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SESSION OF THE UNIDROIT GENERAL
ASSEMBLY AND THE UNIDROIT COMMITTEE
OF GOVERNMENTAL EXPERTS FOR THE
FINALISATION AND ADOPTION OF A DRAFT
MODEL LAW ON LEASING TO WORK IN CLOSE
CO-OPERATION WITH THE UNIDROIT
SECRETARIAT FOR THE PREPARATION OF AN
OFFICIAL COMMENTARY ON THE UNIDROIT
MODEL LAW ON LEASING
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FIRST DRAFT OF AN OFFICIAL COMMENTARY

(prepared by Mr R.M. DeKoven, Reporter to the Joint Session):

PROPOSED DRAFTING AMENDMENTS

(by the Government of Canada)

INTRODUCTION

Further to the comments on the first draft Official Commentary on the UNIDROIT Model Law on Leasing prepared by Mr R.M. DeKoven, Reporter to the Joint Session of the UNIDROIT General Assembly and the UNIDROIT Committee of governmental experts for the finalisation and adoption of a draft model law on leasing, received by the UNIDROIT Secretariat as of 25 May 2009 - from Messrs N.J. Makhubele and I.S. Thindisa (South Africa), Chairmen of the Committee of governmental experts, and the Governments of Canada, France and the United States of America, as members of the Drafting Committee – and grouped together in Study LIXA – Doc. 20, on 22 June 2009 the UNIDROIT Secretariat received a proposed revised draft of the first draft Official Commentary from the Government of Canada. In its covering message, the Government of Canada indicated that its proposed revised draft implemented those of its earlier comments where it had expressed the need for additions or amendments to the first draft Official Commentary without providing specific language. The Government of Canada further indicated that it had greatly benefitted in the preparation of its proposed revised draft from the comments submitted by the Governments of France and the United States of America and had, indeed, incorporated many of their comments and suggested amendments in its proposed revised draft.

The proposed revised draft is set out below, the proposed text of the Official Commentary being set out under each successive provision of the Model Law.

CHAPTER I: GENERAL PROVISIONS

Article 1 – Sphere of application

This Law applies to any lease of an asset, if the asset is within [the State], the centre of main interests of the lessee is within [the State] or the lease provides that [the State's] law governs the transaction.

Commentary

1. Article 1 provides that the Law applies to “any lease of an asset”: see the Official Commentary on the definitions of “lease” and “asset” in Article 2 of the Law.

2. The Law applies if the asset is within the enacting State, or the centre of main interests of the lessee is within the enacting State, or the parties agree that the enacting State's law governs the transaction. The reference to “centre of main interests” implicitly incorporates the definition of that term in the UNCITRAL Model Law on Cross-Border Insolvency Art. 2(b) (UNCITRAL 1997) and European Union Council Regulation 1346/2000, Preamble § 13, 2000 O.J (L 160) 1, 2 (EU).

3. A transaction may fall within the sphere of application of as many as three different States' leasing laws (as where the asset is in State A, the centre of main interests of the lessee is in State B, and the parties agree that the law of State C governs the lease transaction). In such cases, the applicable law is determined by the general choice of law rules of the forum State. In other words, the territorial connecting factors set out in Article 1 are not intended to override the general private international law of a State that enacts the Model Law.

4. For example, the general choice of law rules of the State in which the lessee is located may refer issues relating to the third party effectiveness of the lessor's title to the asset to the law of the State in which the asset is located. If a dispute between the lessor and a third party arises in the State where the lessee is located, the law of the State in which the leased asset is located would apply, notwithstanding that the forum State had adopted the Model Law.

Article 2 – Definitions

In this Law:

Asset means all property used in the craft, trade or business of the lessee, including immovables, capital assets, equipment, future assets, specially manufactured assets, plants and living and unborn animals. The term does not include money or investment securities. No movable shall cease to be an asset for the sole reason that it has become a fixture to or incorporated in an immovable.

Commentary

1. The definition of asset is significant since it determines which assets may be the subject matter of a lease within the sphere of application of the Model Law.

2. Asset is defined to include “all property used in the craft, trade or business of the lessee.” The use of the term “all property” might be understood to include assets over which merely subjective rights having no objectively determinable value exist. However, as reflected in the specific examples given in the definition, only assets which may be the subject of a real right qualify as an asset.

3. The restriction to assets used in the craft, trade or business of the lessee means that a lease of assets acquired by the lessee for personal, family or household purposes does not come within the sphere of application of the Law. There may be cases where the lessee acquires the leased asset for mixed business and personal uses. If the business use is the primary use, the definition of asset is still satisfied.

4. The definition of asset is sufficiently broad to include intellectual property, notably software. The software may be embodied in a tangible asset so as to form a single functional thing, for example an automobile. Here, the subject matter of the lease would be the automobile, not the software, so that the question of whether asset includes software does not arise.

5. However, the software may be independent of the item in connection with which it is to be used, for example, a software programme designed to be installed in a computer. Here, one must take into account the definition of "lease" which requires that the transaction be one in which the lessor "grants a right to possession and use of the asset" The Law does not define possession, thereby leaving the definition of that concept to the general law of each State. In States in which the term "possession" refers to actual physical possession of a tangible asset, "possession" cannot refer to intangible assets such as intellectual property. In that case, the Law would not apply to a transaction in which a "lessee" acquires the right to use intellectual property.

