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

*Comments by Mr R. Castillo-Triana (Colombia),
Member of the Advisory Board,
on memorandum prepared by UNIDROIT Secretariat*

In drafting a model law on leasing, certain elements will likely be uncontroversial. However, many issues require difficult policy choices and may be the subject of considerable discussion.¹ In order to invite the comments of the Advisory Board on these issues at the earliest stage possible, this memorandum identifies several areas on which the Board's views will be especially helpful.

This memorandum should not be understood as an outline of a complete model law on leasing nor as an exhaustive list of the issues that may arise in the drafting process. This memorandum is designed only to highlight particular issues, and far from being designed to limit the Board's input to comments on the issues listed here, the memorandum is but a starting-point. The Board's views on issues not listed here will be as important as its views on the issues identified. To that end, the Secretariat would encourage the Advisory Board to identify the components of a leasing law that it would anticipate being most difficult, in order that the first draft of the law might benefit from the Board's prior input. In the meantime, however, this memorandum may provide a preliminary map to issues on which the Secretariat will seek the Board's input at its opening meeting later this month.² The memorandum begins with three parts dealing with the scope of the law to be drafted, followed by three parts centred on the primary relationships in the transaction and concluding with one part discussing the rights of third parties.

I. Transactions covered

A. General definitions

1. *Definition of a lease.* The first major difficulty is in defining the lease, and specifically in distinguishing an agreement that gives rise to a lease from one that gives rise to a security interest, all while still creating room for financial leases. A variety of tests are possible, primarily focusing on the end-of-term options under the agreement.

¹ Cf. R.C.C. Cuming: Model Rules for Lease Financing: A Possible Complement to the UNIDROIT Convention on International Financial Leasing in *Uniform Law Review* 1998, 371 *et seq.* This article is reproduced in Appendix I to this memorandum.

² See also the preliminary comments submitted to the Advisory Board by Mr R. Castillo-Triana (Colombia), member of the Advisory Board, reproduced in Appendix II to this memorandum.

A focus on end-of-term options looks primarily at the extent to which the lessor can expect to receive anything of value back at the end of the term: the more the lessor can expect, the more likely that the arrangement is a lease. But because the model law will also seek to define financial leases in which equipment is leased for a substantial portion of the equipment's life, it will be important to consider whether the length of the lease in relation to the equipment's life can be a dispositive factor. Other factors to be considered would include whether the agreement permits the lessee to purchase the equipment unilaterally or to renew the lease for the life of the goods for nominal consideration, and whether the agreement requires the lessee to renew or purchase the goods. A law designed solely to attract financial leasing investment might recognise as leases those agreements in which the lessee has a right or is bound to renew the lease, even for the equipment's economic life, and those agreements in which the lessee has a right to purchase the equipment, as long as the lessee is not bound to purchase the equipment. Such a law would permit as leases all but those agreements in which the lessor *cannot* receive anything of value at the end of the term, and would include those agreements in which the lease lasts the entire economic life of the goods. However, by permitting such agreements as leases, such a law might also have undesirable consequences for accounting and taxation policies in implementing States.

Comments of Mr Castillo-Triana: It is suggested that the Model Law shall cover regulations for both Operating Leasing and Financial Leasing transactions. In this connection, it must be noted that in developing economies, the leasing industry evolves from the pure Financial Leasing phase to a more sophisticated industry where lessors combine their financial expertise and ability to assume mainly credit risks and secondarily, the collateral value of equipment with a more sophisticated approach to asset management. In essence, the Model Law must recognize the key role that leasing at large plays in internal capital formation of national economies, and its microeconomic function in balancing the risks and benefits associated to any capital investment decision, either driven by a private entrepreneur or by a Government. Lessors are increasingly able to participate in the overall equipment or property selection, acquisition, installation maintenance, insurance, upgrades, and replacement of capital goods. Therefore, besides the financial leasing concept, which is the necessary seed for a solid and sustainable leasing industry, national economies demand a legal framework to provide juridical security to such investors in capital equipment for the benefit of third parties.

2. *Definition of a financial lease*

- a. *Inclusion of financial leases.* Should the model law aim to include only traditional leases, or should it also include those arrangements known as "financial leases," which are commonly considered much closer to secured loans?

