

A LEGAL ANALYSIS OF FINANCIAL LEASING AND ITS UNIFICATION BY UNIDROIT

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ABSTRACT

Financial Leasing is a novel concept to many countries, compared to earlier forms of commerce in juridical circulation. In spite of this, it is one of the activities that has recently experienced rapid development in many countries all over the world including those in development and in transition ones. In the past decades, the increased economic cooperation between states and the development of international financial operations have helped raise the use of cross-border leasing. International Leasing has shown to be a valuable mean of financing for companies that want to export capital goods (machinery, plant, equipment, etc) or for those who want to develop new production units abroad. However, one should not forget that the complexity of the agreement is enhanced by the operation of two or more markets. Besides the difficulties typically linked with international financing activities (risk management) the fact that for leasing each national system has its own legal framework associated with a different tax treatment creates a tangle of provisions often difficult to unravel. This paper aims *to* provide a theoretical analysis of international financial leasing. The paper is organized into three main parts: The first part points out the needs for unification highlighting the initiatives of UNIDROIT in this context. Then the second part focuses on analyzing the definition, legal nature and some aspects of leasing which are unique in the international environment. The last part mainly discusses the sphere of application both substantive and geographic of the uniform rules and the general provisions

Keywords: UNIDROIT Convention; International Financial Leasing; Scope of application, uniform rules.

INTRODUCTION

In the last decades the development of financial industry, the continuous growth of commercial transactions between countries, the removal of economic barriers has stimulated the development of new forms of contracting in order to meet newly identified market needs and changes, for which the existing range of contractual techniques has proved inadequate.¹ This situation has resulted often in the creation of new contracts, such as financial leasing which has borrowed characteristics culled from different traditional contractual techniques. Over time financial leasing acquired his own conceptual autonomy with specific features in each legal system.

The world market of financial leasing from the beginning was strongly segmented with leasing companies operated inside their own national borders. Whereas financial leasing has been able to realize its full potential at national level in many countries has not been the same in the international level and among the factors held responsible for this shortcoming have been

¹ This phenomenon has been referred to as The "contrat sans loi" in the sense that such law as has grown up in respect of these techniques has fallen within the range of expression of the parties 'freedom of contract. UNIDROIT, Preliminary draft uniform rules on international financial leasing, explanatory report, Rome,1985

undoubtedly the vast differences in the legal treatment of financial leasing in different jurisdiction.

In general most legal systems have simply tried to force leasing into what seem the most appropriate of the existing contractual figures while neglecting the nature and economic reality of leasing. Only some of civil law countries have prepared law that regulate such contract while in other jurisdictions that have not yet taken steps in this direction judges have had to resort to the legal codes obtaining different solutions, while regarding to the common law countries, their different tradition led to solutions that are very distant from continental ones.² It was clear that if for traders is already difficult to read the national legal framework, the approach with the law of another country that has the same characteristics of fragmentation will be even more difficult.

Recognizing the need for certainty in international trade, the UNIDROIT³ secretariat proposed to Governing Council the realization of a preliminary study on the opportunity and the possibility to elaborate uniform rules on international financial leasing operation.⁴ This effort culminated in a multilateral convention in Ottawa in 1988 which governs the civil and commercial aspects of international financial leasing transactions. It took more than twenty years of work to put in practice the idea of creating a body of uniform rules in the field of leasing.

Even though the convention is still not so popular⁵, the unification of the law in this field has set a prerequisite for wider usage of leasing beyond national borders.⁶

The UNIDROIT Convention on International Leasing is structured into three main parts preceded by a preamble⁷:

- The first part includes articles which delimit the convention sphere of application both substantive and geographic, and also include general provisions. (chapter1, Article 1-6)
- The second part represents the main body of the convention and contains substantive provisions dealing with right and obligation of the parties (chapter 2, Article 7-14),
- And the third part include final provision (chapter 3, Article 15-25).
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The UNIDROIT Convention on International Leasing it's intended not only to facilitate the international leasing operations, but also to serve as a model for future national legislation.

² CLARIZIA, I contratti nuovi, page 92

³ The International Institute for the Unification of Private Law (UNIDROIT) was founded in 1926 with the purpose of studying ways of modernizing, harmonizing and coordinating private and in particular commercial law between States and groups of States.

⁴ The Convention is intended to govern only the "civil and commercial aspects of international leasing" while leaving accounting and taxation issues to applicable domestic law.