6. In States in which "possession" is given an extended meaning to include functional control or constructive possession, the Law might apply to a transaction involving the right to use intangible asset. Of course the lessee's right of use would be constrained by the terms and conditions established by the lessor in the lease agreement .

Financial lease means a lease, with or without an option to purchase all or part of the asset, that includes the following characteristics:

(a) the lessee specifies the asset and selects the supplier;

(b) the lessor acquires the asset in connection with a lease and the supplier has knowledge of that fact; and

(c) the rentals or other funds payable under the lease take into account or do not take into account the amortisation of the whole or a substantial part of the investment of the lessor.

Commentary

1. The definition of a financial lease should be read in conjunction with the base definition of a lease as "a transaction in which one person provides another person with the right to possess and use an asset for a specific term in return for rentals." The distinctive feature of a financial lease is the presence of a third party supplier selected by the lessee from whom the lessor acquires the asset under a separate supply agreement.

2. Paragraph (c) of the definition of financial lease confirms that the lessee's payments over the term of the lease need not amortise the entire investment of the lessor. Likewise, the preamble to the definition confirms that the lease need not involve an option to purchase. In other words, a financial lease may include an operating lease. This reflects evolving industry practice in which lessees often are interested only in acquiring the benefit of possession and use of the asset for a specified time period.

3. If the lessor re-leases the asset at the end of the term of a financial lease, the re-lease may qualify as a "financial lease" if it satisfies the requirements of paragraphs (a) and (b) of the

definition. The lessor's ability to re-lease the asset in a transaction that qualifies as a financial lease permits the lessor to lower both lessees' rental payments and gives the subsequent lessee the benefit of the of the duties owed to the original lessee under Article 7 of the Law.

4. The requirement in paragraph (b) of the definition that the supplier have knowledge that the lessor is acquiring the asset in connection with "a lease" is satisfied, since knowledge of the identity of the lessee is unnecessary. The requirement in paragraph (a) that the lessee select the supplier is satisfied so long as the lessee knows that the lease involves a re-lease of an asset acquired by the lessor from a supplier for leasing purposes, and knows the identity of the supplier.

Large aircraft equipment means all "aircraft objects" as defined in the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment, signed in Cape Town on 16 November 2001.

Commentary

1. This definition should be read in conjunction with the commentary on paragraph 2 of Article 3.

Lease means a transaction in which one person provides another person with the right to possess and use an asset for a specific term in return for rentals. The term includes a sub-lease.

Commentary

1. This definition should be read in conjunction with the commentary on the definitions of "asset" and "financial lease."

Lessee means a person who acquires the right to possess and use an asset under a lease. The term includes a sub-lessee.

Commentary

1. In reading this definition, account should be taken of the definition of "asset" which requires that the lessee acquire the asset primarily for business purposes in order for the lease to come within the sphere of application of the Law.

Lessor means a person who provides another person with the right to possess and use an asset under a lease. The term includes a sub-lessor.

Commentary

1. Lessor is defined to mean "any person" who enters into a lease. Accordingly, the lessor need not be engaged exclusively or primarily in the business of leasing. For example, the lessor may be a dealer who also sells assets of the type subject to the lease.

2. Article 2 defines "person" to mean any legal entity or individual, and defines "supplier" to mean "a person" from whom a lessor acquires the asset for lease in a financial lease. Accordingly, the fact that the lessor is a subsidiary of, or otherwise closely affiliated with the supplier does not affect the status of the lessor as long as it is a distinct legal entity or individual.

Person means any legal, private or public entity or an individual.*Commentary*

1. The definition of “person” does not address what constitutes a “legal” entity. This is left to be determined by the general law of persons for each enacting State.
2. The term “person” is used in the definitions of lessee, lessor, and supplier and reference should be made to the Commentary on the definitions of these terms.

Supplier means a person from whom a lessor acquires the asset for lease under a financial lease. Supply agreement means an agreement under which a lessor acquires the asset for lease under a financial lease.*Commentary*

1. These definitions should be read in conjunction with the commentary on Article 7 and on the definition of financial lease in Article 2.

Article 3 – Other laws**1. This Law does not apply to a lease that functions as a security right.****2. This law shall not apply to a lease or a supply agreement for large aircraft equipment unless the lessor, the lessee and the supplier have otherwise agreed in writing.***Commentary*