Comments of Mr Castillo-Triana: This question demands an important methodological warning: We need to be aware of the differences between Common Law regulations of financial leases transactions as secured transactions, as opposed to Civil Law

countries where financial leases demand to be regulated different to the common “secured” transactions. As professor Cuming notes in his article (Appendix I) many efforts have been made at European and Latin American levels to introduce regulations to secured transactions, similar to the regulations for Leases and Security Interests under the Uniform Commercial Code (Articles 2, 2A and 9). However, this is far from becoming a reality. Therefore a Model Law on Leasing shall focus on the necessary protections to the lessors in its ability to use the concerned capital good as a collateral, with a readable possibility to reduce its cash-to-cash cycle by using forthwith repossession remedies and disposition actions, as opposed to lengthy and heavily litigated foreclosures, not to mention effects on Insolvency procedures. In order for Leasing to play its landmark role as a major fuel of capital investment in any national economy, it is imperative to endow lessors with the ownership right or title on leased assets.

- b. *Lessee’s selection of the goods.* The appropriate resolution of many issues regarding the lessee’s and lessor’s ongoing obligations may depend on whether the lessee itself selected the equipment, without input from the lessor. However, lessors may desire to have input in the selection of goods in certain instances, and the factor need not be made a requirement of all financial leases. The model law might just as easily, when the issue calls for it, provide for alternative treatment of leases in which the lessee selected the equipment independently.

Comments of Mr Castillo-Triana: In this particular subject matter, even in the case of Vendor Programs, it is key that the Law provides similar provisions as in article 1 (a) of the UNIDROIT Convention on International Financial Leasing. In our practical experience, such statement is critical to determine further rights and juridical security for lessors, lessees and third parties. The rule must be that lessor acts towards lessee upon lessee’s specifications and Vendor (or Supplier) selection. Many Statute Laws such as the Mexican Law of Auxiliary Credit Organizations provide such principle but require lessors to legitimate lessees to enforce all rights and remedies arising from deficiencies in the equipment. In addition, for purposes of contract construction, there is a necessary “iter contractus” (if this analogy to the “iter criminis” expression is allowed), where, as late professor Carlos Vidal Blanco from Spain used to say “the lessor starts its dealing acting as agent of the lessee when entering into the supply agreement with the supplier or vendor”).

- c. *Secondary leases.* If the law makes the lessee’s selection of goods a requirement of all financial leases, the law may make it more difficult for lessors to let the same goods a second time, after the first lessee had selected the goods and returned them to the lessor at the end of the primary lease. This may be a desirable outcome, because a lessor who lets the same goods multiple times may come to resemble an operating lessor more than a financier. However, if that outcome is not desirable, the law could either create an

exception to the lessee's selection rule, or might not include the lessee's selection rule at all.

Comments of Mr Castillo-Triana: Practical experience demonstrate that there is connection between the lessee's selection of the equipment and the ability of lessor to perform secondary leases. Selection of equipment does not mean at all that all equipments leased are taylor-made. On the contrary, in general, lessors intend to have their investment in equipment that can be useful for third parties as well. In our view, the selection provision must remain.

- B. *Geographic scope.* Although the model law could leave the question of when a leasing arrangement is governed by the law to the implementing State's existing rules regarding choice of law, lenders and investors may prefer that the model law contain a provision that clearly defines when the statute applies.

The statute producing the clearest, bright-line test might limit the law's applicability to arrangements (1) in which the equipment being leased is to be utilised in the implementing State and (2) arrangements in which the parties specifically invoke the implementing State's laws in their contract. However, a State may also wish to expand the law's coverage to protect arrangements in which the lessee has its principal place of business (or some similar test) in the implementing State. This latter course necessarily sacrifices some clarity, inasmuch as a test turning on "principal place of business" or any similar language will surely invite litigation.

Comments of Mr Castillo-Triana: The model law shall have full application within the boundaries of the corresponding State which adopts it. Under prevailing Private International Law principles, such as the Montevideo Inter American Civil and Commercial Conventions, contracts are regulated by the law of the State where they produce their effects, i.e. the place where an obligation is due. In practical terms, despite whatever provision concerning choice of law, ultimately the law of the State where the assets are placed, regulates its repossession remedies, and the law of the State where the debtor complies with its obligations, regulates the enforceability of such obligations, including but not limited to obtaining liens or attachments on obligor's personal or real property.