⁵ This convention has entered into force in Belarus, France, Hungary, Italy, Latvia, Nigeria, Panama, Russian Federation, Ukraine and Uzbekistan

⁶ The few substantive provisions governing only certain aspects of financial leasing transaction have not been sufficient to help the spread of financial leasing transition on a large-scale however they provided a balanced, basic legal framework for cross-border financial, and have paved the way to other important international instruments in this regard such as "Unidroit model law on leasing"

⁷ Which shows the purpose of unifying efforts such as removal of the legal obstacles which interfere with the spread of the international financial leasing, and at the same time, promote a fair balance of interests between the different parts of the operation.

This paper aims to provide an overview of the UNIDROIT Convention on International Financial Leasing focusing on analyzing the definition, legal nature of the contract, the sphere of application both substantive and geographic of the uniform rules and the general provisions.

DEFINITION AND GENERAL FEATURES OF INTERNATIONAL FINANCIAL LEASING

From an economic perspective financial leasing can be define as a financing technique for medium to long-term investments in which the lessor puts directly at the disposal of the lessee the equipment instead of the money needed for their purchase. The UNIDROIT Convention on International Leasing provides a definition of financial leasing that well describes the legal term of this economic operation.⁸ Financial leasing transaction includes three parties⁹ -- the lessor, the lessee and the supplier, and two contracts - the supply contract and the leasing contract.

The Convention appropriately distinguishes the financial leasing operation from the financial leasing contract highlighting the interdependence between the supply contract underneath the lease and the relationships that are created between the three parties involved in the operation. Chronologically and functionally, the tri-partite relationship passes several stages:¹⁰

- The first step in the operation is taken by the prospective lessee whom selects the supplier and the equipment¹¹ according to its requirements¹²;
- Once the equipment has been selected and the supplier chosen the lessee enters into a lease contract with the lessor requiring the acquisition of the equipment from the supplier and granting the use of it in the return for certain (periodic) payments. The rentals

⁸ The drafters of UNIDROIT convention on international financial leasing have imposed a conventional definition of the operation, contrary to what happened with the contract of sale that has not been expressly defined neither by the Vienna Convention of 1980, nor by the Hague Convention of 1964 it. According to part of the doctrine the notion of a sale has its core characteristic commonly recognized in the various legal systems and this somehow justifies the absence of a definition. On contrary the lack of a common framework in national laws for leasing agreement it would make it extremely difficult for the implementation of the Convention in the absence of a definition.

Moreover, the definition adopted by Article 1 incorporates almost textually the definition of "equipment leasing" adopted in 1977 by Leaseurope, the European Federation of Association of the leasing company (which was founded in 1972 and represent an umbrella body comprising the member associations for leasing industry in 33 countries)

⁹ UNIDROIT Convection on International Leasing, art. 1 (1) (a) by the interpretation of which we realize that the convention is inapplicable to a simple bilateral lease, for example, where the supplier and the lessor are one and the same

¹⁰ Herbert Kronke, Financial Leasing and its Unification by UNIDROIT – General Report, page 27 <http://www.unidroit.org/english/publications/review/articles/2011-1&2-kronke-e.pdf>, UNIDROIT, Report on the contract of leasing (credit-bail) Rome, March 1975 page 11-13

¹¹ The UNIDROIT Convection on International Leasing, art.1 (1) (a) specified that the equipment may be "plant, capital goods, or other equipment," Moreover, the Convention applies even when the equipment "has become a fixture to or incorporated in land." art. 4(1).

¹² He chooses according to his production needs and the lessor cannot claim to interfere in any decision regarding firm investment policy. However the use of the term "primarily in the article 1(2)(a) suggests that the lessor may take steps to protect its investment by recommending a particular type of equipment or a dependable supplier.

payable under the leasing agreement are calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment.¹³

- the lessor thereafter enters into a supply contract with the supplier, acquiring the asset selected by the lessee, meanwhile the supplier must be aware that the equipment is being acquired in order to lease to the lessee¹⁴
- the supplier delivers the equipment to the lessee.
- At the expiry of the period fixed in the leasing contract, the lessee has three options:¹⁵
 - He is entitled to seek renewal of the leasing contract for a further period, usually by continuing the contract with reduced rentals calculated on the basis of the equipment residual value at the end of the fixed period.
 - he may return the equipment to the lessor in a good working state or
 - he may exercise the option to purchase the equipment leased with a symbolic price. Typically in countries belonging to civil law family the final purchase option constitutes an essential element of the financial leasing contract but is not so in other countries especially in those belonging to common law systems¹⁶ For this reason the Convention is applicable regardless by the fact that the user has, or not the option of buying the good.¹⁷

The trilateral complex structure of the economic operation does not resolve in the presence of two independent contracts subsisting relationship between the parties which are not regulated directly by them. Although there is no contract between the lessee and the supplier, between them will be established a relationship which, despite not being contractual constitutes the logical basis of the atypical distribution of rights and obligations. For this reason the lessee in certain cases may be entitled to claim directly the supplier on the basis of the general rule that duties of the supplier under the supply contract shall also be owed to the lessee as if it were a party to that contract and as if the equipment were to be supplied directly to the lessee.

