

# THE 1988 UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

by  
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## Introduction

In the seventh decade of this century, the International Institute for the Unification of Private Law (hereinafter: UNIDROIT) started making uniform rules on both international financial leasing and international factoring. After many years of work,<sup>(1)</sup> a UNIDROIT committee of governmental experts adopted on April 24, 1987 a draft convention on international factoring. On April 30, 1987 another draft convention on international financial leasing was adopted. A diplomatic conference for the adoption of these two drafts was held in Ottawa, Canada from 9 - 28 May 1988 (hereinafter: Ottawa Conference). After consideration of these drafts, the Ottawa Conference drew up the UNIDROIT conventions on international financial leasing and on international factoring.

According to article 16 of the leasing convention and article 14 of the factoring convention, both conventions entered into force on May 1, 1995 when Nigeria deposited the third instrument of ratification (after France and Italy). On December 1, 1996, the conventions also entered into force for Hungary. The leasing convention, but only the leasing convention, entered into force for Panama on October 1, 1997.

The main aspects of the UNIDROIT convention on international financial leasing (hereinafter: the leasing convention) will be clarified in the following paper. The UNIDROIT convention on international factoring will hopefully be my topic in a separate publication.

The leasing convention contains a preamble and three chapters. The preamble addresses the purposes and objects of the leasing convention. Chapter one deals with the sphere of application and general provisions (articles 1 - 6). Chapter two addresses the rights and duties of the parties (articles 7 - 14). The third chapter contains final provisions (articles 15 - 25).

Before discussing the different aspects of the leasing convention, the historical development of financial leasing will be clarified, in particular the efforts of UNIDROIT to unify rules on this particular type of transaction.

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(1) The historical Development of financial leasing will be addressed in this article.

## I. Historical Development<sup>(2)</sup>

**A. Growth of Leasing:** The practice of leasing as an alternative to the neighboring legal concepts, e.g., bailment and conditional sale, goes back to the middle of the 19th century. However, the real growth of this special type of transaction began in the 1950's when independent leasing companies were established in the United States of America. After that the Mercantile Leasing was established in the United Kingdom in 1960. In 1962, two further leasing companies were established, namely Deutsche Leasing in the Federal Republic of Germany and Orient Leasing in Japan.

Despite the special character of leasing developed over time, this institution did not come to the attention of the legislature in most countries. Only occasionally was leasing ascribed special legal status by legislators. This was the case, for example, in France, Belgium, Brazil, Spain, Canada and United States of America.<sup>(3)</sup>

As a matter of fact, the advantages of financial leasing for both lessor and lessee were important factors in the growth of this type of transaction:<sup>(4)</sup> For the lessor, financial leasing is a better means than traditional security devices, such as mortgage, because the lessor is still the owner of the leased equipment. The lessee, on the other hand, may circumvent the import restrictions of his country through this type of transaction.

**B. Legislative History:** By the early 1970's, the developing importance of financial leasing came to the attention of UNIDROIT. In 1974, the UNIDROIT secretariat suggested to the governing council that it should examine the possibility of drawing up uniform rules on financial leasing. In 1975, the governing council accepted this suggestion and convened a small working group for that purpose. The working group recommended proceeding with unifying rules on leasing, but suggested many limitations, too.

Upon the recommendation of the working group, UNIDROIT sent out a questionnaire to leasing practitioners and experts throughout the world in 1976. After analyzing the replies to this questionnaire, UNIDROIT set up a six-member working group which actually worked in assistance with the leasing

(2) On this subject, see: Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 16 ff., p. 99 ff.. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 1 ff., p. 169 ff.. May, *Columbia J. Trans. L.* Vol. 22 (1984), p. 334 ff. Poczobut, *RechtsZ.*, Vol. 51 (1987), p. 685 - 689. Knebel, *Der Aufwendungsersatzanspruch*, p. 28 ff.. Dagefoerde, *Internationales Finanzierungsleasing*, p. 97 ff.. Cumming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 40, fn. 2.

(3) Cumming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 41, fn. 5.

(4) Cumming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 45.

experts in the world. This group recommended to the governing council that the fiscal aspects of leasing should be excluded and that a study group should be established to formulate a legal framework around this sui generis transaction.

Accordingly, UNIDROIT set up a study group which held four sessions (in 1977, 1979, 1980 and 1984) and prepared many studies and drafts on financial leasing. In addition, the UNIDROIT governing council decided, pursuant to the recommendation of the study group, to hold symposia to give exposure to the uniform rules from the operators of leasing in the world. In 1981, two symposia were held in New York and in Zurich. In 1983, a third symposium was held in Hong Kong. Also, the uniform rules were discussed in a seminar held in Rome in 1984 for French-speaking African lawyers.

In its fourth session in 1984, the study group, after considering the amendments proposed during the symposia, adopted the "preliminary draft uniform rules on international financial leasing"<sup>(5)</sup> (hereinafter: the 1984 preliminary draft). The UNIDROIT governing council then convened a committee of governmental experts to make the text of a draft convention suitable to be submitted for adoption at a diplomatic conference. This committee held three sessions in 1985, 1986, and 1987. In its last session, the committee adopted a draft convention on international leasing<sup>(6)</sup> (hereinafter: the 1987 draft). Finally, the Ottawa Conference adopted the leasing convention.<sup>(7)</sup>

## II. Scope of Application

### A. Definition of Financial Leasing:

First of all, it should be mentioned that the leasing convention does not explicitly define the term "financial leasing". In article 1 however, the leasing convention describes this special type of transaction. Thus, the decision whether or not the transaction at issue is financial leasing governed by the leasing convention does not depend on how the parties designate it.<sup>(8)</sup> Rather, it depends upon the existence of those features of the transaction described by the leasing convention.