- C. *Arrangements excluded from coverage.* The Advisory Board's input on the substantive scope of the law will also be appreciated. Many arrangements that could otherwise fall under the aegis of leases might best be left outside the scope of the law to be drafted here. For example, the Ottawa Convention³ specifically excluded consumer leases and real estate leases. Consumer leases were there excluded because they are not common in the international transactions that Convention covered; even if this model law is designed to cover transactions occurring entirely within an implementing State's borders, consumer leases may have unique concerns that ought to be dealt with independently of this model law. Similarly, the Ottawa Convention excluded real estate leases due to the difficulty of interweaving the treatment of real and chattel property, an issue that may also be of concern here.

³ The text of the Convention is reproduced in Appendix III to this memorandum. A select bibliography on the Convention and related matters is reproduced in Appendix IV.

Comments of Mr Castillo-Triana: In my opinion, as to consumers' transactions, the Model Law must bring the same provision of the Ottawa Convention. As mentioned, leasing is a tool for capital investment, not for consumption. However, for a Model Law having application within a State, real estate leases should be included. For example, a large portion of the Chilean leasing industry is represented in real estate leases. Chile has experienced an outstanding development of industrial and commercial real estate ventures, thanks to leasing. In addition, leasing needs to be suitable for infrastructure investment, because developing countries require to catch-up in order to build the necessary infrastructure in transportation (roads and its related premises, airports, ports, etc.), energy (power plants, pipelines and other), environmental (water and sewage systems and other environmental facilities), telecommunications (telecommunication centers, antennas, etc.) and so forth.

- II. Freedom of contract.** An issue running throughout the model law will be the extent to which parties to leases covered by the law should be free to contract around its requirements. Although, generally speaking, freedom of contract is to be desired, there may be requirements that ought to be mandatory. Issues for which some might find mandatory provisions desirable may include (A) a lessor's or supplier's implied warranty of merchantability; (B) limitations on liquidated damages; or (C) the lessor's liability for grossly negligent or intentional acts that violate the lessor's duty to ensure quiet possession, among others.

Comments of Mr Castillo-Triana: Fully agree in the principle, but we need to be cautious about the content of such restrictions to freedom of contract. We strongly suggest following the bad experience of the wrong contract interference that the Argentine Government implemented in early 2002 and to provide regulations that fortify the "pacta sunt servanda" principle.

- III. Background provisions of contract law.** Another issue that will arise throughout the model law is the extent to which the law should provide basic elements of contract law, rather than relying on the implementing State's underlying contract law. To the extent that an implementing State's underlying contract law is relatively undeveloped, leasing arrangements in the State may benefit from provisions that provide basic structures regarding, for example, the formation of contracts and the statute of frauds, express and implied warranties, unconscionability, and statutes of limitations for actions arising out of contracts. On the other hand, some might consider such background provisions to be outside the scope of a law on leasing. The Board might consider various options on this issue, including drafting such a background law as part of the overall project, but leaving it distinct from the leasing provisions, so that implementing States might adopt it or not as they see fit, or — given the wide acceptance of the UNIDROIT Principles of International Commercial Contracts — incorporate an appropriate reference to the Principles, for all matters of general contract law.

Comments of Mr Castillo-Triana: For all such countries that some way or another inherited the tradition of the Napoleonic Code of 1804, there are implicit background provisions of contract law included in the Civil Code, all of which are in harmony to UNIDROIT Principles of International Commercial Contracts. Some of them (such as the hardship regulation, or "rebus sic stantibus") need to be updated and perhaps adapted to the specifics of leasing.

IV. Lessee-lessor relationship

- A. *Qualification of lessors.* Should the law include any provisions restricting the ability to enter a lease? For example, should the class of lessors be limited to financial institutions, as some may have suggested?