LEGAL NATURE OF INTERNATIONAL FINANCIAL LEASING

While seeking out the legal nature of financial leasing contract we should bear in mind some important factors:¹⁸

- The purpose of the operation namely to procure for lessee use of equipment instead of the expense of the full purchase price.
- The means resorted to in achieving this purpose, namely the credit facilities;
- The purely financial nature of the role played by the lessor whose sole interest is to have its own investment in the purchase price plus amortisation plus profit margin covered by the aggregate rental payments;

¹³ The UNIDROIT Convention on International Leasing, art 1 (2) (c)

¹⁴ The UNIDROIT Convention on International Leasing art 1 (2) (b)

¹⁵ The UNIDROIT Convention on International Leasing art 1(3)

¹⁶ FRIGNANI, *Leasing finanziario internazionale: analisi comparata*, 2000. P.283

¹⁷ So if a civil law judge is faced with an international leasing contract that does not contain the final purchase option will have to still apply the Convention and likewise a common law judge if is faced with an international leasing contract containing the characteristics required by art. 1 and the final purchase option will still have apply the convention provisions.

¹⁸ UNIDROIT, Report on the contract of leasing (credit-bail) Rome, March 1975, Study LIX-Doc 1, page 25

- The dynamic role played in the transaction by the lease who select the equipment and the supplier on its own;

In attempting to ascertain the legal nature and the qualification for a financial leasing agreement, it is necessary to answer the question whether it is possible to categorise leasing agreements among one of the pre-existing legal classification, or whether it should be considered to be a sui generis agreement. Casting a comparative eye upon the legal regulations in different countries we notice that the qualification of financial leasing agreements has encountered different attitudes in legal doctrine. So long as this analysis of legal nature of leasing remained theoretical, its impact in the on the operation of parties making use of leasing was correspondingly marginal but, with the growing internationalization of leasing transaction, on the one hand and the considered pronouncements of a growing number of courts and legislatures on the nature of leasing, on the other the opportunities for divergences and disparate treatment of leasing from country to country grew apace.¹⁹

UNIDROIT Convention classifies international financial leasing as a form of independent, innovative, sui generis contract. While it's true that financial leasing agreement contain similar elements of different pre-existing agreement regulated by the private law it emerge quite clearly that is not identical to any of those agreements including - neither loan, nor authorisation, nor hire, nor purchase agreements.

THE INTERNATIONALITY OF FINANCIAL LEASING UNDER UNIDROIT CONVENTION

The essence of an international leasing operation lies in the fact that the parties involved are resident or have their place of business in different countries. Considering the trilateral character of leasing transaction which involves the supplier, the lessee and the lessor can be identified four possible international leasing operations (cross border leasing)²⁰

- Export leasing - In an export lease the supplier and the lessor have their places of business in the same state and the lessee operates in another state.

In this case the lease is used as export financial support by the supplier.

- Import leasing - In an import lease, the lessor and the lessee are domiciled in the same country but the equipment supplier is located in a different country. The lessor imports the asset and leases it to the lessee.

- International financing when the leasing company belongs to a different state than the supplier and lessee which operate in the same state

- International leasing in the strict sense when the three parties operate in three different national legal systems

However, according to UNIDROIT Convention article 3 the essential relationship to bear in mind in calculating the internationality of leasing transactions it's the individual leasing contract concluded between the lessee and the lessor, and therefore is required that only the lessee and the lessor have their place of business in different countries, being irrelevant the location of the supplier. This means the third essential party to the international financial lease, may have its

¹⁹ UNIDROIT, Preliminary draft uniform rules on International Financial Leasing, Study LIX –Doc. 25

²⁰ MONFERRA, Il leasing internazionale, in Manuale del leasing, Milano, 1998, page 359

place of business in the same Contracting State as the lessor or the lessee, or in a third-party State. To this end is excluded the Import leasing transactions in which the supplier is seen as the only party belongs to another country.

