

A Legal Analysis of Financial Leasing

UNE ANALYSE JURIDIQUE SUR LE CRÉDIT-BAIL

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Abstract: This paper aims at providing a theoretical analysis of international financial leasing and discusses some controversial issues within this area. Accordingly, it is divided into three main parts. The first part of the essay probes into the definition and fundamental features of international financial leasing. Then the second part focuses on certain debatable issues in the practice field of international financial leasing. The last part of the essay aims at providing a little analysis of the UNIDROIT Convention on International financial leasing which may be of some help to know the development of international financial leasing. This part mainly discusses rights and obligations of each party of an International financial leasing contract and particular remedies of breach of contract. Then, the conclusion provides some future perspectives of international financial leasing.

Key words: UNIDROIT Convention; International Financial Leasing; Private Law

Resumé Cet article vise à fournir une analyse théorique de crédit-bail international et examine certaines questions controversées dans ce domaine. En conséquence, il est divisé en trois parties principales. La première partie de l'essai sonde dans la définition et les caractéristiques fondamentales de crédit-bail international. Puis la deuxième partie se concentre sur certains points discutables dans le domaine de la pratique du crédit-bail international. La dernière partie de l'essai vise à fournir une petite analyses sur la Convention d'UNIDROIT de crédit-bail qui peut être utile pour connaître le développement du crédit-bail international. Cette partie traite essentiellement des droits et obligations de chaque partie d'un contrat de crédit-bail international et des solutions spécifiques de rupture de contrat. Ensuite, la conclusion donne quelques perspectives d'avenir de crédit-bail international.

Mots-clés: Convention d'Unidroit; CrÉDit-Bail International; Droit PrivÉ

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INTRODUCTION

International financial leasing has 'emerged as an important means of economic development in the global marketplace'² especially where capital intensive acquisitions such as aircraft, ships or machinery are involved.³ Of course, as an instrument of finance, international financial leasing has its potential advantages which distinguish it from other financing methods. It has broken through traditional legal relationships from many aspects and has made effective combination of various legal relationships, for example, lease, sale and assurance, etc. It is obvious that these unique features of international financial leasing have met the needs of the development of financial industry. During recent years, international financial leasing has become an important means of financing in international market. So having recognised

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² David. A. Levy, Financial Leasing under the UNIDROIT Convention and the Uniform Commercial Code : A Comparative Analysis, 5 *Ind. Int'l & Comp. L. Rev.* 267, 1994-1995

³ Lawrence M. Taylor, Jr., *International Leasing, in 2 Equipment Leasing - Leveraged Leasing*, Bruce E. Fritch et al. Eds., 3rd ed., (1988) 1225

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'the importance of removing certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction',⁴ the International Institute for the Unification of Private Law (the UNIDROIT) discussed and introduced the UNIDROIT Convention on International Financial Leasing in 1988 Ottawa⁵ which governs certain types of financial leasing arrangements.⁶ This convention is still not so popular (with a few members) in fact but it does have some reference value in practice. After all, international financial leasing needs long way to develop itself in most countries and at the mean while new challenges and legal problems have also emerged hand in hand which ask for attention from both theoretical and practical perspectives.

1. DEFINITION AND FEATURES OF INTERNATIONAL FINANCIAL LEASING

1.1 Definition

In order to understand the exact meaning of international financial leasing, it is necessary to get a clear understanding of the definition of finance lease at first. Unlike traditional economic activities, for example, the sale of goods, financial leasing is novel to many countries including some countries that have mature market and highly developed systems of commercial law.⁷ Nevertheless, with the fast development in the past decades around the world, the definition of finance lease is nearly the same. For instance, in the United Kingdom, 'A finance lease usually involves payment by a lessee to a lessor of the full cost of the asset together with a return on the finance provided by the lessor. The lessee has substantially all the risks and rewards associated with the ownership of an asset, other than the legal title. . .'.⁸ In the International Accounting Standard 17 Leases, 'A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred'.⁹ Obviously, a difference can be found between the two definitions: the legal title of the asset. Since in the UK, the legal title of the asset of a financial leasing contract cannot be transferred or the lease contract is not a finance lease. While in some civil law countries the title of the asset can be transferred to the lessee. So in order to avoid the problem, internationally provisions about legal titles of assets are always make compromises at this point like IAS 17 does.

