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Financial Leasing and its Unification by UNIDROIT
Le crédit-bail financier et son unification par UNIDROIT

Financial Leasing and its Unification by UNIDROIT – General Report

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I. – INTRODUCTION

In the history of the Academy and its International Congress of Comparative Law, this is in all likelihood the first time that one of its topics is not phrased as the programme of an inquiry into the differences and similarities of a certain area of the law in a number of jurisdictions. Rather, the Academy's executive has tasked the National Reporters and the General Reporter with analysing the achievements of an intergovernmental Organisation pursuant to its mandate of harmonising the law in an area which the Organisation's Member States' Governments [1] have identified as one where harmonisation is

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This contribution is the final version of the general report on leasing and its harmonisation by UNIDROIT submitted to the XVIII[th] International Congress of the International Academy of Comparative Law, held at Washington (United States of America) from 25 to 31 July 2010. The General Reports on all topics discussed at that Congress will be published by the International Academy of Comparative Law, Karen Brown and David Snyder (Eds.), Springer (Heidelberg / New York) 2011. The *UNIDROIT Model Law on Leasing*, adopted on 13 November 2008 is accessible in its official English and French versions at <http://www.unidroit.org>).

1 At the time of writing, there are 63 Member States: Argentina, Australia, Austria, Belgium, Bolivia, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Holy See, Hungary, India, Indonesia, Iran, Iraq, Ireland, Israel, Italy, Japan, Latvia, Lithuania, Luxembourg, Malta, Mexico,

particularly desirable. Indeed, investing part of the exceedingly limited resources of the Institute over more than two decades in work on various instruments designed, *inter alia,* to promote standards for both modern sophisticated asset-based financing and basic leasing transactions shows remarkable determination – or missionary zeal –, in particular if one takes into consideration that other intergovernmental Organisations,[2] during overlapping periods of time, have also carried out substantial and related work.

An interesting feature of the reports on leasing is the change of perspective: while we are used to taking a comparative law study basis and point of departure for any work aimed at modernising commercial law in an internationally co-ordinated and harmonising fashion, to this writer's knowledge there has so far never been an effort systematically to look into the harmonising effect – both conscious and unconscious, intended and *de facto* – of transnational commercial law [3] instruments in domestic law. With respect to the method employed as well as the findings, it should be noted that not always will it be possible to establish a clear link of causation between the state of the law in a given jurisdiction and its having been the subject of studies and/or intergovernmental discussion, negotiation and, eventually, adoption of an international instrument. This is particularly true of the earliest and the most recent of the documents we will examine, *i.e.*, the 1988 Ottawa Convention and the 2008 Model Law.

Taking all that into account, this General Report – as well as a number of the National Reports on which it is based –, while complying with the Academy's instruction to focus on work carried out by UNIDROIT, will attempt to provide an analysis of the state of the law of financial leasing as it has developed since the mid-1980s both domestically and at the level of transnational commercial law instruments.

II. – RELEVANT UNIDROIT INSTRUMENTS

To date, five instruments on leasing have been elaborated under the auspices of the International Institute for the Unification of Private Law, better known

The Netherlands, Nicaragua, Nigeria, Norway, Pakistan, Paraguay, Poland, Portugal, Republic of Korea, Republic of Serbia, Romania, Russian Federation, San Marino, Saudi Arabia, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, United Kingdom of Great Britain and Northern Ireland, United States of America, Uruguay, Venezuela.

2 *See infra* VIII.

3 For an extensive discussion of this concept, see Roy GOODE / Herbert KRONKE / Ewan MCKENDRICK, *Transnational Commercial Law. Text, Cases, and Materials* (2007), 1.37-1.67.

under its French short-hand name of UNIDROIT:[4] The *UNIDROIT Convention on International Financial Leasing* (Ottawa, 28 May 1988); the *Convention on International Interests in Mobile Equipment* (Cape Town, 16 November 2001); the *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (Cape Town, 16 November 2001); the *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock* (Luxembourg, 23 February 2007); and the *Model Law on Leasing* (Rome, 13 November 2008).

A third industry-specific protocol to the Cape Town Convention, the draft Protocol on Matters Specific to Space Assets, is still being negotiated and is expected to be adopted in 2011 or 2012.

While there is a certain logic in the history and sequence of the instruments, the underlying policies and strategic objectives pursued by member State Governments were – and are – varying, as will be shown in more detail below. Consequently, even basic features, such as definitions and the respective scope of application, are not necessarily and entirely consistent. Rather, each instrument reflects its own policies, as cast by negotiating Governments, industry as well as other private-sector stakeholders and advisers at the time when that particular step was made.

Turning to the statistics reflecting Governments' involvement in the elaboration of the various instruments, there is a clear increase of tangible interest. Whereas roughly a third of the (then existing) States on which reports were submitted did not participate in the diplomatic Conference for the adoption of the 1988 Ottawa Convention, almost all of them were represented in Cape Town in 2001 and/or in Luxembourg in 2007 as well as at (at least) one of the sessions of any of the three bodies involved in the preparation and adoption of the 2008 Model Law.[5]

III. – NATIONAL REPORTS

At the time of the Congress, of 21 National Reports that had been announced through the National Committees, 14 had been submitted [6] and two more

4 All instruments, including the *travaux préparatoires*, continually up-dated information of their respective status, commentary, bibliography, etc. are accessible at <www.unidroit.org>.

5 *I.e.*, initially the Advisory Board, followed by two sessions of a Committee of governmental experts, and, for the instrument's adoption, a joint session of the General Assembly and the Committee of governmental experts.