The international character is given by a subjective criterion, more specifically the place of business of the lessor and lessee which should be in two different states. The place of business is a criterion normally used in international conventions to determine the international nature of the legal relationship. The concept of “place of business” is not defined under the UNIDROIT Convention the same way as for the Vienna Convention on the International Sale. The concept of place of business itself is uncertain it does not describe a juridical status such as citizenship.²¹

We agree with the part of the doctrine which believes that the place of business must be a permanent and regular place for the transacting, an actual stable business organization²² where the contracting party has autonomous power²³, and would not include a temporary place of sojourn during ad hoc negotiations such as conference centres or rented space in hotels or exhibitions.²⁴ According to the article 3(2) when a party has multiple places of business, to determine the internationality of the contract, the relevant place of business should be considered the one which has the closest relationship to the contract and to its performance²⁵.

The international nature of the relationship is not in fact sufficient to make the convection applicable. The Convention is applicable when not only the lessor and the lessee have their places of business in different contracting countries but also when that the supplier has its place of business in a Contracting country.

THE SPHERE OF APPLICATION OF THE UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

The substantive sphere of application is identified by article 1 which provides a definition of financial leasing that well describes the legal term of this economic operation²⁶ by highlighting also the original, complex, hybrid nature of the agreement. By the combined interpretation of paragraphs 1 and 2 of Article 1 are deduced the various types of leases that are excluded from the scope of the Convention.

²¹ Arthur Rosett, “Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods” available at <http://cisgw3.law.pace.edu/cisg/biblio/rossett.html>

²² Honnold, “Uniform law for international sales under the 1980 united nations convention”, 3rd edition Kluwer Law International, (1999), page 43

²³ Franco Ferrari, “Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing” available at <http://cisgw3.law.pace.edu/cisg/biblio/2ferrari.html#157>

²⁴ Arthur Rosett, “Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods” available at <http://cisgw3.law.pace.edu/cisg/biblio/rossett.html>

²⁵ The UNIDROIT Convection on International Leasing follows the same resolution as the Vienna Convention on the International Sale

²⁶ UNIDROIT Convention on international financial leasing, Ottawa, 28 May 1988, art 1

- **The sale and lease back contract.**²⁷

The tripartite nature of the operation excludes this contract from the scope of the Convention. In this case the parties are two as the supplier and the lessee are the same person. Also this contract is often used in real estate filed that is excluded from the scope of the Convention. In fact, Article 1 establishes in paragraph 1 that the object of leasing consists in plant material or other capital goods. This article has been posed with the intent to limit the scope only to movable property. Some doubt has arisen in connection with the term plant.²⁸ The principal source of difficulty arise when the plant that was leased as a chattel but subsequently became annexed to a land. Article 4²⁹ govern cases in which the good is incorporated or connected to immovable property by resorting to a rule of conflict, according to which the conflicts concerning relations between the lessor and the owner of real estate are subject to the *lex rei sitae*³⁰.

- **The consumer leasing** is explicitly excluded from the scope of the convention because the international financial leasing transaction, as well as described in Article 1, paragraph 4 covers only capital goods the destination of which must not be for personal, family or household use. According to UNIDROIT convention the equipment must be of a type that can be used by the lessee for business or professional purpose only. The exclusion of the consumer leases of movables from the scope of the convention is justified by the quite different criteria applicable to consumer and non-consumer transactions, according to which consumer contracts are subject to a specific and different rules which take into account the position of the consumer as a weaker party. Moreover, this exclusion intends to ensure that domestic consumer-protection laws are not affected by the UNIDROIT convention's provisions. Should be considered also the fact that consumer leasing is a particular case that has rare occurrence on the international filed.

- **The operating leasing** The exclusion of this type of contract is due to its complete assimilation to the rent in fact the lessor does not play a purely financial role as in financial leasing and therefore does not arise the same issues relating to the distribution of risks and responsibilities. Also according to article 1(2)(c) in the financial leasing agreement there is a link between the rentals payable under the leasing agreement and the period of economic amortisation of the leased asset, a link which would not normally exist under an operating lease.³¹

Falls within the scope of the Convention the sub-lease agreement, which is a contract used by a lessee, to lease a portion or the entire object to a third party for the remainder or even a portion of the remaining lease term.

²⁷ Sale and leaseback is the contract in which one party sells a property to a buyer and the buyer immediately leases the property back to the seller.

²⁸ Plant which is defined as the fixtures, implements machinery used in carrying on any industrial process.

²⁹ This article is intended to regulate any conflicts of interest that arise between the lessor and anyone who has property rights to the real estate, situation which in practice happen more frequently when the lessee fails

³⁰ *Lex rei sitae* is a Latin phrase that means "the law where the property is situated". This is a legal doctrine of property law and international private law.