Then what is international financial leasing? How to define international financial leasing from a legal point of view? The answer is not too difficult to find. As can be noticed, the only difference between a financial leasing and domestic finance lease is the word "international" which means at least there are one or more international elements in a transaction. Basically, in a finance lease transaction, if the supplier, lessor and lessee are all have their places of businesses in different countries; or regardless of the place of business of the supplier, the lessee and the lessor have their places of business in different countries, the contract of the financial leasing can be thought as an international financial leasing contract.¹⁰ Of course, besides the most obvious difference between domestic finance leasing, there are other differences could be found and these differences will be discussed in following relevant parts.

1.2 Features

International financial leasing has its typical characteristics which distinguish it from both domestic finance leasing and the traditional operating leasing. Firstly, the most obvious feature is the international element of the parties. As analyzed above, only the lessor and the lessee have their places of businesses in different countries can a financial leasing be international. Secondly, the subjects are usually large equipments or heavy machineries and so on. Equipments that used for Non commercial purposes or equipments for family use do not often prefer this type of transaction. Thirdly, since international financial leasing is a synthese, parties involved (especially the lessor) always ask all the documents in the transaction be signed in a package deal in order to exclude the possibility of dealing with different agreements separately. The purpose of this is to ensure the efficiency and security of the transaction. That is to say, international financial leasing is a comprehensive transaction which combines both the sale of goods, leasing and financing. Contracts of an international financial leasing must be of certain linkage between themselves and the transaction. In addition to the three

⁴ See the preamble of the UNIDROIT Convention on International Financial Leasing (OTTAWA, 28 MAY 1988)

⁵ Hereinafter shortened as the UNIDROIT Convention on IFL

⁶ See LS Sealy & RJA Hooley, *Commercial Law: Text, Cases, and Materials*, 4th ed., (2009) 927

⁷ See Ronald Cuming, Legal Regulation of International Financial Leasing: the 1988 Ottawa Convention, 7 *Ariz. J. Int'l & Comp. L.* 1989-1990, 41

⁸ See Accounting for Leases and Hire Purchasing Contracts, Statement of Standard Accounting Practice No.21, August, 1984, para.15

⁹ See International Accounting Standard 17 Leases, EC staff consolidated version as of 24 March 2010

¹⁰ The recognition of the word "international" in international financial leasing has been widely accepted. For example, article 3 of the UNIDROIT Convention on International Financial Leasing states: "This Convention applies when the lessor and the lessee have their places of business in different States". Accordingly, it does not matter that the supplier has its place of business in the same state as that of the lessor or lessee, or a third state.

main features there are still many other features distinguishing it from other financial instruments, for example, the period of international financial leasing is always longer than domestic financial leasing and so on. For this is an overview of the features of international financial leasing and the word limit, more details may not be mentioned here.

1.3 The Growing Importance of International Financial Leasing

Recently, international financial leasing has developed at a high speed all around the world. Using international financial leasing to expand production is an ideal means of financing. This is a good way to enhance production capacity and at the same time ensure companies use the up-to-date equipments without facing the risk of purchasing. Meanwhile, it could be of great help for reducing operating costs of companies and improving economic performance especially for those companies that need equipments with a shorter useful life than their life span, for example, engineering and construction machineries, etc. Consequently, considered as a whole, there are at least two reasons for the financiers and equipment users to choose international financial leasing as a method of financing in addition to these benefits mentioned above. On one hand, compared with traditional methods of financing, international financial leasing is more flexible for the lessor to establish and protect the ownership rights. On the other hand, international financial leasing can be a good way to “exchange controls or import or export restrictions on equipment can be circumvented”.¹¹ Both these benefits have been promoting the development of international financial leasing in a wider scale than ever before.

2. IMPORTANT ISSUES IN INTERNATIONAL FINANCIAL LEASING

Although every state has its own laws of governing financial leasing transactions, there are still many common issues in international financial leasing contracts. The following paragraphs are going to discuss some main issues within international financial leasing transactions and a few of them are analyzed in details.

2.1 Warranty Clause and the Transfer of the Lessor's Rights under the Supply Agreement

Warranty clause is widely used in international financial leasing contract. It often specifies that the lessor has no obligation on the damage or liability arising from the leased asset, no matter directly or indirectly. From the lessor's point of view it is one of the most important clauses in an international financial leasing contract. Why does the lessor need a warranty clause in international financial leasing contract? Generally speaking, it is the requirement of the nature of the contract. In essence, international financial leasing is a financial transaction which aims at financing for the lessee so the lessor is not in touch with the leased asset directly. Therefore, after the lessor's payment to the supplier the obligation of him is fulfilled. So there is no other obligation for the lessor as long as he does not interfere with the lessee's freedom to choose the supplier or leased property and act with no fault in the transaction.