6 Belgium, Canada (common-law provinces), China, Croatia, France, Greece, Netherlands, Norway, Peru, Poland, Portugal, Slovenia, Turkey, United States of America. In

were envisaged to be submitted subsequently.[7] Two National Reports (for Canada and the United States of America) cover what modern private-law treaties define as 'Multi-unit States', *i.e.*, States within which two or more territorial units of that State, or both the State and one or more of its territorial units, have their own rules of law in respect of any of the issues falling within the substantive scope of the instrument. Article 52(1) of the Cape Town Convention and Article XXIX of the Aircraft Protocol refer to "territorial units [of a Contracting State] in which different systems of law are applicable in relation to matters dealt with in this Convention." This provision was specifically drafted with a view to encompassing also the People's Republic of China and its Special Administrative Regions.[8] Under Article XXIX, the Chinese Government lodged a declaration that "unless otherwise notified by the Government of the People's Republic of China, the Convention and the Protocol shall not apply to the Hong Kong Special Administrative Region and the Macao Special Administrative Region." The National Report also does not cover those territorial units.

The General Reporter had circulated a rather detailed questionnaire, but National Reporters were free to either answer the questions and comment on issues raised or to submit a classic learned article. Some chose the former, others opted for the latter format; others still invented hybrid forms of reporting. As regards the questionnaire, a number of questions may have been relevant for a limited number of jurisdictions and were addressed only by a small number of National Reporters. On the other hand, not all National Reporters included all relevant UNIDROIT instruments in their analysis. In both instances, the present writer took the liberty of filling gaps and leaving white spots according to otherwise available – or unavailable – sources. Finally, it will not escape the sharp observer's attention that the General Report in rare instances "overrules" a National Report where insider knowledge gained during the General Reporter's time at UNIDROIT is more precise. For example, a National Reporter may not be aware of his or her Government's actual

addition, statistics and other illustrative material on certain developments in Latin America as a region were provided.

7 Italy and Canada (Quebec). There was, moreover, hope that a report on Germany could be submitted. Some National Reports had been published at the time of the Congress in collections under the auspices of the National Committees.

8 Comments on (1) "Designated Entry Points" Article (2) "Territorial Units" Article (Presented by China, DCME Doc No 27, 24/10/01, in *Diplomatic Conference to Adopt a Mobile Equipment and an Aircraft Protocol. Acts and Proceedings* (2006), 172.

involvement in the negotiation of one of the relevant instruments and his or her respective inaccurate information therefore required to be rectified.

IV. – BASIC NOTIONS AND DISTINCTIONS

A. Finance lease

The law of twelve out of fifteen countries [9] on which reports were received draws a distinction between "true lease" or "operating lease", on the one hand, and "finance lease", on the other hand. In the case of an operating lease the lessor (owner of the asset) contracts with the lessee, granting possession for a specified period of time; the lessee acquires no property interest in the asset other than a right of possession and a right of use. This type of transaction is generally used where the lessee's objective is to have a right of use in relatively new equipment without incurring the expense of the full purchase price, and where the lessor's calculation is to have its own investment in the purchase price plus amortisation plus profit margin covered by the aggregate rental payments, frequently paid for a number of lease periods by a number of lessees.

A "finance lease", on the other hand is, according to this widely adopted categorisation, a tri-partite relationship between lessor and lessee, who are the parties to a lease contract, and lessor and supplier, who are the parties to a sales contract. Chronologically and functionally, the tri-partite relationship evolves in four stages: (1) the lessee selects the supplier (manufacturer or distributor of the goods) and the equipment according to its requirements; (2) the lessee thereafter enters into a lease contract with the lessor (a specialised leasing company or other financial institution) for that piece of equipment from that supplier; (3) the lessor enters into a sales contract with the supplier, acquiring the asset selected by the lessee; (4) the supplier delivers the equipment to the lessee. Typically, the lease term is equal – or almost equal – to the (assumed) useful economic life, and the lessor does not normally expect the return of the property. At this point it is important to note that, for the purposes of categorising the type of transaction, in certain jurisdictions the lessee's end-of-lease term options and/or obligations are critical.

Canada, where the courts refuse to adopt any bright-line test, favouring instead a "substance test" by looking at the totality of the circumstances, is a particularly clear illustration. If the lessee has an *obligation* to purchase the

9 The term "country" – rather than "jurisdiction" – is deliberately used with a view to including multi-unit States.

leased property at the end of the lease period, this is taken as a strong indication that it is a security lease. In the same vein, if there is an *option* to purchase the leased property at the end of the lease period and if the option is to be exercised at less than fair market value at the time – in other words, an incentive offered only to the lessee and not to other market participants –, this can be taken as the lessee "building equity" (an exquisite metaphor) in the asset, and therefore this speaks in favour of a security lease.

French law, as well as other continental European systems and Chinese law, take the "true lease" (*louage, location, bail; Miete* in German; *huur* in Dutch, etc.), as provided for in the great 19th century civil codes, firmly as the point of departure and nucleus of any leasing transaction. A "finance lease" (*crédit-bail*), where other elements such as the lessor's mandate to enter into a contract with the supplier and the supply contract are grouped around that nucleus is, according to French law, characterised by an end-of-term obligation incumbent on the lessor: the mandatory unilateral undertaking to sell to the lessee at the end of the lease period. Moreover, since the aggregate value of the rentals includes more than the value of the right of use, namely part of the amortisation and the lessor's profit margin, French law and its civilian/continental siblings do recognise that the essential function of the *crédit-bail* is that of a financing transaction rather than a mere grant of possession and a right of use for a period of time.