Comments of Mr Castillo-Triana: This is extremely important in developing countries. Over the years, Governments have encountered that lessors play a financial role in the economy and have tended to assimilate them to financial institutions. In some cases, they have urged to consolidate the leasing business within commercial banks, with the undesired effect of drowning the leasing business within bank commercial portfolio activities. This excessive regulation has played against the desire to encourage and foster leasing as a tool for economic development. It is clear, however, that lessors not guided by acceptable management practices could harm the economy because they can put in jeopardy either the stability of use of leased assets by lessees, or investments of their stakeholders, and in particular of its lenders (with dramatic effects when such lenders are depositors from the public at large). It is interesting to contrast countries such as the United States and the United Kingdom (where lessors are not regulated by the Government and there are no market entry barriers, but there is market transparency and a bankruptcy law that permits orderly market exits), with countries such as Brazil where lessors are fully regulated, but regulation has proven to facilitate implementation of best practices, and with countries such as Venezuela and Ecuador where excessive regulation within the banking regulatory entity, simply lead the leasing industry to disappear. Whether or not a leasing industry must be regulated is a prevailing issue currently in Bolivia, Nicaragua, Honduras, Guatemala, Costa Rica and other countries where the World Bank through IFC is urging domestic legislation. We can expand on this issue during our conference call. Further details about regulations can be found in my book "Legal Aspects of Equipment Leasing in Latin America".

- B. Transferability.

1. Ability to transfer

- a. *Lessee's ability to transfer.* What, if any, restrictions ought there to be on a lessee's ability to sublet or transfer its interest? A lessor might, for its own security, desire that a lessee be required to obtain the lessor's consent before transferring the right to use the equipment. However, it may be desirable for the model law to impose no such restriction but leave such a restriction to the parties' contract.

When a sublease arises, the sub-lessee might then have a relationship with the original supplier either directly (as though the right were assigned) or as mediated through the primary lessee (as in a traditional sublease). The model law might include a default provision and might define circumstances in which a relationship can arise directly between the supplier and the sub-lessee — such as, for example, when the supplier previously was given notice of the financial leasing arrangement.

Comments of Mr Castillo-Triana: There are a couple of practical issues in connection to this point: a)- Lessors ordinarily screen the credit risk inherent to the lessee, and from a risk management perspective require to have knowledge and acceptance of any sublessee, though b)- sometimes, lessees assume the whole risks of their own sub-lessees to the satisfaction of lessor, and that enable the parties to include a limited subleasing provision. This has been the case in our practice in leases to providers of medical equipment and supplies to various hospitals and healthcare institutions (One lessee, subleases to several hospitals, diagnostic equipment, dialysis devises, radiological equipment, etc.) and in the case of education providers intermediaries who sublease computers and IT equipment to several educational institutions.

- b. *Lessor's ability to transfer.* Should there be restrictions on transfers by lessors who have ongoing obligations under their arrangements? They might be treated differently from lessors who have no further obligations and thus presumably are free to transfer their right to receive payment. Lessors who have ongoing obligations might be free to transfer their duties but remain contractually liable, might be free to assign their duties as they desire or might be restricted from transferring their duties except with the lessee's permission.

Comments of Mr Castillo-Triana: Article 14 of the Ottawa Convention covers the issue in a very adequate form. Lessors must be able to transfer their rights. Securitization of leases is an increasing practice and a very important funding source, and it must have a legal ground in the Model Law.

2. *Remedies.* If a party transfers the lease interest in violation of any statutory restriction on transferability or in violation of the contract, what is the consequence of that event? Should the parties be required to wait until the transfer causes one of them harm, in which case the harmed party will have a remedy? Or should the transfer itself be sufficient to trigger a default event, regardless of whether the non-transferring party has suffered harm.

Comments of Mr Castillo-Triana: I suggest leaving this point to freedom of contract. This should not be regulated. The parties must be able to assess, according to the circumstances and their bargaining position, whether or not to include such breach as an event of default or event of termination.

C. Irrevocability.

1. *Irrevocability in two-party leases.* Should the law include a "hell or high-water" clause, under which the lessee's obligations to pay the entire rent become irrevocable at some point? If such a clause is appropriate, at what point does the lessee's duty to the lessor become irrevocable? Upon the lessee's acceptance of the equipment?