1. Some States regulate financial leases within the legal regime that applies to conventional security rights on the theory that they are functionally equivalent transactions from a financing perspective. Accordingly, Article 3(1) excludes “a lease that functions as a security right” from the sphere of application of the Model Law.
2. The UNCITRAL Legislative Guide adopts a functional approach to the concept of a security right. Security right is defined to mean a property right in a movable asset that is created by agreement and secures payment or other performance of an obligation, regardless of whether the parties have denominated the agreement as a security agreement or the transaction creating the right as a security agreement. Under this approach, a financial lease would be treated as a security right under the Guide.
3. The Guide also recognises an alternative concept of “financial lease right” for States that elect to adopt a non-unitary approach to transactions aimed at financing the acquisition of a particular asset. A financial lease would also fall within the Guide in States that adopt this approach.
4. It is hoped that States will adopt both the Model Law and legislation based on the UNCITRAL Legislative Guide. In States that do so, Article 3(1) makes it clear that a financial lease involving movable assets, both tangible and intangible, falls outside the scope of this Model Law on leases, and falls within the scope of the law governing security interests.
5. Article 3(2) provides that large aircraft equipment of the type covered by the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment, adopted in Cape Town in 2001 (i.e. airframes, aircraft engines and helicopters of a certain size) are

excluded from the sphere of application of the Law, unless the lessor, the lessee and the supplier otherwise agree in writing. The words "unless the lessor, the lessee and the supplier otherwise agree in writing" means "unless and to the extent" so that these three parties could agree on partial application. This exclusion removes a potential source of conflict between the Law and the Convention on International Interests in Mobile Equipment.

Article 4 – Interpretation

1. In the interpretation of this Law, regard is to be had to its international origin and to the need to promote uniformity in its application and the observance of good faith.

2. Questions concerning matters governed by this Law which are not expressly settled in it are to be settled in conformity with the general principles on which this Law is based.

Commentary

1. Paragraph 1 of Article 4 reflects a longstanding rule of interpretation in international instruments aimed at encouraging courts to consider the jurisprudence and doctrine of other States where they share a common instrument so as to promote uniformity. Clearly this interpretation rule does not apply to State-specific modifications to the Model Law.

2. Paragraph 2 is also a common rule of interpretation in international instruments aimed at ensuring that minor gaps and ambiguities in the text do not become a conduit for introducing broader national law variations. Accordingly, questions not explicitly settled in the Law are to be settled in conformity with its general principles. This rule of interpretation only applies to subject areas addressed by the Law. It is not a licence to create new explicit rules on subject areas on which the Law is silent.

Article 5 – Freedom of contract

Except as provided in Articles 7(4) and 22(3) and the law of [this State], the lessor and the lessee may derogate from or vary the effect of this Law and are free to determine the content of a lease.

Commentary

1. Article 5 endorses the principle of party autonomy in leases. Accordingly, the provisions of the Law are subject to, and may be varied by agreement between the lessor and the lessee. This enables the parties to organise relations between themselves in accordance with their particular concerns while still being in conformity with the Law.

2. Article 5 recognises two specific exceptions to the parties' freedom of contract: Article 7 (concerning the supply agreement between the lessor and supplier) and Article 22 (concerning agreements on liquidated damages).

3. Article 7 recognises that it is the lessee on whose behalf the supply agreement between the lessor and lessee is entered into. Accordingly, it places the lessee in the same legal position against the supplier that it would have been in had it contracted directly with the supplier while also relieving the lessor of the duties of the supplier vis-à-vis the lessee. In order to avoid upsetting this outcome – which is in the interests of all three parties - Article 7 provides that they may not derogate from Articles 7(1), (2) and (3) (paragraph 4).

4. Article 22 empowers the parties to agree to a specified sum of liquidated damages in the event of default. However, the agreed sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the default. The parties cannot derogate in their lease from this consequence. Making this provision mandatory ensures that a lessee, who may have less bargaining power in everyday standard form lease transactions, is not exposed to broader financial ruin as a result of breaching a lease agreement that causes a real loss for the lessor that is grossly disproportionate to the agreed sum. In theory, however, either party could be the beneficiary of the provision

5. Article 5 also makes the parties' freedom of contract subject to other law of the enacting State (for example, mandatory rules concerning the effects of fraud, legal incapacity and so forth).

CHAPTER II: EFFECTS OF A LEASE

Article 6 – Effectiveness between the parties and as against third parties

Except as otherwise provided in this Law:

- (a) a lease is effective and enforceable according to its terms between the parties; and**
- (b) the rights and remedies of such parties are enforceable against purchasers of the asset and against creditors of the parties, including an insolvency administrator.**

Commentary

1. Paragraph 1 of Article 6 confirms that the lease is effective and enforceable according to its terms between the lessor and lessee. Paragraph 2 provides that the rights and remedies of the parties under the lease are enforceable against purchasers and creditors, including an insolvency administrator.

2. Article 6 applies except "as otherwise provided elsewhere in this law." Other provisions of the Law incorporate exceptions arising under other law of the State, thereby indirectly incorporating exceptions in addition to those set out explicitly in the Law. In particular, the effectiveness of a lease as between the parties under paragraph 1 is subject to the exceptions set out in Article 5, which incorporates exceptions under other law of the enacting State (see the Commentary on Article 5). Similarly, the enforceability of the rights and remedies of the parties against third party creditors is subject, under Article 8, to the priority rights of creditors under other law of the enacting State (see the Commentary on Article 8). In both situations, other law would include, for example, insolvency law.

Article 7 – Lessee under financial lease as beneficiary of supply agreement

1. In a financial lease, the duties of the supplier under the supply agreement shall also be owed to the lessee as if the lessee were a party to that agreement and as if the asset were to be supplied directly to the lessee. The supplier shall not be liable to both the lessor and the lessee in respect of the same damage.