The National Report for the United States highlights the importance of even the slightest variations of terminology and, at the same time, the efforts that parties to a transaction may invest in arranging it so as to be a (true) lease for one purpose but not for another. Commercial law, tax law and accounting rules seem to be developing in opposite directions. A "finance lease", a term of art, is a true lease (!) in which the lessor and the supplier are separate and only the supplier, not the lessor, has responsibility to the lessee for conformity (quality, absence of defects, performance, etc.) of the goods.[10] In this connection, the National Report emphasises that, "financing lease" and "financial lease" are – unlike "finance lease" – *not* terms of art in commercial law, that they are broader and that both the legislative history of the Bankruptcy Reform Act of 1978 and subsequent case law suggest that they refer to a "disguised security interest, as opposed to a true lease." The reporter recommends that the term "financing lease" be avoided altogether for commercial law purposes, while conceding that it cannot be avoided when discussing U.S. accounting rules.

10 U.C.C. § 2 A-103(1)(g).

It follows that another distinction has to be made, and that is between a true lease (including a finance lease) and a security interest. Section 1-203 of the U.C.C. defines the true lease by establishing that a "transaction in the form of a lease" is not a true lease but a disguised security interest if (a) it is not subject to termination by the lessee and (b) at least one of four listed situations is present. These are (i) that the original term of the lease equals or exceeds the remaining economic life of the asset, (ii) that the lessee is bound to renew for the remaining economic life or to become the owner of the asset, (iii) that the lessee may renew for the remaining economic life for no or nominal additional payment, and (iv) that the lessee may become the owner at the end of the lease term for no or nominal additional payment. However, the courts have held that, even if none of these four criteria is met, the transaction may be characterised as a disguised security interest if the lessor has no reasonable expectation of a meaningful residual value in the goods.

Apart from the fact that using the terms "finance lease" and "financial lease" interchangeably has become common in particular in transnational commercial law instruments,[11] whereas greater precision is required with respect to jurisdictions such as France and the United States, this brief discussion of the most basic notions permits three statements. First, the distinction of true leases and finance leases as well as the criteria for drawing the line between them are almost universally accepted. Second, it is generally accepted that certain types of finance lease serve similar functions as secured transactions. Third, the degree to which the finance lease's roots in the true (or simple, or traditional) lease entails the applicability of common-law rules or legislative rules governing true leases varies. Canadian law seems to be least inclined to follow tradition and most determined to adopt a functional approach.

B. Commercial transactions

Starting in the early 1970s, courts, legislators and legal writers increasingly paid attention to the phenomenon of structural imbalances that typically characterised contracts between large corporations and other businesses and less knowledgeable, less informed individuals with inferior bargaining power (the "weaker party"). Legal systems throughout Western Europe and North America responded in different ways, one being the development of special rules ("consumer contract law") designed to remedy certain undesirable

11 Obviously, what may appear as sloppy drafting is irrelevant for legal systems in all non-English-speaking countries.

consequences of those imbalances. Businesses that contracted with consumers were required to provide more, and more detailed, information about goods and services they offered, consumers were given specific rights to terminate contracts, demand replacement of non-conforming goods, or claim damages if those duties had not been complied with, etc. For this reason and in view of the international instruments tending to address only commercial transactions, the General Reporter's questionnaire inquired whether legislation or judge-made law in the relevant jurisdiction distinguished between commercial/professional leasing transactions and consumer transactions. It appears from the National Reports that this distinction is actually made in the vast majority of legal systems. All EC/EU Member States have implemented Directives 87/102/EEC and 2008/48/EC which lead to a special regimen at least for the purposes of those instruments. Only the report for the People's Republic of China states that – except for the purposes of standard-terms scrutiny – no such distinction is made. It has to be borne in mind that until 1999, when the new and unitary Contract Law, which regulates financial leasing as a distinct type of lease, entered into force, Chinese contract law distinguished according to the social and economic status of the contracting partners [12] and that the legislator in all likelihood rated the uniformity achieved higher than any considerations labelled as "consumerism". Anyway, the use of financing leases as a means to provide credit to consumers is (or at least until recently was) probably not as economically relevant as in other jurisdictions.

V. – THE 1988 OTTAWA CONVENTION

A. Scope

The Ottawa Convention applies, as its title indicates, only to *international* transactions. The internationality requirement and the relevant connecting factors [13] are set forth in Article 3. According to Article 3(1), the Convention

12 The Contract Law of the People's Republic of China was adopted at the Second Session of the Ninth National People's Congress on March 15, 1999. Lease contracts are regulated in Art. 212-236, financial leases in Art. 237-250. On the state prior to 1999 and the reform process, see Herbert KRONKE, "Der Gesetzgeber als Rechtsvergleicher, Aspekte der chinesischen Vertragsrechtsreform", in Jürgen BASEDOW / Hein KÖTZ / Ernst-Joachim MESTMÄCKER, *Festschrift für Ulrich Drobnig zum siebzigsten Geburtstag* (1998), 579.

13 See, generally, Herbert KRONKE, "Internationality and Connecting Factors in Conflict of Laws and Transnational Commercial Law", in Katharina BOELE-WOELKI / Talia EINHORN / Daniel GIRSBERGER / Symeon SYMEONIDES, *Convergence and Divergence in private International Law – Liber Amicorum Kurt Siehr* (2010), 57.

applies when the lessor and the lessee have their places of business in different States and (a) those States and the State in which the supplier has its place of business are Contracting States or (b) both the supply agreement and the leasing agreement are governed by the law of a Contracting State. Quite in line with the general policy pursued by many Governments at the time, both alternatives lead to an exceedingly modest scope of application. This is particularly obvious with respect to alternative (b): for the provision to apply, the court seised must, first, be a court of a Contracting State and, second, the forum's conflict-of-laws rules – with their full range of conceivable connecting factors – must point to the law of a Contracting State not only with respect to one but two different agreements.