Comments of Mr Castillo-Triana: In my view, the obvious answer must be yes to the “hell or high water clause”, but not as an imposition from the strong party (lessor) to the weak party (lessee), but as an equitable remedy attended the fact that the intention of the parties shall prevail, and the intention of lessor, (as should be known be lessee) is to recover its investment in the equipment (“The whole or a substantial part thereof” as provided by article 2 (c) of the Ottawa Convention). In practical terms, the hell or high water clause starts its force after the so-called D&A (“Delivery and Acceptance”) certificate is signed by lessee, which means that, in equitable terms, the parties already acknowledge that lessee should not be bound to pay rentals unless its has the actual possibility to use it for having it under its physical control. All further circumstances should not excuse lessor to pay rentals as agreed, since at the moment of signing the D&A, lessee shall be redeeming lessor of delivery and performance obligations in connection to the equipment, hence having all such remedies exclusively vis-à-vis the Supplier or Vendor.

2. *Irrevocability in financial leases.* If the lessor warrants the equipment’s merchantability and fitness or plays some additional role beyond pure financing, then perhaps the lessee’s duty should not become irrevocable, because there are continuing obligations on each side.

Comments of Mr Castillo-Triana: The irrevocability in financial leases must be absolute. In operating leases, the parties may modify such irrevocability, but it shall also be the rule by default.

D. Right of quiet enjoyment

1. *Guarantee by lessor.* On the one hand, a traditional lessee expects to enjoy the equipment free from any concerns about title. Indeed, some argue that if the lessor holds the title, the lessor ought to carry some responsibility for the goods. On the other hand, if the lessee selects the equipment, then it may be difficult for the lessor to guarantee the equipment’s title.

Although the model law could provide for a right of quiet enjoyment or not, the model law could also make the lessor’s obligation in this respect dependent on whether the lessee actually selected the equipment.

Comments of Mr Castillo-Triana: A lessor must always in due diligence make sure that its title is legally perfect. But such must be its unique role, to guaranty eviction only due to deficient title caused by lessor’s own fault. No more than that.

2. *Freedom of contract.* If the model law provides a right of quiet enjoyment, whether in all covered leases or only those meeting certain criteria, should that warranty be mandatory or should the parties be free to contract around it? If providing such a guarantee of title is appropriate but there is reluctance to limit the freedom of contract, the right could be made mandatory in certain instances. Options might include making the guarantee mandatory against interference due to the lessor’s error or due to the lessor’s grossly negligent or intentional acts.

Comments of Mr Castillo-Triana: The course suggested in the last sentence is the preferable regulation.

3. *Guarantee by supplier.* Consideration might be given to whether, in lieu of such a guarantee by the lessor, it would be desirable to require a right of quiet enjoyment from the supplier to the lessee.

Comments of Mr Castillo-Triana: It is very important to open here 2 different ranges of events that could alter lessee's quiet possession: a)- Title deficiency ("garantie d'eviction") and b)- operating deficiencies of the equipment or asset. As mentioned, title deficiencies should be covered by lessor, since it shall be within its professional scope of diligent behaviour verifying such completeness of title. However, since lessee should be the person or party who operates the equipment, its shall bear all operating, mechanical and physical risks of the equipment, including but not limited to such "vices redhibitoires". Such defects must be guaranteed by the supplier, not by the lessor.

E. Default

1. Generally

- a. *Security and the right to demand assurance.* Should either party have the right, upon reasonable grounds for insecurity, to demand adequate assurance of performance, with the right to suspend performance until that assurance is received?

Comments of Mr Castillo-Triana: Except for the "hell or high-water clause", the answer should be yes.

- b. *Excused performance.* Should the law provide circumstances in which performance is excused, such as when performance would be impracticable? Or should that issue be left to the implementing State's background contract law?

Comments of Mr Castillo-Triana: This should be both subject to freedom of contract first, and then to background contract law.

2. Default by lessor

- a. Acceptance and rejection of non-conforming tenders
 - i. *Grounds for rejection.* Under what circumstances can a lessee reject goods as non-conforming? Two key questions are (a) should rejection be permitted for any non-conformity or only those non-conformities that substantially affect the lessee's purpose and (b) what effect should a lessee's initial acceptance of the goods have on the lessee's ability to reject the goods. With respect to the latter question, rejection following an initial acceptance could be

barred entirely, limited to rejection for hidden and serious non-conformities, permitted on the same grounds as rejection prior to acceptance or made dependent on whether the acceptance was explicit and whether the acceptance was made in reliance on the supplier's representations. Alternatively, the model law could leave these questions open, if it were preferred that the right of rejection incorporate on the implementing State's background law of sales.