According to article 1(1), a financial leasing transaction involves three

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- (5) You may see the text of this preliminary draft in: *Revue de Droit Uniforme* 1984 II, p. 65 - 75. *May, Columbia J. Trans. L. Vol. 22 (1984), p. 353 - 358*
  - (6) You may see this draft, in: *Diplomatic Conference, Vol. I, p. 22-27.*
  - (7) The text of the leasing convention has been included as an Appendix to this article.
  - (8) *Stanford, Revue de Droit Uniforme* 1984 II, Nr. 54, p. 143. *Stanford, Revue de Droit Uniforme* 1987 I, Nr. 37, p. 209.

parties, i.e., the lessor, the lessee, and the supplier. The lessee selects equipment which the lessor acquires from another, i.e., the supplier. It does not suffice if the lessor has the right to use the equipment only;<sup>(9)</sup> he shall be the owner of it.

The conditions under which the supply agreement is concluded shall be "approved by the lessee so far as they concern its interests". By so providing, the leasing convention actually differs from the 1987 draft under which all terms of the supply agreement were to be approved by the lessee. This rule could clearly have restricted the sphere of application of the leasing convention.<sup>(10)</sup> Under the present rule of the leasing convention, the lessor may, without the lessee's consent, arrange provisions of the supply agreement which do not concern the lessee, e.g., terms relating to the price of the equipment or payment. Although it is sometimes not easy to define the terms which concern the lessee and those which do not, the present rule is better than that of the 1987 draft.

The term "supply agreement" means any contract according to which the contractor acquires the equipment.<sup>(11)</sup> In addition to sale contracts, it covers contracts for work and services ("in which the party undertakes to bring about a particular result, e.g., ... to transport goods ... over a specified distance"<sup>(12)</sup>) and contracts for work and materials (that is, "contract for work and services in which the contractor supplies the material from which the work is to be made"<sup>(13)</sup>).<sup>(14)</sup> However, in practice the supply agreement is mostly a sale contract.<sup>(15)</sup>

In addition to the supply agreement made between the supplier and the lessor, the financial leasing transaction includes another agreement, namely: the leasing agreement between lessor and lessee. Under the leasing agreement, the lessee uses the equipment and pays periodic rentals to the lessor.

Obviously, the lessor concludes the supply agreement with the supplier and the leasing agreement with the lessee; he acquires the equipment from the

(9) Dagefoerde, Internationales Finanzierungsleasing, p. 110, 111.

(10) Comment on the 1987 draft by the Japanese government, in: Diplomatic Conference, Vol. I, p. 151, 152.

(11) It should be noted that that is the reason why the authors use the term "acquire" in article 1(1)(a) instead of "purchase", the term was used in a previous version of this subparagraph, (Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 69, p. 159).

(12) Dietl and others, *Dictionary* p. 722.

(13) Dietl and others, *Dictionary*, p. 722.

(14) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 694. Knebel, *Der Aufwendungsersatzanspruch*, p. 58, 59.

(15) Dagefoerde, *Internationales Finanzierungsleasing*, p. 110.

supplier and grants the lessee the right to use it. Thus, the lessor is actually a mere financier.<sup>(16)</sup> Taking into account the lessor's financial role and the fact that the lessee has to choose the supplier and to specify the equipment, this transaction shall be dealt with as such;<sup>(17)</sup> it can not be dealt with as two separate contracts.<sup>(18)</sup> This is reinforced by the preamble of the leasing convention. In the first paragraph of the preamble, the authors make it clear that "removing certain legal impediments to the international financial leasing of the equipment" is one of the main objectives of the leasing convention. Among these legal impediments, as the authors note,<sup>(19)</sup> is the inadequacy of legal treatment of financial leasing under most domestic laws.

From the title and preamble of the leasing convention, it is very obvious that this convention only addresses financial leasing transactions. However, in order to (clearly) differentiate this transaction from related legal concepts, the drafters of the convention provided in article 1(2) that a financial leasing transaction shall include all<sup>(20)</sup> of the following characteristics:

- the lessee specifies the subject matter of the leasing transaction, i.e., the equipment, and selects the supplier without relying on the skill and judgment of the lessor.

In fact, this characteristic is to some extent understandable from the provision of article 1(1)(a) under which the lessor, "on the specifications" of the lessee, makes the supply agreement with the supplier.<sup>(21)</sup> Thus, the provision of article 1(2)(a) only serves to illustrate further this characteristic.

(16) This term "financier" had been used during the legislative history to describe the lessor. But, it has not generally be used officially because it was "considered to be dangerous as a label", (Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 64, p. 153. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 62, p. 231).

(17) In fact, UNIDROIT has emphasized from the beginning, that financial leasing is legally distinct from classical contractual categories, (May *Columbia J. Trans. L.* Vol. 22 (1984), p. 337 - 338. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 58, p. 227. Knebel, *RIW* 1993, p. 539). This was actually clear from the label "sui generis lease" used until the preparation of the draft uniform rules on international leasing in 1981 to describe this transaction (Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 46, fn. 26).