B. Objectives of the Convention and position under national legal systems

The Convention has five key objectives:[14] recognition of the typical tri-partite relationship (*supra* IV A), Article 1(1); transfer of the responsibility for non-conforming equipment from the lessor to the supplier; restriction of the lessor's liability to third parties; safeguarding the lessor's property interest in the event of the lessee's insolvency; and ensuring the effectiveness of provisions for some of the lessor's default remedies, such as accelerated payment, liquidated damages, etc.

1. Removal of responsibility from lessor to supplier

Under a traditional lease, the lessee has rights against the lessor, but the standard terms of a finance lease usually make it clear that the equipment is selected by the lessee, who exercises its own skill and judgment, and that the lessor has no responsibility for non-conformity of the equipment and is entitled, under so-called "hell or high water" clauses, to be paid the agreed rental come what may. Two techniques have evolved to deal with this problem. In the first, the lessor agrees to make claims against the supplier on the lessee's behalf as well as, or as an alternative to, its own claims. The

14 For an overview, see Ronald CUMING, "Legal Regulation of International Financial Leasing: The 1988 Ottawa Convention", *7 Arizona Journal of International Comparative Law* (1989), 39; Carsten DAGEFÖRDE, *Internationales Finanzierungsleasing* (1992); Franco FERRARI, "General principles and international uniform commercial law conventions: a study of the 1980 Vienna Sales Convention and the 1988 UNIDROIT Conventions", *Unif. L. Rev. / Rev. dr. unif.* (1997) 451; Daniel GIRSBERGER, "Leasing", in Herbert KRONKE / Werner MELIS / Anton SCHNYDER, *Handbuch internationales Wirtschaftsrecht* (2005), 757-768; Martin STANFORD, "Explanatory Report to the Preliminary Draft Uniform Rules in International Financial Leasing, *Unif. L. Rev. / Rev. dr. unif.* (1984), 76.

problem here is that the lessor can recover only for its own loss, and its exclusion of liability and right to payment of rentals in any event usually means that it suffers no loss. In the second, the lessor agrees to assign to the lessee any claim it may have against the supplier. Again, however, the lessee, claiming in right of the lessor, can recover only for the lessor's loss, which is usually zero. Articles 8, 10, 11 and 12 of the Convention, first, give the lessee direct rights against the supplier and, second, remove liability from the lessor, though not completely. Apart from a warranty of quiet possession – Article 8(2) – the lessee has no other claim against the lessor except to the extent to which the breach results from the act or omission of the lessor – Article 12(5).

As a logical concomitant of the special features of a finance lease, the vast majority of national legal systems examined for this session recognises the tri-partite relationship. A minority, however, insists on basing its analysis on the two separate contracts (supply contract and lease). Consequently, this latter group does not normally contemplate a transfer of responsibility for non-conformity to the supplier but provides in a traditional fashion for claims of the lessee against the lessor.

2. Liability to third parties

It follows from the special features of a finance lease that the lessor shall not, in its capacity of lessor, be liable to third parties for death, personal injury or damage to property caused by the equipment – Article 8(1)(b). This principle does not govern any liability of the lessor in any other capacity, for example as owner – Article 8(1)(c). Ownership of movables as such does not usually attract liability in national legal systems. In the case of motor vehicles, it is usually the "operator" who is liable in tort or under some special regime. But these cases fall typically in the category of "operating lease" (see *supra* IV A). A prominent case of owner liability derives from the 1969 Brussels *International Convention on Civil Liability for Oil Pollution* which establishes liability of the owner of a vessel for oil pollution.

The position under the Ottawa Convention would appear to be shared by a majority of States on which reports were received.

3. Protection against lessee's insolvency

Article 7 provides that the lessor's real rights are valid against the lessee's trustee in bankruptcy (more recent instruments use the neutral term "insolvency administrator") and creditors, including creditors who have obtained an attachment or execution. By "real rights" is meant rights *in rem,*

or proprietary rights, as opposed to purely personal rights, or obligations. In many systems, even a lessor who is not the owner but who holds under a head lease or a conditional sale agreement is considered to have real rights in the equipment in the sense of rights available against third persons generally, not only against its own lessor or conditional seller. Article 7 is designed to prevent the leased asset from being treated as part of the insolvent lessee's estate so as to be available to its general creditors. However, under Article 7(2), any public notice requirements prescribed by the applicable law (see Article 7(3)) as a condition of validity against the insolvency administrator and general creditors must be satisfied.

At least, the basic rule enshrined in Article 7(1) appears to enjoy unanimous support in the national legal systems that form the subject of a report to the session.

4. Default remedies of the lessor

Article 13 confers on the lessor a set of basic default remedies of the kind given by national laws. The lessor is entitled to recover unpaid rentals with interest and, in the case of substantial default, may require accelerated payment of the value of future rentals or, alternatively, terminate the leasing agreement and recover such damages as will place it in the position in which it would have been if the lessee had performed the agreement in accordance with the terms. Article 13(3) validates a provision in the agreement for liquidated damages, which is enforceable unless it would result in damages substantially in excess of what is necessary to put the lessor in the position in which it would have been if the contract had been properly performed.

Nine out of fourteen reporting national laws are in conformity with the general approach taken by Article 13 subject, however, to a number of general limits (on agreed penalties) and qualifications.