2. At the request of the lessee, the lessor shall assign its rights to enforce the supply agreement to the lessee. If the lessor does not, the lessor is deemed to have assumed the duties of the supplier.

3. The rights of the lessee under this Article with respect to a supply agreement that was approved by the lessee shall not be affected by a variation of any term of such agreement unless consented to by the lessee. If the lessee did not consent to such variation, the lessor is deemed to have assumed the duties of the supplier to the lessee that were so varied to the extent of the variation.

4. The parties may not derogate from or vary the effect of the provisions of paragraphs 1, 2 and 3.

5. Nothing in this Article shall entitle the lessee to negotiate a modification, termination or rescission of the supply agreement without the consent of the lessor.

Commentary

1. *The lessor's function in a financial lease is to provide the financing to enable the lessee to acquire the right to use and possess the asset. Unlike a conventional loan extended directly to a debtor, financing in a financial lease is provided through a two-step indirect process (see the definition of financial lease in Article 1). The lessor first enters into a supply agreement with a supplier specified by the lessee under which it acquires the asset, or at least the right to re-lease the asset, in exchange for an agreed sum. The lessor then seeks to recoup and profit from its investment from the rental payments agreed to by the lessee in exchange for the right to possess and use the asset for the agreed term of the lease.*

2. *In the event that the supplier fails to honour its duties under the supply agreement as they relate to the quality of the asset and the supplier's title to the asset, the real impact will be felt by the lessee whose productive use of the asset is impaired. Without an independent cause of action against the supplier, the lessee is dependent on the willingness of the lessor to commence an action on its behalf. Since the lessee generally is under a duty to continue making rental payments to the lessor after it has accepted the asset, however defective the asset may turn out to be, the lessor does not have the same incentive as the lessee in pursuing the complaint against the supplier.*

3. *Article 7(1) enables the lessee directly to pursue its complaints against the supplier. Article 7 (1) extends the duties owed by the supplier to the lessee to the same extent as if it had been a party to the supply agreement. This gives the lessee a direct right of action against the supplier without the need for co-operation by the lessor. The granting of these rights to the lessee benefits the lessor, since it no longer bears primary responsibility for pursuing action in respect of the lessee's loss.*

4. *Article 7(2) enables the lessee to assume exclusive control over its action against the supplier, excluding the lessor entirely. Article 7(2) places the lessor, at the request of the lessee, under the duty to assign its rights to enforce the supply agreement to the lessee. If the lessor does not accede, the lessor is deemed to have assumed the duties owed by the supplier to the lessee. Acceding to the request of the lessee for an assignment benefits the lessor, since it relieves the lessor from any responsibility to assist the lessee in enforcing the lessee's complaints concerning the asset against the supplier.*

5. *Article 7(3) protects the lessee against a modification of its direct rights against the supplier under Articles 7(1) and 7(2) as a result of an agreement between the supplier and lessor to modify the original supply agreement. If the lessee does not consent to the variation, the lessor is deemed to have assumed the duties of the supplier to the lessee that were so varied to the extent of the variation.*

6. *Articles 7(1), (2) and (3) are mandatory and cannot be varied or derogated from by the parties.*

7. Article 7 does not effect a legal novation. In other words, it does not operate to substitute the lessee for the lessor as the party to the supply agreement. Accordingly, Article 7(5) confirms that a variation of the supply agreement entered into between the lessee and supplier does not affect the rights of the lessor if he has not consented to it. This protects any residual economic interest the lessor has in the capital value of the asset, as where the financial lease is for a limited term at the conclusion of which the lessor intends to resume possession for its own use or for the purposes of a re-lease. In cases where this concern is not present, Article 7(5) confirms that the parties are free to agree to a different regime.

Article 8 – Priority of liens

Except as otherwise provided by the law of [this State]:

(a) a creditor of the lessee and the holder of any interest in land or personal property to which the asset becomes affixed take subject to the rights and remedies of the parties to the lease and cannot impair any interest arising under the lease; and

(b) a creditor of the lessor takes subject to the rights and remedies of the parties to the lease.

Commentary

1. Article 8 should be read in conjunction with the Commentary on Article 6, which provides for the enforceability of the rights and remedies of the lessor and lessee against their creditors, including an insolvency administrator.

2. Article 8 provides rules for determining priority between the rights of the lessor or lessee where a creditor of either obtains a lien or similar right against the leased asset under other law of the State, for example, under the law governing judgment enforcement or insolvency.

3. Under paragraph (a), a creditor of the lessee takes subject to the rights of the parties in the leased object and cannot impair either party's interest under the lease. Accordingly, the creditor cannot impair the lessor's rights in the leased asset or disturb the lessee's rights of possession and use under the lease. Similarly, under paragraph (b), a creditor of the lessor takes subject to the rights of use and possession of the lessee.

Article 9 – Exclusion of liability of the lessor

In a financial lease, the lessor when acting in its capacity of lessor and as owner within the limits of the transaction, as documented under the supply agreement and the lease, shall not be liable to the lessee or third parties for death, personal injury or damage to property caused by the asset or the use of the asset.