(18) Knebel, *Der Aufwendungsersatzanspruch*, p. 56. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 55, p. 145, Nr. 69, p. 159. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 58, p. 227.

(19) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 42, p. 215. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 30.

(20) Poczobut, *RebelsZ*, Vol. 51 (1987), p. 696. Dagefoerde, *Internationales Finanzierungsleasing*, p. 107.

(21) Compare: Basedow, *RIW* 1988, p. 3.

- acquisition of the equipment by the lessor is connected with the leasing agreement. The supplier shall be aware of this leasing agreement. It makes no difference whether this agreement is already made or to be later on made between the lessor and the lessee. This characteristic makes it easy to understand the rules of the leasing convention on non-conformity and damages (articles 10, 12 and 13).<sup>(22)</sup>

It should be mentioned that variation in the leasing agreement is a matter that concerns only the lessor and lessee; the supplier's consent to such variation is not necessary, as this clearly does not concern him.

- periodic rentals to be paid by the lessee under the leasing agreement shall be calculated so as to take into account in particular<sup>(23)</sup> the whole amortization of the equipment cost or at least a substantial part of it. In other words, the use and enjoyment by the lessee of the leased equipment shall be for a period of time corresponding to its economic working life. Thus, rental payments by the lessee are not the only consideration for his right to use the equipment, but also guarantees the lessor the amortization of the cost he sustained when acquiring the equipment.<sup>(24)</sup> As long as a substantial part of the lessor's investment can be recovered, it would make no difference whether rentals relating to returns that were derived from the use of the equipment.<sup>(25)</sup>

Clearly, the leasing convention only governs leasing transactions involving three parties. In fact, it was a principal aim of the UNIDROIT working group to regulate only this kind of transaction.<sup>(26)</sup> This is emphasized in the third paragraph of the preamble of the leasing convention. In contrast, the two parties' other transactions are not addressed by the leasing convention. This is, for instance, the case concerning the so-called "sale and lease back", in which the

(22) Knebel, *der Aufwendungsersatzanspruch*, p. 40. Compare: Basedow, *RIW* 1988, p. 3.

(23) This makes it clear that other factors may also be considered when calculating the lessee's rentals, e.g., the cost of the transaction sustained by the lessor, (*Stanford, Revue de Droit Uniforme* 1987 I, Nr. 70, p. 241), or the price of the equipment that is to be sold or released at the end of the leasing agreement either to the lessee or to a third party, (*Cuming, Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 48, fn. 33).

(24) *Stanford, Revue de Droit Uniforme* 1987 I, Nr. 32, p. 205.

(25) This argument had been mentioned at the Ottawa conference to make it clear that the leasing convention applies to financial leasing transactions made by the MIGA (i.e., Multilateral Investment Guarantee Agency), established in 1988 under the auspices of the World Bank, for the purpose of insuring investment in developing countries against non-commercial risks, e.g., contract breach by governmental agencies, (*Diplomatic Conference*, Vol. II, p. 51-52).

(26) *Stanford, Revue de Droit Uniforme* 1984 II, Nr. 21, p. 107.

lessee first sells the leased equipment to the lessor and then leases it.<sup>(27)</sup> Likewise, the leasing convention does not apply to a transaction in which the supplier and the lessor are one and the same person, e.g., the lessor himself produces the equipment.

The leasing convention also does not govern operating leasing which is normally done for so short period of time that the equipment can be leased many times to different lessees in succession.<sup>(28)</sup> In this kind of transaction, the lessor buys the equipment under his own initiative before the lessee comes on the scene.<sup>(29)</sup>

Operating leasing normally causes no problem. As a two-party contract, it can be characterized as one of the well-known types of contracts,<sup>(30)</sup> normally as bailment.<sup>(31)</sup> Problems arising from three-party leasing, in particular those caused by the lack of contractual relation between the supplier and the lessee, do not arise in connection with operating leasing.<sup>(32)</sup> In fact, that's why the drafters decided to limit the scope of application for the leasing convention to financial leasing transactions.<sup>(33)</sup>

Also, the third characteristic under article 1(2) that rentals shall cover the cost of the equipment incurred by the lessor should make it clear that the leasing convention only governs the three-parties leasing transaction. Operating leasing is excluded, as the lessor can not normally recover the cost of the equipment

(27) Knebel, *Der Aufwendungsersatzanspruch*, p. 39. Dageforde, *Internationales Finanzierung-leasing*, p. 108, 112, 113. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 54, p. 223. Dagefoerde, *RIW* 1995, p. 266. Comment on the 1987 draft by the Pakistani government, in: *Diplomatic Conference*, Vol. I, p. 164, 165.

(28) Knebel, *Der Aufwendungsersatzanspruch*, p. 57, Goode, *J. Bus. L.* 1987, p. 318, 399. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 7, p. 87.

(29) Goode, *J. Bus. L.* 1987, p. 318. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 7, p. 87.

(30) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 54, p. 143. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 35, p. 207.

(31) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 35, p. 207.

(32) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 43, p. 131. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 36, p. 209.