C. Results: evaluation of the Ottawa Convention

1. Formal results

Viewed purely in terms of the number of ratifications the Convention, despite its merits in overcoming the problems created by the tripartite relationship of lessor, lessee and supplier, has not become one of the – exceedingly few – success stories of transnational commercial law. It has so far attracted only 10 ratifications, and only two of the reporting States (France and Italy) are among the Contracting States. Moreover, for important categories of high-value

mobile equipment it has been – or, in the case of future protocols, will most likely be – superseded by the 2001 Cape Town Convention. The low level of adoption may reflect the point made in the Explanatory Report of the draft Convention that one of the major facts to emerge from the preparatory research was the narrow scope of application (*supra* A) and that truly cross-border leasing transactions are still relatively rare occurrences.[15]

2. Informal results

However, the Convention has had a significant impact on domestic developments that are, according to the National Reports submitted, occasionally reflected in the *travaux préparatoires* of domestic legislation as well as case law. In this respect, the reader is referred in particular to the Italian National Report, which provides rich evidence for the Italian courts' habit of either applying the Convention by analogy to domestic cases or in any event acknowledging its persuasive authority. Furthermore, there is anecdotal evidence gleaned from inquiries on the part of international law firms with the UNIDROIT Secretariat that the Convention may serve as a template for the documentation in truly tri-partite cross-border transactions. Lastly, the Convention is the model adopted by those engaged in running projects for the International Finance Corporation for the building up of leasing industries in developing countries, and it forms the basis of the work on the Model Law (*infra* VII) that commenced 15 years later.

VI. – THE 2001 CAPE TOWN CONVENTION AND ITS PROTOCOLS

The 1988 Ottawa Convention is essentially an instrument aimed at the harmonisation of contract law. Article 7, the provision dealing with the protection of the lessor's real rights in the lessee's insolvency, is, however, an early harbinger of the ever-increasing importance of property in international transactions. The idea of building on the Leasing Convention to provide an international regime for security interests (in the broadest possible sense of the term) in high-value mobile equipment was first mooted by the Canadian President of the Ottawa diplomatic Conference, T.B. Smith, QC, and later promoted by the Canadian Government. The rationale for such a regime was that a security interest in such equipment that had been created validly and

15 "Explanatory Report on the Draft Convention on International Financial Leasing", in *Diplomatic Conference for the Adoption of the Draft UNIDROIT Conventions on International Factoring and International Financial Leasing. Acts and Proceedings*, Vol. I, 27 No. 3 (1991).

was enforceable in one jurisdiction might be unprotected or less efficacious when the equipment moved to another jurisdiction, so that creditors, conditional sellers and lessors could not be confident of the validity and ready enforceability of their interests outside their own jurisdiction. This uncertainty either inhibited asset-based financing or made it significantly more expensive. The ordinary – and universal – conflict-of-laws rule, namely that property rights were governed by the *lex rei sitae* (or *lex situs*) was unsuited to dealings in equipment having no fixed *situs* but moving routinely across national frontiers. Moreover, there was the problem of wide differences in the substantive laws of different States, some of which were considerably less favourable to non-possessory security interests.

A. Scope

The Cape Town Convention did not follow earlier instruments (concerning vessels and aircraft) in their approach of providing for the recognition of an interest created under the law of one jurisdiction in all other Contracting States. Rather, the "international interest" under the Convention is a property interest deriving its force from the Convention, not from national law. It is an artificial concept encompassing the position of (i) a seller under reservation of title; (ii) a chargee under a security agreement; and (iii), relevant for our purposes here, the lessor under a leasing agreement – Article 2(2).

Another significant break with tradition, and a bold step forward, is that there is no "internationality" requirement, the only – but obviously functional – delimitation being the connecting factor that the debtor is situated in a Contracting State – Article 3. Again, a change that met immediate approval on the part of both negotiating Governments and industry: situations involving property in aircraft, railway rolling-stock, space assets and the like are by definition at least potentially trans-border situations.

B. Key features and position under domestic law prior to ratification or accession

Prior to the adoption of the Convention and its equipment-specific Protocols all but two (Canada, United States) of the jurisdictions that are the subject of National Reports characterised the legal position of the "security giver" along the lines of traditional concepts (owner, chargee, lessor), rather than on those of their economic function and a "substance test". Apart from re-conceptualising three technically distinct legal positions functionally as a

uniform and genuinely international property right, the "international interest" (*supra* A), there are four key features of the Cape Town instruments.

1. Registration

The Convention (Articles 16 to 28), the Aircraft Protocol (Articles XVII to XX) and the Rail Protocol (Articles XII to XVII) provide for registration in an international registry (one for each category of mobile equipment under its respective Protocol). Registration is not a prerequisite for the creation of the international interest (see Article 7). However, upon registration the international interest is accorded priority over purely national interests (whether registered or not) and over subsequently registered and unregistered interests (Article 29). Moreover, in insolvency proceedings against the debtor, an international interest is effective if registered in conformity with the Convention (Article 30) prior to the commencement of the insolvency proceedings.

The registration system is asset-based, not debtor-based. An entry is made against an asset that is uniquely identifiable, *e.g.*, an airframe through a manufacturer's serial number. In line with the design of a uniform property right (subject to distinguishing for the purposes of available remedies, see Articles 8 and 10), the registration system covers interests of chargees, of conditional sellers as well as *interests of lessors*. (Prior to adopting and implementing the Convention, the latter were not registrable outside Canada, the United States and New Zealand.) More generally, it is to be emphasised that registration in the international registry goes far beyond registration as provided for in certain national systems, such as Croatia, where the transactions are indeed registered but where leasing contracts, on the one hand, and charges and title reservations, on the other hand, are registered in separate registries, reflecting the law's conceptual rather than functional approach.