- ii. *Rights upon rejection.* If the lessee exercises a right of rejection, the questions arise whether the rejection can terminate the lease and whether the lessor or supplier should have a right to cure the non-conforming tender — which may depend, for example, on whether the cure would come within the original time for performance or with additional payments of the lessee's costs incurred by the non-conforming tender.

There is an additional question of whether the lessee may withhold payment for non-conforming goods. The appropriate resolution of this question may be different in a financial lease, in which the lessor has had little involvement in selecting the goods, and a traditional lease, in which the lessor and supplier are identical. In the financial lease, the lessee may have a direct cause of action available against the supplier, so it may be inappropriate to withhold payment from the lessor; that consideration is not present in a traditional lease.

Comments of Mr Castillo-Triana: As mentioned, the practice in business as usual is that lessors drive suppliers to deliver the goods to the lessee and lessors only pay suppliers upon reliance of lessees satisfactory receipt and acceptance of the goods. Therefore, rejection should not be predicated against lessor, but against suppliers.

- b. *Acceptance.* Assuming that acceptance can be either explicit or implicit, under what circumstances can acceptance be revoked? Should it be revocable if, at the time of acceptance, the non-conformity was unknown, unknowable or known but minimised by the supplier?

Further, if the non-conformity is discovered at some point subsequent to acceptance but not timeously raised with the supplier or lessor, does the lessee thereby waive any claims based on it? Or should such a waiver depend on whether the supplier or lessor is prejudiced by that delay?

Comments of Mr Castillo-Triana: Business as usual practices leave this issue for direct settlement between supplier and lessee. In practical terms no grave issue has happened by following this

course of action. It would inappropriate to impose to lessor (who is merely a good faith investor and a catalyst of the viability of lessee's business or enterprise) such undue burden that has nothing to do with its own performance.

3. Default by lessee

- a. *Lessee is insolvent but has not defaulted.* If lessee appears insolvent but has not yet repudiated or defaulted on its obligations, the lessor may be entitled to take advance action to minimise the cost of a potential default. Should that advance action include the right to stop delivery of (or refuse to deliver) the goods, without first demanding the lessee's assurance?

Comments of Mr Castillo-Triana: Up to date, background insolvency law have referred to this issue, and it has been in general implemented as follows: In case of a reorganization (Chapter 11, Concurso Mercantil, Concordato, or similar proceeding), lessor is not entitled to terminate the lease if lessee is current, or if it failed to terminate the lease prior to the reorganization petition. If such happens, then either the parties a)- may agree to terminate and voluntarily reinstate lessor in possession of the asset, if such asset is not needed for the continuation of the business, or b)- the lessee shall keep paying all rentals accrued after the petition as an operating expense, which has priority over all other payments. In such event where, notwithstanding the above, lessee keeps in default during the "automatic stay" of the bankruptcy, then lessor must be entitled to terminate and outright repossess the leased asset.

- b. *Right to recover goods.* If a lessee in possession of the goods defaults, should the lessor be entitled to recover the goods without first obtaining judicial permission (provided that the recovery does not breach the peace)? If not, the law may need to include provisions tailored to the judicial procedures appropriate in the implementing States.

Comments of Mr Castillo-Triana: This is a highly debated issue. Some countries and jurists, following the Roman tradition of the emperor Constantine sustain that since the "pacta commissoria" has been forbidden by Civil Law (This was due to the need to avoid that assets given as collateral could be applied to pay a debt, giving rise to an "illegal" collection of interest as such times where Roman, under Canonic Law influence forbade the pact of interest), then it shall be deemed unconstitutional a repossession without a prior judicial order. This is a prevailing (and in my opinion wrong) opinion in most of Civil Law countries. In Common Law countries, this provision would be redundant. There is even a TV series in the United States about the adventures of such individuals as the Repossessors, who are a group of private practitioners that execute repossession of leased and secured property, such as cars and

other. In general terms, the due process guaranty should be safeguarded if there is transparency. Some jurisdictions may require posting an affidavit at a Public registry, which should compromise the liability of any party abusing of its right to repossess. I vote for the possibility to repossess with such legal environment which should bring comfort to legislators at National orders in terms that the constitutional guaranty of due process will be respected but that in the other hand, it is necessary to provide adequate remedies to lessors to encourage them to invest in capital goods for the sake of economic development.