Commentary

1. Article 9 excludes the financial lessor from liability for actions taken in the course of performing its duties as lessor and as owner where the lessee or a third party suffers personal or property damage caused by a defect in or use of the leased asset.

2. Article 9, while limiting liability based on the lessor's capacity as lessor or owner, does not exclude liability based on other grounds, i.e. fraudulent acts of the lessor, liability to the State or liability arising under the State's international obligations

3. The rule provided in Article 9 differs from the rule provided in Article 8(1) of the UNIDROIT Convention on International Financial Leasing (Ottawa, 28 May 1988). That provision excludes liability of the lessor in its capacity as lessor but is silent as to liability based on the lessor's capacity as owner. See Article 8(1)(c) of the Ottawa Convention. The rule in Article 9 recognises that, while the lessor in a financial lease is an owner of the asset, the lessor is essentially a conduit between the supplier and the lessee and is protected because its role is limited to financing the leasing transaction.

CHAPTER III: PERFORMANCE

Article 10 – Irrevocability and independence

1. (a) In a financial lease, the duties of the lessor and lessee become irrevocable and independent when the asset subject to the lease has been delivered to and accepted by the lessee.

(b) In a lease other than a financial lease, the lessor and lessee may agree to make any of their duties irrevocable and independent by specifically identifying each duty that is irrevocable and independent.

2. Except as otherwise provided in Article 23(1)(c), a duty that is irrevocable and independent must be performed, regardless of the performance or non-performance of any other party, unless the party to whom the duty is owed terminates the lease.

Commentary

1. Reflecting the financial lessor's limited role as a financier, Article 10(1)(a) makes the parties' duties irrevocable and independent once the asset subject to the lease has been delivered to and accepted by the lessee. Article 10(2) confirms that a duty that is irrevocable and independent must be performed, regardless of performance or non-performance by any other party of its duties, "unless the party to whom the duty is owed terminates the lease."

2. Notwithstanding the termination of the lease by the lessor in accordance with Article 23, the lessee may still owe the lessor duties, including the duties of maintenance and return as set forth in Article 18(2) of the Law, and duties derived from the lessee's default or performance prior to the termination under Article 23(2). Generally, after the delivery and acceptance of an asset subject to a financial lease, the lessor has no continuing duties under the Law.

Article 11 – Risk of loss

1. In a financial lease:

(a) risk of loss passes to the lessee when the lease is entered into; and

(b) when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease and the lessee enforces its remedies under Article 14, the lessee, subject to Article 18(1), may treat the risk of loss as having remained with the supplier.

2. In a lease other than a financial lease, risk of loss is retained by the lessor and does not pass to the lessee.

Commentary

1. Reflecting the financial lessor's limited role as a financier, Article 11(1)(a) provides that the risk of loss with respect to an asset subject to a financial lease passes to the lessee when the lease is entered into. This allocation of risk recognises that the financial lessee is the best person to bear the burden of insuring the asset because it presumptively has the primary economic interest in the capital value of the asset. The presumption is the converse in the case of a lease that is not a financial lease. Accordingly, the lessor retains the risk of loss under Article 11(2).

2. Article 11(1)(b) provides an exception, in the case of a financial lease, where, after the lease has been entered into, an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, and the lessee enforces its remedies under Article 14. The lessee may, subject to Article 18(1), treat the risk of loss as having remained with the supplier.

Article 12 – Damage to the asset

1. In a financial lease, when an asset subject to a lease is damaged without fault of the lessee or lessor before the asset is delivered to the lessee, the lessee may demand inspection and either accept the asset with due compensation from the supplier for the loss in value or seek such other remedies as are provided by law.

2. In a lease other than a financial lease, when an asset subject to a lease is damaged without fault of the lessee or lessor before the asset is delivered to the lessee,

(a) if the loss is total, the lease is terminated; and

(b) if the loss is partial, the lessee may demand inspection and either treat the lease as terminated or accept the asset with due allowance from the rentals payable for the balance of the lease term for the loss in value but without further right against the lessor.

Commentary

1. Article 12 provides rules to govern the circumstance in which an asset is lost or damaged without fault of the lessee or of the lessor before it is delivered to the lessee.

2. If the lease is a financial lease, Article 12(1) provides that the lessee may demand inspection and either accept the asset with due compensation from the supplier for the loss in value or seek such other remedies as are provided by other law. Article 12 is subject to the principle of freedom of contract in Article 5. Accordingly, when a lessee accepts a damaged asset with due compensation from the supplier for the loss in value, Article 12 does not prevent the lessee and the lessor from agreeing that such compensation is to be remitted to the lessor and applied to reduce the rentals owed.

3. If the lease is not a financial lease, Article 12(2) provides that the lessee may terminate the lease if the loss is total. In the case of partial loss, the lessee may elect either to terminate the lease or accept the lease with due compensation for the loss from the lessor.

4. The lessee cannot terminate the lease once the asset has been delivered and accepted, even if the equipment does not operate as a result of the damage. See Articles 10(1)(a), 14, and 23(1)(b) of this Law. Its remedy is limited to damages: see Article 13.