Since the international registry is a fully electronic, automated system operating on a 24/7 basis and employing no legally trained staff, no transaction documentation is examined or even submitted, and the Registrar is under no duty to enquire whether consent to registration under Article 20 has in fact been given or is valid – Article 18(2). In other words, the Convention has opted for the legal technique of "notice filing". Essentially, the function of an entry is to warn third parties contemplating, for example, extending credit to a potential borrower against security in an asset, to verify whether an interest entered in the Registry actually exists.

2. Equipment-specific remedies

Second, the adoption of a two-instrument approach (the Convention containing the general part, *i.e.*, provisions applicable to all categories of equipment, and each protocol addressing the specifics of each category and the needs of financing practice in that industry) enabled the protocols to provide for additional equipment-specific remedies to the basic default remedies under Articles 8 to 15 of the Convention.

The most prominent – and critical for that industry – example so far is the irrevocable de-registration and export request authorisation issued by a debtor in accordance with a template annexed to the Aircraft Protocol – Article XIII. Such authorisation is a necessary pre-requisite for the creditor's effective exercise of any of the remedies provided for under the Convention, where taking control of the aircraft depends on the ability legally to remove it from the debtor's country of residence and the State of registration of the aircraft under the Chicago Convention.

3. Enhanced creditor rights in lessee's insolvency

The acid test of a security interest is its efficacy in the debtor's insolvency, and as the Convention characterises a finance lease functionally as a security interest, this focuses our analysis on the lessor's rights in the lessee's insolvency. As mentioned, under Article 30 an international interest registered prior to the commencement of the insolvency proceedings is effective – that is, enforceable against the insolvency administrator and creditors – except in so far as it is subject to avoidance under rules of insolvency law relating to preferences and transfers in fraud of creditors. Article XI of the Aircraft Protocol (see also Article IX of the Rail Protocol with a modified approach that takes the rail industry's specific level of development and its practices into account),[16] which applies only in a Contracting State that has made a declaration to that effect, goes further. Alternative A, the so-called "hard option", which a Contracting State may select by declaration, provides that, on the occurrence of an insolvency-related event, the insolvency administrator must either cure all defaults and agree to perform all future obligations within a specified waiting period, or give up possession of the aircraft object. This

16 *Convention on International Interests in Mobile Equipment and Luxembourg Protocol Thereto on Matters Specific to Railway Rolling Stock. Official Commentary* by Professor Sir Roy GOODE CBE, QC, as approved for distribution by the UNIDROIT Governing Council pursuant to Resolution No. 4 adopted by the Luxembourg Diplomatic Conference (2008) Article IX, Comment 5.27, 5.37-5.41.

provision is based on the US Bankruptcy Code and leaves the court no discretion to impose a stay. Alternative B, the so-called "soft option", requires the insolvency administrator, at the request of the creditor (*i.e.*, the lessor), to give notice within the time specified in the Contracting State's declaration whether it will cure all defaults and agree to perform all future obligations or give the creditor an opportunity to take possession of the aircraft object. Upon the insolvency administrator's failure to give such notice or to honour its undertaking to give possession, the court may permit the creditor to take possession. A Contracting State may also choose not to make any declaration under Article XI. In that event, its own insolvency law will continue to apply.

Of the 40 Contracting States (including the EU), 24 have made a declaration opting for either of the alternatives, and only one of those, Mexico, has chosen Alternative B.

4. Party autonomy regarding the governing law

Provided that a Contracting State has made a declaration to this effect, under Article VIII of the Aircraft Protocol and Article VI of the Rail Protocol, the parties to an agreement (*i.e.*, a security agreement, a title reservation agreement, or a leasing agreement, *cf.* Article 1(a) of the Convention) may freely agree on the law which is to govern their contractual rights, wholly or in part. Given the persistent reluctance of a great number of legal systems to grant unlimited party autonomy in conflicts rules on contracts, the fact that Articles VIII and VI respectively do so in the immediate vicinity of property law (some even within the boundaries of property law *strictu sensu*) certainly is a qualitative leap ahead.

Of the 40 Contracting States, no fewer than 28 from all four corners of the Earth (among them the reporting States China and the United States) and representing all legal traditions have made that leap. Moreover, all Member States of the European Union, among them Ireland, Luxembourg and Malta, who are also Contracting States, as well as Belgium, France, Greece, Italy, Poland, Portugal and Slovenia, jurisdictions that formed the subject of National Reports, would make that declaration since it is in accordance with Article 3 of EC Regulation 593/2008.

C. Methods employed

A comparative law study is carried out as a matter of course in all major harmonisation projects undertaken by any of the relevant intergovernmental

Organisations.[17] In the Cape Town context, however, that study was only a first step. Following a survey of the existing legal environment, two leading applied economists were tasked with an economic impact assessment study aimed at identifying the salient features of a secured-credit financing instrument capable of producing the benefit which in law reform projects is so often promised but rarely measurable. The economic impact assessment study did actually quantify potential benefits – *i.e.*, savings on interest that certain legal features were capable of achieving –, and these targets then served as starting point for what is now called the "commercial approach" to commercial law reform.[18]

Indeed, the Cape Town Convention is probably still the best example of an instrument aimed at reaching a predetermined economic objective where Contracting States stand to gain from making the right choices. The objective is lower credit cost, and it is pursued by way of providing for predictable, measurable, risk-reducing creditor rights in default and insolvency situations. The objective of the negotiation process was not to strike a compromise between pre-existing solutions under the law of negotiating States but to find rules that, in the economists' view, would yield maximum benefit due to maximum predictability of the outcome in a default scenario. Therefore, the Convention and the Protocols offer a menu of options on certain key issues, such as the insolvency regime mentioned above. As we have seen, the clear majority has made the right choice, *i.e.*, has opted for a "hard" (and economically beneficial) rather than a "soft" (and economically neutral or detrimental) solution.