(33) Notably, at the symposia held in New York in 1981, United States practitioners objected to this decision: They argued that operating leasing agreements are often made by the same finance companies that make financial leasing transactions. Thus, it would be illogic to make the leasing convention only applicable to one part of these companies' transactions. In addition, it is necessary to protect the lessor in both types of leasing transactions when the lessee is declared bankrupt or otherwise does not perform, (Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 34, p. 119, Nr. 40, p. 129).

during the short term of the contract. In this transaction, rentals are based on the use-value of the equipment because the period in which the equipment is used by the lessee is less than its actual economic working life.<sup>(34)</sup> The amortization of the lessor's cost is therefore realized only when the equipment is leased many times.

Admittedly, the term "amortization" itself has been criticized. It belongs to tax law and is therefore not proper for defining a civil law term.<sup>(35)</sup> In addition, it is questionable whether the above mentioned characteristic differentiates a financial leasing transaction from other types of leasing. When calculating the lease price, the lessor - in all types of leasing, including operating leasing - actually takes into account the period of use of the leased equipment and the time of amortization.<sup>(36)</sup> Because rentals in financial leasing cover the amortization of the equipment cost, this transaction is typically concluded once with the equipment in question. But the formula of article 1(2) does not necessarily lead to this conclusion. Thus, the authors should have used another characteristic, namely that the equipment is leased just one time,<sup>(37)</sup> in which the term of the lease is substantively equivalent to the period of economic amortization of the equipment.<sup>(38)</sup>

This opinion is supported by legislative history,<sup>(39)</sup> in particular by the fact that the diplomatic conference in Ottawa did not adopt article 13(2) of the 1987 draft convention.<sup>(40)</sup> Under this article, the leasing convention should have been applied to cases where more than one leasing transaction was concluded with different persons concerning the same equipment. The provision was not adopted because this case seldom occurs in praxis: the

(34) Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 47.

(35) Dagefoerde, *Internationales Finanzierungsleasing*, p. 113. Poczobut, *RabelsZ*, Vol. 51 (1987), p. 696.

(36) Dagefoerde, *Internationales Finanzierungsleasing*, p. 114. Dagefoerde, *RIW* 1993, p. 265. May, *Columbia J. Trans. L.* Vol. 22 (1984), p. 343. Basedow, *RIW* 1988, p. 3.

(37) Basedow, *RIW* 1988, p. 3.

(38) May, *Columbia J. Trans. L.* Vol. 22 (1984), p. 343. Dagefoerde, *RIW* 1993, p. 265.

(39) The UNIDROIT study group noted that the accommodation of both financial and operating leasing in the same text would prejudice the chances of success of this text, (*Stanford, Revue de Droit Uniforme* 1984 II, Nr. 45, p. 133).

(40) It provided as follows: "In the case of a series of transactions involving the same equipment which includes more than one financial leasing transaction, this Convention applies as if the last financial lessor were the lessor and as if the supplier from whom the first financial lessor acquired the equipment were the supplier".

term of the leasing transaction is normally equal to the period of the economic use of the equipment.<sup>(41)</sup>

The leasing convention enlarges its sphere of application in two aspects. First, this convention applies to financial leasing transaction regardless of "whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental", article 1(3). In fact, this provision is of great importance as domestic laws are completely different on this point. According to French, Belgian and Portuguese laws, such an option forms an important ingredient of leasing.<sup>(42)</sup> This is also the case under Italian<sup>(43)</sup> and Brazilian<sup>(44)</sup> laws. On the other hand, in English law the transaction cannot be characterized as leasing if it includes this option; it is instead a conditional sale or a hire-and-purchase.<sup>(45)</sup> Therefore, it was necessary to make it clear that both kinds (i.e., with or without the option) are considered financial leasing transactions which the leasing convention governs. Taking into account that the leasing convention governs international financial leasing only, the provision of its article 1(3) will not prejudice particular solutions adopted by the contracting states regarding "wholly domestic transactions".<sup>(46)</sup>

Second, the leasing convention addresses financial sub-leasing. This means that this convention also applies if the lessee has leased the equipment which is the subject matter of the original leasing transaction. In such cases, the original lessee is considered lessor in his relation to the new lessee under the sub-leasing; the supplier under the original leasing is considered supplier under the sub-leasing, article 2. Thus, the original supplier will always be the supplier regardless of how many sub-leasing transactions are made. Due to his main role as a financier, the original lessor is not considered supplier under the sub-leasing.

Likewise, the leasing convention may apply to so-called "leveraged

(41) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 716.

(42) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 697, fn. 6. Knebel, *Der Aufwendungsersatzanspruch*, p. 4, 5, 9. Dagefoerde, *Internationales Finanzierungsleasing*, p. 119. Goode, *J. Bus. L.* 1987, p. 319. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 8, p. 87.

(43) Dagefoerde, *Internationales Finanzierungsleasing*, p. 119.

(44) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 8, p. 87.

(45) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 697, fn. 6. Knebel, *Der Aufwendungsersatzanspruch*, p. 4, 9. Dagefoerde, *Internationales Finanzierungsleasing*, p. 119. Goode, *J. Bus. L.* 1987, p. 319. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 8, p. 87, Nr. 71, p. 161.

