovered in relation to the equipment, after satisfaction of the outstanding lease obligations. The net result of these provisions therefore is to accomplish substantially the level of compensation described in paragraph 2(b) of Article 11. However, paragraph 4 of Article 11 appears to outlaw this method of calculating the compensation payable.

Paragraph 5 of Article 11 is a matter which is usually negotiated between lessor and lessee. It is not always appropriate for there to be a cure period where the default is sufficiently serious to prejudice the lessor's interest or possibly expose the lessor to liabilities. For example, if with a potentially dangerous asset, such as an aircraft, the lessee fails to maintain insurances, a lessor should be entitled to terminate the lease, thus enabling it to take steps to ground the aircraft. This may be the only effective way the lessor has of preventing itself being exposed to uninsured liabilities. I do not therefore think that the provision for a general "reasonable opportunity of remedying the default" is necessarily appropriate.

Article 12

I wonder if Article 12 is intended to say that the lessee can be relieved of his obligation under the leasing agreement by effecting a transfer pursuant to paragraph 2? In paragraph 1 the lessor's obligations are expressly reserved following a transfer by the lessor. The lessee's obligations are not reserved in paragraph 2. I am not sure who the third parties are referred to in paragraph 2.

Registration of aircraft and ships

You asked me specifically to let you have a copy of the presentation which I made at a conference in Washington last year on the subject of registration of aircraft. This is enclosed.

I am not quite sure what is intended in the way of a qualification to the general protection of a lessor's title provided for in Article 5 relating to ships and aircraft. Registration systems for ships and aircraft vary

round the world. Their function, in relation to aircraft, is determined by the Chicago Convention of 1944 which is not primarily concerned with protecting lessors' interest. In the UK, for example, registration has absolutely nothing to do with the protection of a lessor's interest. Indeed, the aircraft is typically registered in the name of the lessee as operator, with no mention appearing on the register at all of the existence of the lessor. Other registries, for example France, register aircraft on the basis of legal title. In the U.S., registration is in the name of the owner, but this may include the economic owner, who is not necessarily the title holder. I am not sure therefore that it would be appropriate to exclude ships and aircraft altogether from the protection which is proposed in Article 5.

You are, no doubt, familiar with the provisions of the Geneva Convention on the International Recognition of Rights in Aircraft. The Convention provides that each state will recognise the rights which were created in the state of registration of the aircraft and apply those rights in the state where enforcement is taking place. The Geneva Convention has not, however, been ratified by a significant number of countries.

Conclusion

I fear that you will think my comments excessively negative. I do have serious doubts as to whether the provisions in the draft Convention which would replace terms agreed between the parties will be found to be generally acceptable. They do not appear to me to reflect the normal agreements arrived at between lessors and lessees. This is mainly because they do not reflect the purely financial nature of the interest of the lessor. I cannot imagine a situation in which I would advise a lessor to agree to the provisions of such a Convention applying to a transaction.

A convention to establish some uniform rules of law relating to the recognition of the rights of lessors against the lessee's creditors would be useful. However, I am unsure as to exactly how far Article 5 of the Convention is intended to provide protection.

From the point of view of a lessee's creditors it would be desirable to link this protection to a registration requirement so that creditors can discover whether equipment in the possession of the lessee is subject to a lessor's rights.

It might also be helpful to try to encourage accounting standards institutes to adopt rules along the lines of the U.K. SSAP 21 so that the true financial nature of leases is reflected in a lessee's balance sheet.

So far as registration of aircraft is concerned, an attempt to produce a convention which is more widely accepted than the Geneva Convention would be desirable, but I think that this is more likely to succeed if the question was faced directly by examining what the Geneva Convention did, why it did not achieve more acceptance, and trying to produce something which is more likely to succeed. I am not sure what the objectives of the present draft Convention are in this respect.

Yours sincerely,

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Encl.

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