It is already a widely accepted business practice that the lessor has the right of having warranty clause in international financial leasing contract which is recognised by most countries and relevant provisions of international convention, for example, Article 8(1) of the UNIDROIT Convention on IFL. Nonetheless, there are many circumstances that the lessor cannot escape the liability. For instance, the lessee chooses the leased asset depended on the special skill of the lessor, the lessor has interfered the freedom of the lessee to choose the asset, the lessor fails to inform the lessee of the defect of the asset or the lessor and the supplier has certain close business connection such as parent company and subsidiary company. In a word, this kind of clause is in essence one of the many symbols of financial leasing, without these risks transferred from the lessor the transaction could not be called a financial leasing.

In the transaction of international financial leasing, practically, the obligation of delivering the leased asset has been transferred to the supplier by the lessor through the supply agreement. However, when the delivery has been deferred by the supplier, or the leased asset has not been delivered, or the delivered asset has defects, the lessee has no right to demand the supplier to fulfil its duty while this right belongs to the lessor according to the supply agreement between the lessor and the supplier. In the interest of the lessee, there is always a clause of transferring the right of the lessor of the supply agreement to the lessee in international financial leasing transaction. This is a very important clause for both the lessor and the lessee. It guarantees the lessee's right for claim when the supplier fails doing its duties. Also, it can avoid unnecessary problems and cost for the lessee and the lessor to resolve dispute on this issue.

2.2 Tax Issue

Tax is a vital economic element in international transactions. It is known that 'leasing is a method of financing the purchase of a capital asset, where the tax effects of owning an asset improve the cost of funds to the user of the asset'¹². And there are many tax rules which are set up to control the avoidance of tax through financial leasing. 'With a finance

¹¹ See Ronald Cuming, n.6, *ibid* 45

¹² Emer Hunt & Mark Middleditch, *Finance Leasing -- A Snapshot*, Tax Journal, Issue 727, 14, 2004, 9, February

lease assets must be shown on the balance sheet of the lessee, with the amounts due on the lease also shown on the balance sheet as liabilities. This is intended to prevent the use of lease finance to keep the lease liabilities off-balance sheet'. Thus, no matter for the lessor or the lessee, a clear understanding of tax policies upon international financial leasing is of great importance in the transaction.

Although in international financial leasing contract the lessor and the lessee can make agreement on the distribution of tax costs, the effect of the clause shall depend on actual conditions. The reason for this is that tax laws are mandatory in all the states and tax jurisdiction can represent the sovereignty of that country. However, because international financial leasing has its particular function in enhancing employment and expanding investment, almost every state has its own preferential tax policy on it to advance its development. Every party involved in international financial leasing has to obey the policies of at least two countries so it is a very complex issue in both practice and theory. To avoid double taxation, both the parties and the related governments need to take measures. Parties may have their tax issue written in the agreement. For the governments, there should be some mutual agreement on avoiding this situation.

Preferential tax policies have promotive effect on the development of international financial leasing, in a sense, at the beginning of the international financial leasing, without governments' preferential tax policies of each country, the advantages of it cannot be revealed. 'The essence of finance leasing is to allow the lessor of the asset a tax deferral, through utilization of capital allowances, which can be passed to the lessee in the shape of reduced funding costs'.¹³ Thus it is the reason for the lessor who needs these assets to compare financial leasing with purchasing directly. 'The lessee loses the tax depreciation of the leased assets (that is, no capital allowances are available to the lessee) but instead deducts the lease payment in full. The lessor, who is (or will become) the legal owner, benefits from tax depreciation but is also taxed on the lease income'.¹⁴

When mentioning tax issue in international financial leasing, one significant case must be given a reference to. The *Barclays Mercantile Business Finance Limited (BMBF) v Mawson*¹⁵ case is crucial to the application of the United Kingdom's anti-avoidance rules and has immense impact on international financial leasing practice. This case has set a fine example of the application of capital allowances provision of the Capital Allowances Act 1990. In the case of a financial leasing, only the acts and purposes of the lessor matter when determining the availability of capital allowances according to the Act. In the BMBF case, the transaction is a sale to BMBF and leaseback to BGE between Scotland and the Republic of Ireland. The requirement of the BMBF for capital allowances was denied by the Inland Revenue according to the Ramsay principle. Since the object of capital allowances is to 'provide a tax equivalent to the normal accounting deduction from profits for the depreciation of machinery and plant used for the purposes of the trade',¹⁶ the Inland Revenue argued that 'these arrangements were artificial and lacked business purpose in contrast to the fiscal purpose of obtaining allowances'.¹⁷

2.3 Liquidation Issue

In this paragraph the liquidation issue means that when the lessee goes into liquidation, the possible consequence to the lessor and the leased asset. Both the lessor and the lessee need to conclude this kind of issue into their contract for the purpose of protecting the lessor who could maintain the legal title of the leased asset by terminating the contract when the lessee is or will be bankrupt. The lessor always asks for the right of termination of the contract when the lessee is or will be bankrupt or cannot afford the rental during the period of the contract. After the termination, the lessor also has the right to recall the leased asset. The leased asset cannot be listed as the bankruptcy property. In addition, the unpaid rental must be counted as debt of the lessee. However, in the practice of international financial leasing, liquidation is a very complex issue. It concerns huge amount relations and all of them need to pay careful attention to.