(46) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 78, p. 251.

leases".<sup>(47)</sup> In this transaction, the lessor puts up only a part of the equipment cost. For the other part, the lessor recourses to one or more lenders who, in turn, "assure their position by requiring an assignment to themselves of the stream of rentals provided for under the leasing agreement".<sup>(48)</sup>

Finally, in order to apply the leasing convention, both contracts that the leasing transaction entails, i.e., the supply agreement and the leasing agreement, should be made on or after the date in which the leasing convention becomes effective in the concerned contracting states, article 23.

### **B. Focus on Equipment:**

According to article 1(1)(a), the leasing convention applies to transactions "under which the lessor acquires plant, capital goods or other equipment (the equipment)". This makes it clear that this convention governs all transactions whose subject matter is movable leased objects. In fact, this was the clear intention of the authors. However, they decided not to use the term "movable" because its meaning differs considerably from one legal system to another.<sup>(49)</sup>

The leasing convention does not apply to immovable objects, e.g., pieces of land.<sup>(50)</sup> this rule actually corresponds to the fact that real estate leasing does not normally have international aspects.

However, the leasing convention may - under article 4(1) - apply to transactions where "the equipment has become a fixture to or incorporated in land". This is mostly the case concerning huge industrial plants.<sup>(51)</sup> Under domestic law, the equipment in such a case is no longer personal property; instead it is generally considered real property. This clearly endangers the lessor's rights in the equipment. Thus, the rule of the leasing convention is of considerable importance, since it safeguards the lessor's interests.<sup>(52)</sup>

Nevertheless, the leasing convention itself does not determine when equipment has become a fixture to or incorporated in land. This is defined

(47) Knebel, *Der Aufwendungsersatzanspruch*, p. 41, 42. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 39, p. 211, Nr. 57, p. 227. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 46, fn. 27.

(48) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 103, p. 205. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 39, p. 211, Nr. 141, p. 317. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 44, fn. 21.

(49) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 63, p. 151, 153. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 63, p. 233.

(50) In fact, the UNIDROIT working group set up in 1975 had decided to exclude the leasing of land "because of the obviously enormous difficulties" in unifying rules on real estate, (May, *Columbia J. Trans. L.* Vol. 22 (1984), p. 334. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 18, p. 103).

(51) Dagefoerde, *Internationales Finanzierungsleasing*, p. 117.

(52) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 715.

according to applicable domestic law, i.e., the law of the state in which the land is situated. This law also determines "the effect on the rights inter se of the lessor and a person having real rights in the land".

In addition, the leasing convention applies to the leasing of ships and aircraft. (It makes no difference whether the ship is a sea-going or domestic vessel<sup>(53)</sup>). This is actually derived from article 1(1)(a): As they are not expressly excluded, the term "capital goods" implicitly encompasses them.<sup>(54)</sup> This is reinforced by article 7(3)(a) and (b).

It is worth noting that the UNIDROIT working group recommended in 1975 that the uniform rules on financial leasing should not apply to the leasing of ships and aircraft.<sup>(55)</sup> In 1977, the subsequent study group decided that ships and aircraft should be included in the general scope of the uniform rules on leasing.<sup>(56)</sup> However, the 1987 draft did not include a provision on this topic. The Ottawa Conference did not maintain a proposal according to which any contracting state could declare that it will not be bound by any part of the leasing convention if the subject matter of the leasing transaction is a ship.<sup>(57)</sup>

Thus, the rule of the leasing convention is actually very important in this respect because ships and aircraft are often the subject matter of international financial leasing.<sup>(58)</sup> In fact, such financial leasing transactions are called "Big-Ticket-Leasing".<sup>(59)</sup>

It should finally be mentioned that the leasing convention does not apply to a financial leasing transaction whose subject matter is an equipment "which is to be used primarily for the lessee's personal, family or household purposes", article 1(4).<sup>(60)</sup> In fact, international financial leasing is generally not concluded for such purposes.<sup>(61)</sup> Rather, it is normally made for business or professional

(53) Diplomatic Conference, Vol. II, p. 19.

(54) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 64, p. 233.

(55) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 21 (vi.), p. 109.

It should be mentioned that, regarding ships, this was also the opinion of the Comité Maritime International as stated in its position paper submitted to the Ottawa Conference, (Diplomatic Conference, Vol. I, p. 207 - 209. Diplomatic Conference, Vol. II, p. 59, 77 ff.).

(56) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 23, p. 113.

(57) This proposal was made by the United Kingdom delegation, (see: Diplomatic Conference, Vol. I, p. 244, 276. Diplomatic Conference, Vol. II, p. 59).

(58) Dagefoerde, *Internationales Finanzierungsleasing*, p. 118. Comité Maritime International, in: Diplomatic Conference, Vol. II, p. 60.

(59) Knebel, *Der Aufwendungsersatzanspruch*, p. 5.

(60) In fact, the leasing convention, in so providing, actually follows the formula adopted by CISG, article 2(a).

(61) Knebel, *Der Aufwendungsersatzanspruch*, p. 43. Dagefoerde, *Internationales Finanzierungsleasing*, p. 121. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 56, p. 225. Basedow, *RIW* 1988, p. 4.

purposes. In any event, this rule should encourage states which hold to a high standard of consumer protection to ratify the leasing convention, as such a ratification in no way endangers this standard.<sup>(62)</sup>

### C. International Transactions:

According to both the title and the preamble of the leasing convention, it is clear that this convention only governs international financial leasing transactions.<sup>(63)</sup> This is reinforced by article 3.<sup>(64)</sup> This article also provides for the terms that should be satisfied for a financial leasing to be considered "international".