D. Results: evaluation of the Cape Town Convention

1. Formal results

With 40 Contracting States (including the European Union as a Regional Economic Integration Organisation, *cf.* Article 48 Cape Town Convention,

17 For an overview, see GOODE / KRONKE / MCKENDRICK, *supra* note 3, 4.33-4.48, 6.10-6.12.

18 See Jeffrey WOOL, "Rethinking the notion of uniformity in the drafting of international commercial law: a preliminary proposal for the development of a policy-based unification model", *Unif. L. Rev. / Rev. dr. unif.* (1997), 46; *idem*, "Economic Analysis and Harmonised Modernisation of Private Law", *Unif. L. Rev. / Rev. dr. unif.* (2003), 389; Herbert KRONKE, "The Takeover Directive and the 'Commercial Approach' to Harmonisation of Private Law", in Klaus Peter BERGER / Georg BORGES / Harald HERRMANN / Andreas Schlüter / Ulrich WACKERBARTH, *Private and Commercial Law in a European and Global Context – Festschrift für Norbert Horn* (2006), 445.

Article XXVII Aircraft Protocol, Article XXII Rail Protocol) at the time of writing and, according to industry sources, an estimated 80-85% of all secured-credit transactions (mainly finance leasing) for aircraft worldwide covered by the Convention, it is fair to state that the Convention has so far been a phenomenal success. Of all the countries on which National Reports were submitted, China and the United States are Contracting States.

2. Informal results

Over and above the foregoing, the Cape Town Convention and Protocols have had, and continue to have, a significant impact on domestic developments in States preparing for ratification or accession. In some cases, that impact extends beyond the Convention's substantive scope, *i.e.*, high-value mobile equipment, as legislators come to appreciate certain features such as the design of certain default remedies or the registration system. Moreover, for the first time in the history of transnational commercial law, there is tangible evidence of the instruments' impact on contract practice. This is made possible by the decision of leading practitioners [19] to share their experience with other stakeholders and to publish relevant documentation.[20]

VII. – THE 2008 MODEL LAW ON LEASING

A. Historical background, scope, and principal features

While a model law on leasing could have been the natural follow-up to the 1988 Ottawa Convention,[21] the limited resources of the UNIDROIT Secretariat and important Member States' Governments were thought to be needed with a higher degree of urgency for the work on what was to become the 2001 Cape Town Convention. It was only in late 2005 that work on the Model Law commenced, starting with three sessions of an Advisory Board made up primarily of UNIDROIT correspondents and involving, first, experts working for the International Finance Corporation (I.F.C.) on commercial law reform in

19 The Legal Advisory Panel of the Aviation Working Group – AWG.

20 See THE UNIFORM LAW FOUNDATION (Ed.), *Contract Practices Under the Cape Town Convention*, Cape Town Paper Series, Vol. I, Cwmbran (2004); *Idem*, *Advanced Contract and Opinion Practices under the Cape Town Convention*, Cape Town Paper Series, Vol. 2, Oxford and Portland, Oregon (2008).

21 For an early analysis by one of the pioneers and fathers of the work on leasing at UNIDROIT, see Ronald CUMING, "Model Rules for Lease Financing: A Possible Complement to the UNIDROIT Convention on International Financial Leasing", *Unif. L. Rev. / Rev. dr. unif.* (1998), 371.

developing countries and transition economies and, second, relevant industry associations from a variety of geographic regions.[22] Both the composition of the Advisory Board and the Committee of governmental experts and the history of the formulating stages, reflect the understanding that this instrument was primarily aimed at developing countries and their small and medium-size businesses.[23]

With respect to its substantive scope of application, it is important to note that the Model Law does not only contemplate financial leases but any lease – Article 2. On the other hand, the Model Law does not apply to leases that function as a security right – Article 3(1), nor to leases or supply agreements for large aircraft equipment unless the lessor, the lessee and the supplier have otherwise agreed – Article 3(2). This exclusion removes a potential source of conflict between the Model Law and the Cape Town Convention and the Aircraft Protocol.

Conversely, the provisions of the Model Law cover the full range of relevant issues, as addressed in items D (10) to (23) and E (10) to (23) of the questionnaire circulated to National Reporters (*supra* III) except in so far as issues of general contract law are not taken up by the Model Law; in this respect, its users are referred to the *UNIDROIT Principles of International Commercial Contracts* or will rely on their domestic law. The Model Law provisions' content reflects the basic features of the 1988 Ottawa Convention and develops details on the basis of state-of-the-art comparative analysis and benchmark contract practice.

B. Results: evaluation of the Model Law

Model laws, as one type of the by now large variety of facultative instruments,[24] are usually easier to negotiate than binding treaties, but their implementation at the domestic level is exceedingly difficult to monitor. The model-law technique has been very successful in some instances, where legislators were keen to benefit in the international arena from the "hi-fi factor" (as in the case of the 1985 *UNCITRAL Model Law on Arbitration*). But where no such incentive exists, the absence of a depositary and fellow signatories, who take an interest in their peers' handling of the negotiated

22 For details, see *Official Commentary to the UNIDROIT Model Law on Leasing*, UNIDROIT 2010 – Study LIXA Doc. 24 –, *Unif. L. Rev. / Rev. dr. unif.* (2010), 548-609.