F. Damages

1. *Governing principle.* In the event of a breach by either party, what principle should govern damages? An “expectation damages” remedy would seek to put the harmed party in a position equal to the position that the party would have been in if the lease had been fully performed; that is, if the lessor paid out \$9,000 to purchase the equipment and was to collect \$10,000 in rent, under an “expectation damages” theory the lessor would be entitled to the present value of the \$10,000 that the lessor expected to collect under the lease. Expectation damages are generally considered to result in an economically efficient outcome but they can create surprising awards when a slight breach has dramatic consequences on a large contract.

Alternatively, an “out-of-pocket damages” remedy would seek to compensate the harmed party for the cost of its own performance under the contract or to restore the party to the position it was in when it entered the lease; under this theory, the lessor in the example above would be entitled to recoup its original \$9,000 expenditure but not the extra \$1,000 profit.

Damages under either theory could be limited by a requirement that the harmed party undertake reasonable efforts to mitigate its damages, either by re-letting the equipment or seeking replacement equipment from another source.

Comments of Mr Castillo-Triana: The best definition ever on the scope of damages is such contained in article 13 (2)(b) of the Ottawa Convention.

2. *Liquidated damages.* To what extent should the parties be free to specify in their contract a damages figure, in lieu of actual damages? Liquidated damages, either in the form of a specified sum or a formula, might be deemed impermissible under any circumstances, permissible under any circumstances or permissible provided that the damages are not unconscionable or bear a relationship to the actual (or anticipated) damages sustained.

Comments of Mr Castillo-Triana: Permissible but up to the limit as set forth in article 13 (2)(b) of the Ottawa Convention.

3. *Specific performance.* Should parties be entitled to seek specific performance in the event of a breach? That remedy, under which parties are ordered to perform the contract according to its terms, is disfavoured in some circles, because it forces parties to continue a relationship that one party has deemed unsustainable. However, the remedy may be desirable in arrangements that involve unique goods, for which cover is unavailable.

Comments of Mr Castillo-Triana: This should be left to freedom of contract.

V. Financial leases: the lessee-supplier relationship

- A. *Notice to supplier.* In order for a transaction to come within the terms of a financial leasing statute, should the supplier be given notice of the lease's three-way structure? If the supplier is to be held liable to the lessee, in lieu of actual contractual privity there is an argument that the supplier ought to be informed of the nature of the arrangement. On the other hand, requiring notice to the supplier may add little economic value, so requiring notice may be undesirable. One option would be to make certain rights — such as whether variations in the supply agreement should require the lessee's agreement — depend on whether the supplier had notice of the financial lease when the agreement was entered; if the supplier had notice that the agreement was to serve the lessee, then the lessee would have the right to approve or reject any proposed modifications to the supply agreement.

Comments of Mr Castillo-Triana: In my view, notice to supplier or evidence of knowledge about the leasing transaction must be always present if any risk or legal obligation is intended to be enforced against supplier and not lessor.

- A. *Risk of loss.*
 1. *Lessor's risk.* A traditional lessor, entering a sale-of-goods transaction with the supplier, would bear the risk of loss at some point, even if the lessor passed that risk to the lessee. If it is desirable for the risk of loss to be treated in the manner of a traditional sale of goods, then there arises the further question of whether the model law should contain such a risk of loss provision or whether the law should simply allow that matter to be governed by the implementing State's existing law regarding the sale of goods. However, a lessor in a financial lease, like a traditional financier, desires to limit its exposure to such risks of loss, so it may be desirable to treat the risk of loss as passing directly from the supplier to the lessee.

Comments of Mr Castillo-Triana: It is my opinion that we will need to include a clear distinction between the risk of loss of the goods and the risk of loss of the investment made by lessor. If the asset is lost, such loss would have to be borne by its legal owner, i.e. the lessor. However, lessor's investment shall be safeguarded by lessee. This is the rationale why in prevailing practice, lessor requires lessee to insure the asset and to assume the shortfalls not covered by insurance, such as deductibles, coinsurance and similar.