Article 13 – Acceptance

1. Acceptance of an asset occurs when the lessee signifies to the lessor or supplier that the asset conforms to the agreement, fails to reject the asset after a reasonable opportunity to inspect it or uses the asset.

2. After a lessee has accepted an asset,

(a) in a financial lease, the lessee is entitled to damages from the supplier if the asset does not conform to the supply agreement; and

(b) in a lease other than a financial lease, the lessee is entitled to damages from the lessor if the asset does not conform to the lease.

Commentary

1. Article 13 identifies the circumstances that denote acceptance of an asset by the lessee, as well as, in conjunction with Articles 10 and 14, the consequences of acceptance. The lessee's acceptance of the asset may have additional consequences under other laws of an enacting State, such as the law of sales.

2. After a lessee has accepted an asset, the lessee is entitled to damages from the supplier, in the case of a financial lease, and from the lessor in the case of a lease other than a financial lease. Article 13 is subject to the principle of freedom of contract in Article 5. Accordingly, when a lessee is entitled to damages for a non-conforming asset, Article 13 does not prevent the lessee and the lessor from agreeing that the compensation is to be remitted to the lessor and applied to reduce the rentals owed.

Article 14 – Remedies

1. In a financial lease, when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee may demand a conforming asset from the supplier and seek such other remedies as are provided by law.

2. (a) In a lease other than a financial lease, when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee has the right to accept the asset, to reject the asset or, subject to this paragraph and Article 23, to terminate the lease. Notice of rejection or termination must be given by the lessee within a reasonable time after the non-conforming delivery.

(b) In a lease other than a financial lease, once a lessee has accepted the asset, the lessee may reject the asset under the preceding sub-paragraph only if the non-conformity substantially impairs the value of the asset and either

(i) the lessee accepted the asset without knowledge of the non-conformity, owing to the difficulty of discovering it, or

(ii) the acceptance by the lessee was induced by the assurances of the lessor.

(c) In a lease other than a financial lease, when the lessee rejects an asset in accordance with this Law or the lease, the lessee is entitled to withhold rentals until the non-conforming delivery has been remedied and to recover any rentals and other funds paid in advance, less a reasonable sum corresponding to any benefit the lessee has derived from the asset.

(d) If the lessee rejects an asset in accordance with paragraph 2 and the time for performance has not expired, the lessor or supplier has the right to remedy its failure within the agreed time.

Commentary

1. Article 14 provides rules on the lessee's remedies when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the leasing agreement.

2. In a financial lease, the lessee is entitled under Article 14(1) to demand a conforming asset from the supplier and to seek such other remedies as are provided by law. Article 14(1) should be read in conjunction with Article 7, which gives the lessee the right directly to pursue the supplier for breach of the duties owed by the supplier to the lessor in relation to the quality and conformity of the asset.

3. In a non-financial lease, the equivalent duties are owed by the lessor to the lessee and the lessee is accordingly entitled to the diversity of remedies set forth in Articles 14(2)-(4)..

Article 15 – Transfer of rights and duties

1. (a) (i) The rights of the lessor under the lease may be transferred without the consent of the lessee.

(ii) The lessor and lessee may agree that the lessee shall not raise against a transferee any of its defences or rights of set-off against the lessor other than those arising from the incapacity of the lessee.

(iii) Nothing in this sub-paragraph shall affect the lessee's ability to assert its rights against the lessor.

(b) The duties of the lessor under the lease may be transferred only with the consent of the lessee, which may not be unreasonably withheld.

2. The rights and duties of the lessee under the lease may be transferred only with the consent of the lessor, which may not be unreasonably withheld, and subject to the rights of third parties.

3. The lessee, lessor and third parties may consent to such transfers in advance.

Commentary

1. Article 15(1) entitles the lessor to transfer its rights against the lessee without the consent of the lessee. This enables the lessor to use the stream of rental payments owing by the lessee to finance its own capital needs, including, for example, by granting a security right in its payment rights against the lessee. This approach is in line with other international instruments, such as the United Nations Convention on the Assignment of Receivables in International Trade.

2. Article 15 does not affect the right of the lessee to raise against the transferee any defences and rights of set-off it may have against the lessor under other law. However, it explicitly permits the parties to agree that the lessee will not assert against a transferee defences or rights of set-off it has against the lessor except for defences arising from the lessee's lack of legal capacity under other law.

3. Article 15 also provides for the transfer of the lessee's rights and the transfer of both parties' duties, but only with the consent of the other party, which consent may be given in advance and may not reasonably be withheld.

Article 16 – Warranty of quiet possession

1. In a financial lease:

(a) the lessor warrants that the quiet possession of the lessee 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 a court, where such title, right or claim derives from a negligent or intentional act or omission of the lessor; and

(b) a lessee that furnishes specifications to a lessor or a supplier shall hold the lessor and the supplier harmless against any claim of infringement that arises out of compliance with the specifications.

2. In a lease other than a financial lease, the lessor warrants that the quiet possession of the lessee will not be disturbed by a person who has a superior title or right, who claims a superior title or right and acts under the authority of a court or who makes a claim by way of infringement.

3. Except as otherwise provided by Article 23(1)(c), the sole remedy for a disturbance of the quiet possession of the lessee under sub-paragraph (a) of paragraph 1 and under paragraph 2 is an action for damages against the lessor.