In order to apply the leasing convention, one of the following two situations should obtain. First, the state in which the lessor has his place of business, the state in which the supplier has his place of business, and that state in which the lessee has his place of business shall be contracting states of the leasing convention, article 3(1)(a).

Second, it suffices if both the supply agreement and the leasing agreement are governed by the law of a contracting state, article 3(1)(b). In this situation, the leasing convention (relatively) enlarges its scope of application; it may be applied in a non-contracting state. Moreover, the contracting states of the leasing convention cannot - unlike, for instance, the 1980 UN Convention on Contracts on the International Sale of Goods (hereinafter: CISG), article 95 - declare that they will not be bound by article 3(1)(b). The authors of the leasing convention actually refused a provision to this effect.<sup>(65)</sup>

(62) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 698.

(63) However, it is also an intention of the authors that the leasing convention may - in countries still lacking a legislation on the financial leasing - be a basis of domestic law designed to fill this legislative gap, (Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 40, p. 213).

(64) This article in fact follows the approach adopted by CISG; article 1(1), 10(a).

(65) The draft final provisions capable of embodiment in the draft convention on international financial leasing drawn up by a UNIDROIT committee of governmental experts included, in its article F, a provision which was based on CISG, article 95. It provided: "A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession that it will not be bound by article 2(1)(b)", (see: *Diplomatic Conference*, Vol. I, p. 110). Pursuant to the proposal of the Hague Conference on Private International Law, this provision had been deleted on the ground that it would jeopardize the widespread application of the leasing convention; it would narrow further the already narrow geographical scope of application of this convention which, in order to apply, requires either that the principal places of business of all three parties are in contracting states or that both the supply agreement and the leasing agreement are governed by the law of a contracting state, (*Diplomatic Conference*, Vol. I, p. 177 - 180. *Diplomatic Conference*, Vol. II, p. 65. Compare also the proposal of the Denmark delegation to the Ottawa Conference, in: *Diplomatic Conference*, Vol. I, p. 205. *Diplomatic Conference*, Vol. II, p. 65, 66).

The most important point in this situation is that the supply and leasing agreements are subject to the law of a contracting state (not necessarily the same state<sup>(66)</sup>). This law can be defined according to the conflict-of-law rules of the forum state.<sup>(67)</sup> Needless to say, the parties choice of law is very important in this respect. The parties may choose the law of a contracting state or the law of a non-contracting state.

It should be noted that each situation is independent from the other,<sup>(68)</sup> none of them can complete the other. For instance, the leasing convention is not applicable only when the lessor and the lessee have their places of business in contracting states. It is of no importance here whether the law governing the supply agreement is a law of a contracting state.

In either situation however, the lessor and the lessee shall in addition have their places of business in different states, article 3(1) first sentence. (A proposal to disregard this requirement in certain situations had been rejected at the Ottawa Conference<sup>(69)</sup>). In so providing, the authors make it clear that the leasing agreement is much more important here than the supply agreement<sup>(70)</sup>:

Normally, the supplier has his place of business in the state in which the lessor also has his place of business. This means that an international financial leasing transaction in this case entails a (national) supply agreement between the lessor and the supplier and an (international) leasing agreement between the lessor and the lessee.

By way of contrast, the leasing convention does not apply to a financial leasing transaction in which the leasing agreement is national (i.e., the lessor and the lessee have their places of business in one state). In such a case, it does not matter whether the supply agreement is international (i.e., the lessor and the supplier have their places of business in different states).

Notably, the requirement that the supplier's place of business is in a contracting state or his contract with the lessor is governed by the law of a contracting state is also important, as article 10 of the leasing convention creates a legal relationship between the supplier and lessee.<sup>(71)</sup>

(66) Goode, J. Bus. L. 1987, p. 319.

(67) Stanford, Revue de Droit Uniforme, 1984, Nr. 66, p. 157.

(68) Dagefoerde, Internationales Finanzierungsleasing, p. 123.

(69) According to the United State delegation, this requirement should be disregarded whenever it was, at the time of conclusion, not clear that the lessor and lessee have their places of business in different states, (Diplomatic Conference, Vol. I, p. 213).

(70) May, Columbia J. Trans. L. Vol. 22 (1984), p. 334. Stanford, Revue de Droit Uniforme 1984 II, Nr. 65, p. 155. Stanford, Revue de Droit Uniforme 1987 I, Nr. 73, p. 245. Cuming, Arizona J. Int'l & Comp. L., Vol. 7:1 (1989), p. 49.

(71) Cuming, Arizona J. Int'l & Comp. L., Vol. 7:1 (1989), p. 49, 50.

Finally, if the party has more than one place of business, the place of business which has the closest relationship to the concerned agreement and its performance shall be considered, article 3(2). In so providing, the leasing convention actually follows the formula of CISG, article 10(a).