2. *Identification of the goods and casualty before delivery.* Some jurisdictions recognise a point in which goods or equipment are “identified,” at which point the lessee obtains an insurable interest. In determining when the risk of loss should pass from the supplier to the lessee (or to the lessor), consideration might be given to linking identification to passage of the risk of loss. If identification did not occur until passage of the risk of loss, each party’s interest would be more clear at each stage. This clarity would be useful, for instance, when goods that have already been identified suffer casualty before they are delivered; some jurisdictions provide that in such circumstances, the entire contract is cancelled. By linking identification to risk of loss, an arrangement could survive the destruction of goods before they were delivered.

Comments of Mr Castillo-Triana: This should be left for freedom of contracts.

3. Note regarding right of rejection: One conceptual difficulty with the risk of loss arises with the lessee’s right of rejection. If the model law permits a lessee’s right of rejection to arise, in some circumstances, after the lessee has accepted the goods, then there will be occasions when the supplier could suffer loss by rejection *after* the risk of loss has passed.
- B. *Warranties.* If an implied warranty of merchantability and fitness for a particular purpose is desirable, should those warranties come from the supplier or the lessor? Again, in a traditional sale of goods and lease, the lessor would likely warrant the equipment’s quality to the lessee. However, if the financial lease is purely a finance agreement, the supplier’s warranties may run directly to the lessee.

Comments of Mr Castillo-Triana: Certainly, my suggestion is to allocate all such warranties on the Supplier. Only the title risk should be retained by lessor.

VI. Rights of third parties

A. Priority rules

1. *Choice of law.* To what extent should the law simply rely on the implementing State’s rules governing priority of interests? The law could either be silent in this respect, or it could provide for priority for certain interests. When an implementing State has existing rules, it may be hesitant to disrupt those rules with additional provisions; however, protecting a lessor’s interest here may be critical to gaining lessors’ acceptance.

Comments of Mr Castillo-Triana: This is the most important benefit that this Model Law must bring. If any value has to be added by the Law, is this important regulation. All States are in the process and need to implement priority of interest rules if they want to be competitive in the current global environment. The Inter American Development Bank undertook a study about the banking industry in Latin America and it encountered the need for such reforms. In a similar context, Peruvian economist Hernando De

Soto, in his book "The Mystery of Capital" encourages this kind of legislation.

2. *Lessor's interest.* When the law is deemed a lease rather than a security interest of any kind, it may be desirable to specify that the lessor's interest takes priority over the interests of any of the lessee's creditors. The priority of the lessor's interest may be made dependent on the lessor's compliance with any notice requirements of the implementing State or the model law may include a reporting structure for any jurisdictions that do not already have one.
 - a. *Statutory liens.* The lessor's interest may take subject to statutory liens, in order not to minimise disruption to the implementing State's existing priority rules.
 - b. *Lessor's creditors.* Should the law provide priority rules with respect to the lessor's creditors? Given the lessee's interest in obtaining the equipment free from any concerns regarding title, protecting the lessee against the lessor's creditors may be desirable. However, this might be accomplished through means besides the priority rules; guaranteeing the right of quiet enjoyment, for example, may satisfy this concern.
3. *Mechanics' lien.* Should the lessor's interest take priority over the interest provided in a traditional mechanics' lien? The unique status of mechanics' liens may warrant maintaining their priority, with the statutory lien, over the lessor's interest.

Comments of Mr Castillo-Triana: If the current regulation of title as prevailing in major Civil Law countries recognize ownership of the lessor as opposed to lessee, lessors rights should have priority rights even over such 3 Statutory liens. It is my opinion that this must be the case.

- B. Third parties in tort. Existing tort principles may give rise to actions against the lessee or lessor when a third party is harmed by the leased goods or equipment. However, it may be inappropriate to hold the lessor liable when the lessor played no role in selecting the goods. Thus, whilst it may be inadvisable to interfere with implementing States' determinations of when liability should exist, it may be appropriate to define which party to the lease should be liable for a particular harm.

Comments of Mr Castillo-Triana: It is clear that the Model Law must be clear in terms that there vicarious ("responsabilité objective") must not apply to leased assets. In addition, any harm caused in connection with the operation or use of the leased asset must be borne by whomever operates or uses such asset, i.e. generally, the lessee.