Commentary

1 Article 16 provides that the lessor warrants that the quiet possession of the lessee will not be disturbed by a person who has or claims a superior title or right to the asset or acts under the authority of a court.

2. In a financial lease, the lessor's warranty is limited to a disturbance of quiet possession by a third party whose superior title, right or claim derives from a negligent or intentional act or omission of the lessor (compare Articles 16(1)(a) and 16(2)). This limitation recognises that in a financial lease the lessee is responsible for the selection of the supplier and therefore bears the responsibility to ascertain the quality of the supplier's rights in the leased asset.

3. Article 16(1)(b) confirms that a lessee that furnishes specifications to a lessor or a supplier shall hold the lessor and the supplier harmless against any claim of infringement that arises out of its compliance with the specifications. In a lease other than a financial lease, the lessee naturally warrants to the lessor and the supplier that its quiet possession will not be disturbed by any claim of infringement; on the other hand, in the case of a lease covered by Article 16(2) this warranty will be given by the lessor.

4. The lessor's warranty of quiet possession does not interfere with any right of an owner or any other holder of a superior interest to take possession of the asset subject to the lease. Article 16(2) entitles the lessee to claim damages from the lessor for disturbance of its possession. In the event of "a fundamental default" by the lessor in respect of the warranty of quiet possession under a financial lease, the lessee may also terminate the lease (Article 23(1)(c)).

Article 17 – Warranty of acceptability and fitness for purpose

1. In a financial lease, the supplier warrants that the asset will be at least such as is accepted in the trade under the description in the lease and is fit for the ordinary purposes for which an asset of that description is used. Subject to Article 7(2), the warranty is enforceable only against the supplier.

2. In a lease other than a financial lease, the lessor warrants that the asset will be at least such as is accepted in the trade under the description in the lease and is fit for the ordinary purposes for which an asset of that description is used if the lessor regularly deals in assets of that kind.

Commentary

1. Article 17(2) provides that, in a financial lease, a supplier warrants that the asset being leased conforms to what is accepted in the trade and is fit for its ordinary purposes. The warranty is enforceable by the lessee only as against the supplier unless the financial lessor is deemed to assume the supplier's duties by reason of a refusal to assign its rights under the supply agreement to the lessee under Article 7(2).

2. In a lease other than a financial lease, the lessor has the same warranty obligation as a supplier provided the lessor regularly deals in assets of the kind subject to the lease and can therefore be expected to have specialised knowledge about the expectations of the trade. Unlike a supplier, this cannot be presumed in the case of a non-financial-lease, which may sometimes involve a discreet leasing arrangement for a specific asset.

Article 18 – Duties of the lessee to maintain and return the asset

1. (a) The lessee shall take proper care of the asset, use the asset reasonably in the light of the manner in which such assets are ordinarily used and keep the asset in the condition in which it was delivered, subject to fair wear and tear.

(b) When a lease sets forth a duty to maintain the asset or the manufacturer or supplier of the asset issues technical instructions for the use of the asset, the compliance by the lessee with such agreement or instructions shall satisfy the requirements of the preceding sub-paragraph.

2. When the lease comes to an end or is terminated, the lessee, unless exercising a right to buy the asset or to hold the asset on lease for a further period, shall return the asset to the lessor in the condition specified in the preceding paragraph.

Commentary

1. Article 18(1)(a) specifies the standard of care required of the lessee in relation to its use and maintenance of the asset. The lessee is considered, under Article 18(1)(b), to have satisfied the required standard of care if it complies with a duty to maintain the asset set out in the lease or with technical instructions for the use of the asset issued by the manufacturer or supplier.

2. Article 18(1)(b) applies only to the extent that the lease or instructions specifically address the issue. If something occurs that is not contemplated in the lease or the instructions, the lessee is still liable for failure to satisfy the standard of care set out in Article 18(1)(a).

3. On termination of the lease, Article 18(3) places the lessee under the duty of returning the asset in a condition consistent with the lessee's exercise of the standard of care required by Article 18(1).

CHAPTER IV – DEFAULT AND TERMINATION

Article 19 – Definition of default

1. The parties may agree to the events that constitute a default or otherwise give rise to the rights and remedies specified in this Chapter.

2. In the absence of agreement, default for the purposes of this Law occurs when one party fails to perform a duty arising under the lease or this Law.

Commentary

1. Under Article 19(1) the parties may agree on the events that constitute a default; Article 19(2) provides a default definition in the absence of agreement.

2. Article 19 does not address whether a particular default is fundamental. "Fundamental default" is discussed in the Commentary on Article 23.

Furthermore, Article 5 authorises the parties to agree on what they consider to amount to "fundamental default".

Article 20 – Notices

An aggrieved party shall give a defaulting party notice of default, notice of enforcement, notice of termination and a reasonable opportunity to cure.

Commentary

1. Article 20 recognises the duty of an aggrieved party to give notice of default, enforcement action or termination to the other party and to provide the other party with a reasonable opportunity to cure its default.