The huge risk of bankruptcy of the lessor and the lessee has existed since the beginning of financial leasing. Thus the bankruptcy issue has as well been paid much attention to especially in the circumstance of international financial leasing. International financial leasing always has a relative long period and the asset leased is of large value which both causes many uncertainties of the risk of bankruptcy. There are many factors which can affect an international financial leasing contract, such as politics, currency, force majeure and credit risks. Of course, among those risks the major cause of bankruptcy is the credit risk. Lessors of international financial leasing are always banks or other financial institution which has a solid financial strength and they usually have a small probability of bankruptcy. However lessees are usually more possible to be bankrupt.

¹³ See Emer Hunt & Mark Middleditch, n 11. *ibid* 14

¹⁴ See Emer Hunt & Mark Middleditch, n 11. *ibid* 15

¹⁵ Case *BMBF Ltd v Mawson* [2004] UKHL 51

¹⁶ Herbert smith, *UK: Lords clarify law on taxing statutes*, International Tax Review, February 2005, Visited on 20 April, 2010. , <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=14050&SID=494288&TYPE=20>

¹⁷ *Ibid* n.13

3. THE UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

After taking full consideration of the practice of the international financial leasing and legislations of different countries, the UNIDROIT Convention on IFL has stipulated rights, obligations and remedies of each party. As seen in the definition of international financial leasing, it is clear that there are at least three parties in an international financial leasing transaction. That is to say, there exists a ‘distinctive triangular relationship’ in it. What is more, international financial leasing is a combination of two separated contracts. One is the contract between the lessor and the lessee on leasing and the other is between the lessor and the supplier on supplying the leased property. Of the two contracts, the agreement between the lessor and the lessee is definitely plays the most important part. In this contract, the lessor acts as the financier and has one major obligation which is to purchase the equipment required by the lessee while the lessee leases the property from the lessor and pays for the leased property.

3.1 Rights and Obligations of the Lessor

In international financial leasing, the lessor always has these following rights. First, the lessor has the right of having the legal title of the leased property. Since the lessor purchases the leased property from the supplier, he has gain the full title of the property. Then the property is leased to the lessee with the right of using or occupying it but not the legal title and the lessee has no right to disposing the property. Second, the lessor has the right to collect the rental from the lessee. Third, Article 7(1) (a) of the Convention provides that “the lessor’s real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution” However, it does not give an clear answer to the question whether the lessor have the right to take back the leased property when the lessee goes bankrupt. It is because that bankruptcy laws are domestic laws which are different in different countries. Thus it is impossible for a convention to give a uniform provision on this.

3.2. Rights and Obligations of the Lessee and the Supplier

The lessee has the right of quiet possession of the leased asset in accordance with Article 8 of the UNIDROIT Convention on IFL and has the obligation of taking proper care of the equipment¹⁸ as well as paying the rent. The supplier’s obligation in an international financial leasing contract is to ensure the legal title of the subject matter is not defect and transfer it to the lessor.

3.3. Remedies for Breach of Contracts

3.3.1 Remedies for the lessor

Article 13 of the Convention stipulates: "in the event of default by the lessee, the lessor may recover accrued unpaid rentals, together with interest and damages". Both in the civil law and common law systems the right for damages is the most important right when the other party defaults. This right cannot be lost even the defaulted party has made other remedies. The remedies for the lessor shall be equal to the loss of him including profits which could be brought by the contract.

Apart from the right for damages, there are other rights under Article 13 for the lessor. According to Article 13 (2), the lessor can require “accelerated payment of the value of the future rentals” if the lessee’s default is “substantial” and there are related clauses in the agreement. However, it is obvious that the word “substantial” is very ambiguous which needs further explanation in both practice and theory. Furthermore, there are still two conditions should be met when the lessor tends to accelerate the payment. The first is Article 13 (5) which provides: “The lessor shall not be entitled to exercise its right of acceleration or its right of termination under paragraph 2 unless it has by notice given the lessee a reasonable opportunity of remedying the default so far as the same may be remedied”. The second is that there is no other requirement that contradicts the acceleration requirement such as termination of the leasing agreement by the lessor.