### **III. Interpretation, Gap-Filling and Exclusion of the Leasing Convention**

#### **A. Interpretation of the Leasing Convention:**

Article 6(1) defines the purposes of the interpretation of the leasing convention. When interpreting any provision, the object and purpose of the leasing convention should be taken into account. The preamble clearly provides for the purposes of the convention. The most important of these purposes is the removal of "legal impediments to the international financial leasing of equipment" and the maintenance of "a fair balance of interests between the different parties to the transaction". The special character of financial leasing transactions should not be prejudiced when interpreting a leasing convention provision.<sup>(72)</sup>

In the interpretation of the leasing convention, attention must be drawn to "its international character and to the need to promote uniformity in its application and the observance of good faith in international trade". In so providing, the leasing convention actually follows the approach already adopted by CISG. But both conventions do not provide for the means of interpretation. This subject has been discussed in detail in another article of the present writer to which reference could be made.<sup>(73)</sup>

#### **B. Gap-Filling of the Leasing Convention:**

The leasing convention only includes some of the rules concerning international financial leasing. In other words, this convention does not address all aspects of a financial leasing transaction. Of course, in relation to matters governed by the leasing convention, any disputes can be settled according to the rules of this convention. In cases of dubious provisions, tribunals may interpret them according to the principles set forth in article 6(1) mentioned above.

Needless to say, matters that are not dealt with by the leasing convention

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(72) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 152, p. 327.

(73) See: Dawwas, *Uniform Interpretation Under article 7/1 of CISG*, to be published in *DIRASAT Journal* - University of Jordan.

are still to be settled under applicable domestic law. But questions concerning matters governed by the leasing convention which are not expressly settled in it are to be settled in a different way. First, they should be settled according to the general principles on which the leasing convention is based. In fact, the drafters recognized the fact that these general principles do not provide any help in certain cases. Therefore, they - in the absence of the general principles<sup>(74)</sup> - allow reference to domestic law applicable by virtue of the rules of private international law.<sup>(75)</sup>

Briefly, the settlement of such questions according to applicable domestic law is only permissible under article 6(2) as a last resort. This approach clearly supports the autonomous nature of the leasing convention.

### C. Exclusion of the Leasing Convention:

The leasing convention only governs financial leasing transactions involving three parties. Accordingly, it is logical that exclusion of the leasing convention in toto is only effected if the three parties of the transaction agree to this, article 5(1). This means that each party has a veto the application of the leasing convention.

It should be mentioned that this rule of article 5(1) completely differs from that of article 14(1) of the 1987 draft.<sup>(76)</sup> Under the provision of the latest article, complete exclusion of the leasing convention could have been effected either by the parties to the supply agreement or by the parties to the leasing agreement. This rule of the 1987 draft convention, article 14(1) could clearly have led to an unreasonable outcome, namely the application of more than one law to a financial leasing transaction.<sup>(77)</sup> For example, where the parties to the leasing agreement excluded the leasing convention, then the lessor-lessee relationship would have been governed by a body of law different from the law applicable to the lessee-supplier relationship. Furthermore, article 14(1) of the 1987 draft gives priority to bilateral agreements, which contradicts the fact that financial leasing transactions involve three parties.<sup>(78)</sup> Thus, the restrictive rule laid down in the

(74) It should be mentioned that the 1987 draft did not provide for the priority of general principles over applicable law. article 15(2) thereof provided that reference in such cases should be made to the general principles of the leasing convention **and** to the law applicable by virtue of the rules of private international law.

(75) In so doing, the leasing convention adopts word for word the formula of CISG, article 7(2). For more details on this topic, see: Dawwas, DIRASAT, supra fn. 74.

(76) This article provided as follows: This convention shall not apply where it is excluded either by the terms of the supply agreement or by the terms of the leasing agreement".

(77) Dagefoerde, Internationales Finanzierungsleasing, p. 125.

(78) Comment on the 1987 draft by the Swiss government and by the Hague Conference on Private International Law, in: Diplomatic Conference, Vol. I, p. 163, 180, respectively.

leasing convention, article 5(1) is much better, as it precludes that one of the parties is surprised, namely when the leasing convention is excluded entirely without the knowledge of this party.

It should also be noted that Mr. Rebmann, the representative of the Federal Republic of Germany, and Mr. Réczai, the representative of Hungary, suggested at the Ottawa Conference making the supplier's consent unnecessary for exclusion of the leasing convention in its entirety.<sup>(79)</sup> The reason behind this suggestion, they argued, was the fact that the supplier's main interest is to sell the equipment and whether or not this equipment was the subject matter of a financial leasing transaction is "of no direct concern" to him.<sup>(80)</sup> Fortunately, this opinion was not supported by the convention. It does not actually take into account that the lessee, under the leasing convention, article 10, has direct right of action against the supplier. It goes without saying that this is of considerable importance for the supplier.

In contrast, the possibility of contracting out of any of the leasing convention's provisions is not so restricted. The parties to the supply agreement as well as the parties to the leasing agreement may exclude any provision of the leasing convention, provided that this provision only concerns the interests of the excluding parties. This is clearly provided for in article 5(2). It reads in part "the parties may, in their relations with each other, derogate from or vary the effect of any of its provisions". As the parties may only exclude a provision concerns their relation among each other, there is no risk that such exclusion disadvantages the third party of the transaction.

However, the leasing convention includes some provisions of mandatory nature that the parties cannot exclude article 5(2) defines these provisions. They are the provisions of articles 8(3) and 13(3)(b) and (4). Under article 8(3), the parties may not derogate from or vary the lessor's warranty to the lessee of quiet possession in so far as the superior title, right or claim of others is derived from the lessor's intentional or grossly negligent act or omission. Article 13(3)(b) preserves the court's power to strike down any contractual clause which provides for damages substantially in excess of the non-performance damages the lessor is entitled to claim. Article 13(4) precludes the lessor from claiming accelerated payments of future rentals when he terminates the leasing agreement.