³¹ UNIDROIT, Draft convention on International Financial Leasing 30 April 1987 page 32-33

Article 2 provides that in the case of one or more sub-leasing transactions involving the same equipment, for the scope of this Convention the supplier is the person from whom the first lessor bought the equipment and the supply contract is the one with which the equipment was originally acquired. Essentially independently of the number of sub-leasing contracts that have taken place there will be one supplier and one of supply contract, the original one. The Convention say nothing more about the form and the content that should characterize the contract and the type of connection.

Article. 5 of UNIDROIT convention on international financial leasing establishes the dispositive character of the uniform rules in terms of leasing by recognizing the autonomy of the parties a central role. This article provides the opportunity for the contracting parties to choose the applicable law and to define the exact terms of their contract.

The principle of party autonomy established in UNIDROIT Convention on international financial leasing Art. 5 is of paramount importance and represents a guarantee in the context of international trade.³² The basic objective of this principle is not the exclusion of the Uniform Law but to ensure the freedom of the contracting parties to choose the law applicable to their contractual relationship. In this connection, what is important to be discussed is the extent of the contracting parties' freedom of choice.

Unlike the provisions of the Vienna Convention, Party autonomy is a limit in three Convectional provisions which witch have imperative nature: Articles 8(3) lessor's warranty of quiet possession in case of intentional or grossly negligent acts of the lessor, Article 13(3)b lessor's damages in the event of default by lessee, Article 13(4) acceleration of rentals due.

Given the fact that the financial leasing operation includes three parties -- the lessor, the lessee and the supplier, and two contracts -- the supply contract and the leasing contract it was necessary to determine how the three parties contribute in determining the exclusion or derogation of the uniform rules. For the exclusion, the Convention, similar to the line followed for the field of application, has provided to involve all the three parties participating in the operation, so the exclusion of the Convention must be result of both the supply contract and the lease contract. In contrary the derogation from individual provisions are agreed by the parties in their mutual relations and is thus possible that one of the parties remains aliens to the exclusion of any conventional rules.

Another important principle in UNIDROIT convention is the good faith principle which is to be used for interpreting provisions of the Convention as a uniform international law text as stated in paragraph 1 of Article 6. Paragraph 1 therefore introduces indexes that must be followed in the

³² UNIDROIT Convention on International financial Leasing, (Ottawa, 28 May 1988), Art. 5

1.-*The application of this Convention may be excluded only if each of the parties to the supply agreement and each of the parties to the leasing agreement agree to exclude it.*

2. *Where the application of this Convention has not been excluded in accordance with the previous paragraph, the parties may, in their relations with each other, derogate from or vary the effect of any of its provisions except as stated in Articles 8(3) and 13(3)(b) and (4).*

UNIDROIT Principles, Article 1.1 - Freedom of Contract

The parties are free to enter into a contract and determine its content.

interpretation of this convention such as: a) the object and the objectives of the Convention just as enshrined in the Preamble, b) the international nature of the Convention, c) the uniformity application of this Convention, d) the observance of bona fides in international trade.

This provision clearly requires arbiters and judicial officers to treat the Convention as a creature autonomous from domestic laws, namely in interpreting the Convention, decision-makers must not be quick to "read in" domestic concepts.³³

CONCLUSION

Nowadays, international financial leasing has emerged as an important means of financing in international market. Being a type of contract still new that has not yet reached a stable comprehensive regulation in many countries, from the legal point of view the problem of harmonization, so as to lessen the degree of legal uncertainty, is felt more in this field than others. In this regard The UNIDROIT Convention on International Financial Leasing represents an important legal development for parties considering cross-border leasing transactions and has set a prerequisite for wider usage of leasing beyond national borders while also serving as a model for future national legislation.

UNIDROIT Convention recognized international financial leasing as "distinctive triangular relationship" highlighting her independent, innovative, sui generis nature. The sphere of application of the UNIDROIT convention is defined by Articles 1 – 6 according to which the convention governs the contract of international financial leasing (application *ratione materiae*) between the parties the lessee and the lessor whose places of business are in different States (application *ratione personae*) when the states of the three parties (lessee, lessor and supply) are Contracting States (direct application) or when the rules of private international law lead to the application of the law of a Contracting state (indirect application).

The inclusion of principles such as party autonomy, the obligation of good faith in the provisions of the UNIDROIT Convention reflects the strong conviction of the international community that specific warranties are the cornerstones of an open, market-oriented and competitive international economic order³⁴.

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³³ Disa Sim, The Scope and Application of Good Faith in the Vienna Convention on Contracts for the International Sale of Goods, September 2001, <http://www.cisg.law.pace.edu/cisg/biblio/sim1.html>

³⁴ Comment of article 1.1, UNIDROIT PRINCIPLES 2010, <http://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2010/>

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