There is one important right under Article 13 (2) for the lessor which is the right to terminate the leasing agreement. Due to the extraordinary nature of international financial leasing transaction, the termination by one party of the financial leasing contract is often prohibited before the end of the leasing contract. Only the parties both agree to or under particular circumstances can termination be made. For the lessor, when the lessee fails to pay the rental or has any other “substantial” default, the lessee has caused loss of the expectation interest of the lessor. Thus, the lessor can terminate the leasing agreement and take further actions under Article 13(2)¹⁹.

¹⁸ Article 9 of the UNIDROIT Convention on IFL

¹⁹ Article 13 (2) of the UNIDROIT Convention on IFL provides these rights for the lessor after termination of the leasing agreement: “(a) recover possession of the equipment; and (b) recover such damages as will place the lessor in the position in which it would have been had the lessee performed the leasing agreement in accordance with its terms”.

3.3.2 Remedies for the lessee

Like remedies for the lessor, the Convention also stipulates rights for the lessee when the lessor defaults. Article 12 provides the right for the lessee to "reject the equipment or to terminate the leasing agreement" when "the equipment is not delivered or is delivered late or fails to conform to the supply agreement. Under these conditions, the lessee has the right to "withhold rentals payable under the leasing agreement until the lessor has remedied its failure to tender equipment in conformity with the supply agreement or the lessee has lost the right to reject the equipment"²⁰. As the lessor, the lessee has the right to terminate leasing agreement according to Article 12. Nevertheless, this right has caused problems in practice. When giving the right of termination to the lessee, the lessor is also given the right to 'remedy its failure to tender equipment in conformity with the supply agreement'.²¹ In fact, the Convention here provides a conflict of laws provision rather than a substantive rule. That is to say, when the lessee rejects the equipment or terminates the leasing agreement, the applicable law of the international financial leasing has turned to be the applicable law of the supply agreement from the Convention. This provision could cause lots of conflict in practice for the different rules of every country on this issue.

Generally speaking, the Convention treats the remedies for the lessee more or less as normal sales contracts which seems contradict with the essential nature of international financial leasing contract and turns to be too harsh for the lessor. There are still many other issues need to be taken serious considerations for countries willing to sign the Convention. In the practice of international financial leasing, many practitioners have been complained about these dispositive provisions. They thought that these provisions do not 'reflect the typical terms of a finance lease, with its hell-or-high-water clauses for payment of rent, its provisions for damages on termination for default, and the like'.²² In a word, both the Convention and the practice of international financial leasing have a long way to go.

CONCLUSION

As one of the important instruments of international financing, international financial leasing has been played an irreplaceable role nowadays. With the competition intensify and the increasing trend of globalization in trade, no doubt it will be used in more business activities. International financial leasing contracts always involve very large sum and multiple parties between two or more legal jurisdictions. These elements definitely increase many unexpected situations and more risk which may not occur in domestic financial leasing. Nevertheless, since most international financial leasing transactions are large projects, the profit of them are tremendous which cannot be achieved by domestic transactions. Thus, it is wise for businessmen to get a clear understand of every aspects of international financial leasing before deciding to use it.

In a word, compared with other traditional financing methods international financial leasing is still very young. There are many problems which need further exploration. At the present time, due to the different financing situation of every country, even though the UNIDROIT Convention can be used as a reference, there has been no consensus on the parties' rights and obligations in an international financial leasing contract. For instance, in some countries such as China and France, it is always thought as an essential element in a financial leasing contract that the bargain purchase option of the lessee must be contained while in other countries such as the USA it will be thought as a conditional sale. In addition, there are still many articles in the Convention remain controversial. For example, does the lessee has the right to refuse to accept the leased asset when the supplier makes a late delivery or delivers the asset which is not comply with the supply contract. If the lessee has the right to reject the asset as mentioned above, does it mean that he also has the right to refuse to pay the rental or cancel the leasing contract? The UNIDROIT Convention gives out a positive attitude of this question but the truth is a lot of countries have the opposite view. Moreover, the provisions in the Convention cannot reach every detail of an international financial leasing contract, all of them and disputes require every state's own provisions of substantive law. Generally speaking, international financial leasing has a potential to be of popular among international businesses but it still needs to develop and be more mature.

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²⁰ Article 12 (3) of the UNIDROIT Convention on IFL

²¹ Article 12 (1) of the UNIDROIT Convention on IFL

²² Roy Goode, Rule, practice, and pragmatism in transnational commercial law, *I.C.L.Q.*(2005) 560

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