23 See, in particular, the first, second, fourth and eighth recitals of the Preamble.

24 On the available types of instrument, see GOODE / KRONKE / MCKENDRICK, *supra* note 3, 5.07-5.16.

template, makes a sufficiently reliable feed-back from users a rare occurrence. Taking this into consideration, with respect to leasing we are in an above-average situation. Reference to the (draft) Model Law is or has been made in current domestic reform discussions in four of the States on which National Reports were submitted. Moreover, recent reports from the UNIDROIT Secretariat indicate that the following States have implemented the Model Law or that implementation is underway: Afghanistan, Jordan, Latvia, Palestinian National Authority, Tanzania, Yemen.

VIII. – WORK OF OTHER INTERGOVERNMENTAL ORGANISATIONS AND CO-OPERATION AMONG ORGANISATIONS

A. Scope of inquiry

All National Reporters were invited to indicate whether and, if so, to what extent their Governments had participated in related work on secured-credit transactions and functional equivalents carried out within the framework of other intergovernmental Organisations, such as the Organization of American States (OAS), the United Nations Commission on International Trade Law (UNCITRAL), the European Bank for Reconstruction and Development (EBRD), or other regional development banks. Only a limited number of National Reporters answered the relevant questions in Section D of the questionnaire.

The Secretariats of the Organization of American States and UNCITRAL very generously either provided answers to the questions raised or submitted general comments on the topic and the instruments adopted by their respective Organisations, as well as on the co-ordination of Governments' work in the three Organisations and co-operation among them.

B. OAS Model Law and Model Regulations

The Organization of American States adopted the *Model Inter-American Law on Secured Transactions* in 2002 and the *Model Registry Regulations* in 2009.[25] Mindful of the need for close co-ordination in all attempts to provide a consistent legal framework for asset-based, non-possessory secured credit financing, UNIDROIT and the OAS Secretariat for Legal Affairs participated as

[25] The Model Law is reproduced in *Unif. L. Rev.* / *Rev. dr. unif.* (2002), 262, with an introduction by Boris KOZOLCHYK and John WILSON, "The Organization of American States: The New Model Law on Secured Transactions", at 69; most recently, see John WILSON, "Model Registry Regulations under the Model Inter-American Law on Secured Transactions", *Unif. L. Rev.* / *Rev. dr. unif.* (2010), 515.

observers in each other's work. The OAS, like UNIDROIT, places emphasis on a "substance test" that should be used to examine the relationship between the parties to determine whether a transaction is a (true) lease or a security device. Second, the OAS Model Law, like the Cape Town instruments, recognises that systems in which the law of leasing and the law of secured transactions compete against each other in the manner in which they provide (or do not provide) notice to third parties, are inherently inefficient, as they produce legal uncertainty concerning the applicable rules and the effect they have on priority. The OAS Model Law creates a uniform system for all non-possessory interests in movable property by way of a single registry and priority system. Whereas the provisions relating to creation, priority and enforcement testify to the existence of a common core of benchmark principles, the design of the registration system under the Model Regulations reflects important differences, not least due to the comprehensive scope of the Model Law as opposed to the narrow class of high-value mobile equipment contemplated by the Cape Town instruments.

While a number of OAS Member States have made use of the Model Law, a first assessment of the experience with law reform efforts based on the instrument points to as yet insufficient implementation.[26] Mexico being the only country that has ratified the Cape Town Convention and adopted the OAS Model Law, it would appear worthwhile to closely monitor implementation and application of both instruments in that country.

C. UNCITRAL Legislative Guide

The *UNCITRAL Legislative Guide on Secured Transactions*, adopted on 14 December 2007, may be considered as an educational exercise for policy makers engaged in designing a system of secured-transactions law for their country.[27] The document identifies and discusses substantive issues and problem areas as well as options for solutions and offers recommendations.

The Guide does not deal with security interests in high-value mobile equipment as covered by the Cape Town instruments. The notion of "security right" (preferred to "security interest") includes all types of right created by agreement to secure payment or other performance of an obligation, regardless of the apparent form of the transaction or the language used by the parties. It thus includes financial-lease rights if they function as an "acquisition

26 For a recent evaluation, see Alejandro GARRO, "The OAS-sponsored Model Law on Secured Transactions: Gestation and Implementation", *Unif. L. Rev.* / *Rev. dr. unif.* (2010), 391.

27 For an overview, see Spiros BAZINAS, "The Work of UNCITRAL on Security Interests", *Unif. L. Rev.* / *Rev. dr. unif.* (2010), 315.

security right". Security rights have to be registered in a notice-based public registry for third-party and priority effects.

As this is the first legislative guide developed in intergovernmental negotiations, the international law-reform community will be watching closely whether and, if so, how legislators will make use of both the exceedingly rich materials discussed and the recommendations. Viewed from the perspective of the Academy's query, *i.e.*, the results of UNIDROIT's three decades of work on the unification and modernisation of the law of financial leasing, it may be stated that the Guide is a high quality complementary tool for legislators called upon to make informed choices at the intersection of the law of leases and secured financing.

IX. – CONCLUSIONS

Although the limited number of National Reports submitted as well as the degree of detail provided in some of them call for caution in formulating results, it would appear safe to conclude that the law of financial leasing has advanced significantly since UNIDROIT took up work on this topic thirty-five years ago.

As mentioned *supra* I, in many instances it will not be possible (outside the Cape Town context) to find hard evidence that certain choices made at the intergovernmental level have had identifiable effects domestically. However, this note of caution is not confined to this specific area of the law but reflects a more general experience in the process of harmonisation of commercial law.

Finally, law reformers should take comfort from the finding that it was not a great design, such as a comprehensive instrument (be it a convention, be it a model law) on, for example, secured transactions that brought about the measure of harmonisation achieved, but rather incremental and sectorial progress, including trial-and-error approaches, in the early stages. Patience and steadily increasing realism on the part of all involved are bearing fruit.