2. Whether notice is adequate is governed by other law of the State. Article 1.10(1) of the UNIDROIT Principles of International Commercial Contracts provides that, where notice is required, it may be given by any means appropriate under the circumstances. Article 1.10(2)-(3) of those Principles provide that a notice is effective when it reaches the person to whom it is given, whether by being given to that person orally or delivered at that person's place of business or mailing address.

3. Whether the opportunity to cure is reasonable is determined by other law of the State. Under Article 7.1.4 of the UNIDROIT Principles of International Commercial Contracts, the right to cure is not precluded by notice of termination. The cure must be permitted when the cure is accompanied by notice, given without undue delay, from the defaulting party indicating the proposed manner and timing of the cure; the cure is appropriate in the circumstances; the aggrieved party has no legitimate interest in refusing cure; and the cure is effected promptly.

Article 21 – Damages

Upon default, the aggrieved party is entitled to recover such damages as will, exclusively or in combination with other remedies provided by this Law or the lease, place the aggrieved party in the position in which it would have been had the agreement been performed in accordance with its terms.

Commentary

1. Article 21 entitles an aggrieved party to recover damages in an amount sufficient to place it in the position it would have been in the absence of default.

2. The damages standard in Article 21 can be displaced by an agreement providing for liquidated damages as contemplated by Article 22.

Article 22 – Liquidated damages

1. When the lease provides that a defaulting party is to pay to the aggrieved party a specified sum or a sum computed in a specified manner for such default, the aggrieved party is entitled to such sum.

2. Such sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the default.

3. The parties may not derogate from or vary the effect of the provisions of this Article.

Commentary

1. Article 22(1) permits the parties to agree to a liquidated damages sum for any default. Article 22(2) provides that if the agreed amount is “grossly excessive” in relation to the harm resulting from the default it may be reduced to a reasonable amount. In the normal course, determination of whether a reduction is warranted would be decided by an application to the court or other tribunal that has jurisdiction over the disputes arising under the lease pursuant to other law of the State.

2. Article 22(2) is not subject to the principle of freedom of contract in Article 5. Accordingly, the sum agreed to by the parties is not subject to reduction merely because it exceeds the loss actually suffered; it must be grossly excessive. This recognises that agreements on compensation fulfil the dual functions of compensating the aggrieved party for its loss and deterring parties from breaching their agreements by adding a penalty for breach. This also ensures greater certainty and predictability in the enforceability of such agreements while still protecting the lessee from general financial ruin where the sum agreed to is grossly in excess of the lessor’s actual loss..

Article 23 – Termination

1. (a) Subject to sub-paragraph (b), a lease may be terminated by operation of law, by operation of Article 12, by agreement of the parties or by an aggrieved party upon fundamental default by the lessee or lessor.

(b) Except as otherwise provided in sub-paragraph (c), after the asset subject to the lease has been delivered to and accepted by the lessee, the lessee in a financial lease may not terminate the lease upon fundamental default by the lessor or the supplier but is entitled to such other remedies as are provided by the agreement of the parties and by law.

(c) In the event of a fundamental default by the lessor in respect of the warranty of quiet possession referred to in Article 16, the lessee in a financial lease may terminate the lease.

2. Subject to Article 10, on termination all duties under the lease that are executory on both sides, except for duties intended to take effect upon termination, are discharged but any right based on prior default or performance survives.

Commentary

1. Article 23(1)(a) addresses the events which may bring about a termination of a lease. These include where the lease is terminated by operation of law, including by operation of Article 12 or by agreement of the parties. In addition, a lessor or lessee may unilaterally terminate a lease upon fundamental default by the other party. Under Article 12(2), termination discharges all the parties' future duties but does not discharge any right based on prior default or performance.

2. Article 23(1)(b) excludes an aggrieved party's right of termination for a fundamental breach of a financial lease that occurs after the asset has been delivered to and accepted by the lessee. Although the lessee may no longer terminate the lease, it is entitled to such other remedies as are provided by the agreement of the parties and by law.

3. Article 23(1)(b) is subject to Article 23(1)(c), which preserves the lessee's right of termination, even after delivery and acceptance, for a fundamental breach of the warranty of quiet possession referred to in Article 16.

4. Under Article 7.3.1 of the UNIDROIT Principles of International Commercial Contracts, whether a default amounts to a fundamental default shall be determined with regard to whether (a) the default substantially deprives the aggrieved party of what it was entitled to expect under the agreement unless the other party did not foresee and could not reasonably have foreseen such result; (b) strict compliance with the duty that has not been performed is of essence under the agreement; (c) the default is intentional or reckless; (d) the default gives the aggrieved party reason to believe that it cannot rely on the other party's future performance; and (e) the defaulting party will suffer disproportionate loss as a result of the preparation or performance of the agreement is terminated.

5. Article 23 is subject to the principle of freedom of contract.

Article 24 – Possession and disposition

After the lease comes to an end or is terminated, the lessor has the right to take possession of the asset and the right to dispose of the asset.

Commentary

1. Article 24 provides that the lessor has the right to take possession of the leased asset at the end of the lease. Article 24 should be read in conjunction with Article 18, which places the lessee under the duty to return the asset on termination of the lease.

2. The means by which a lessor may take possession of an asset is left to be determined by other law of the State.