Obviously, the provisions of the leasing convention which are mandatory are all to the lessee's advantage. This reflects the fact that the lessor normally has such a strong economic and bargaining position that he could exploit the lessee.

(79) Diplomatic Conference, Vol. II, p. 73, 74.

(80) Diplomatic Conference, Vol. II, p. 73, 74.

It should also be mentioned that the parties to the supply agreement or those to the leasing agreement may not contract out of articles 5 and 6, as these do not concern their relation with each other.<sup>(81)</sup>

#### IV. Rights and Duties of the Parties

The leasing convention does not govern all rights and duties of the parties.<sup>(82)</sup> Even some of the main duties of the parties are not clearly addressed by the leasing convention. Examples are the duty of the supplier vis-à-vis the lessee to deliver the equipment contracted for, the duty of the lessor to lend the lessee using the leased equipment, and the duty of the lessee to pay periodic rentals. However, these duties may be concluded from the provisions of the leasing convention. (In fact, the leasing convention mainly addresses cases of non-performance by the supplier and the lessee).

In the following section, the rights and duties of the parties addressed by the leasing convention will be considered. First, these rights and duties will be dealt with in general. Second, two special cases will be addressed in details, namely: non-conformity of the equipment and default of the lessee.

##### A. Rights and Duties in General:

According to the special character of financial leasing, the lessee's main obligation is to choose both supplier and equipment. The lessor mainly finances the leasing transaction; he acquires the chosen equipment and grants its use to the lessee.

Under the leasing convention, the lessor must, when modifying the terms of the supply agreement, take the consent of the lessee into account as far as this modification affects the lessee's interests, article 11. The leasing convention does not however address the results of non-compliance with this duty by the lessor. Thus, reference shall be made in this regard to rules of the applicable law on ex contract.<sup>(83)</sup>

For his use of the equipment, the lessee shall pay periodic rentals to the lessor. When defining the volume of these rentals, the amortization of the whole

(81) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 149, p. 325.

(82) In so doing, the authors actually wanted to underscore the precise nature of financial leasing which differentiates it from related legal concepts, e.g., bailment and conditional sale. This approach could also enhance the chances that the leasing convention be accepted by a large number of concerned parties, (Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 34, p. 207, Nr. 47, p. 219).

(83) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 699.

or a substantial part of the cost of the equipment shall in particular be taken into consideration. The leasing convention does not deal with other matters concerning rentals, e.g., the manner in which they are to be paid.<sup>(84)</sup> Such questions shall therefore be decided under applicable law.

In the following discussion, two cases clearly addressed by the leasing convention will be dealt with, namely: the lessor's liability (article 8(1)), and the lessee's duty to take care of the equipment (article 9).

**1. Liability of the Lessor:** In financial leasing it is the supplier who delivers the equipment conforming to the specifications indicated by the lessee. It is therefore realistic that the leasing convention generally excuses the lessor from liability for non-conformity of the equipment, article 8(1) also excludes the lessor's liability in tort, e.g., his liability for death and personal injury caused by the equipment to the lessee.<sup>(85)</sup> This rule does not however apply if the parties (explicitly<sup>(86)</sup>) agree to or the leasing convention itself provides for the contrary (e.g., articles 8(2) and 12).

Thus, the remedies the lessee normally demands in cases of non-conformity of equipment may not - under article 8(1) - be claimed against the lessor. For example, the lessee may not ask the lessor for delivery of substitute equipment or for repair of the defective equipment. Also, the lessee may not claim against the lessor the recovery of damages resulting from non-conformity of the equipment.

In fact, the general rule laid down in article 8(1) corresponds to the precise legal character of financial leasing transactions under which the lessor's main role is purely financial. He neither makes the equipment nor delivers it. Moreover, he does not choose either the equipment or the supplier. On the contrary, it is the lessee who generally has to choose both supplier and equipment. Accordingly, it is logical that the lessor is not responsible for the condition of the equipment. Otherwise, the lessee could blame the lessor for the lessee's own bad choice of supplier or equipment. (The lessee can seek redress from the supplier in cases of non-conformity of equipment, article 10). In this

(84) Dagefoerde, Internationales Finanzierungsleasing, p. 128. Poczobut, *RabelsZ*, Vol. 51 (1987), p. 705.

(85) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 109, p. 283.

(86) It should be mentioned that Mr. Brennan, the representative of Australia, proposed, at the Ottawa Conference, the addition of the word "expressly" to the provision of article 7(1) of the 1987 draft (equivalent to article 8(1) of the leasing convention) in order to make it clear that an implied term of the leasing agreement has no effect in this regard, (Diplomatic Conference, Vol. II, p. 120). As only seven delegations indicated their support to this proposal, Mr. Brennan withdrew it. However, the understanding of the provision at issue, as indicated by the Chairman without objections by the delegations, is that "the leasing agreement" does not "include implied terms of that agreement", (Diplomatic Conference, Vol. II, p. 122 - 125).

respect, the leasing convention differs from most domestic laws under which the lessor is liable against the lessee for non-conformity of the equipment.<sup>(87)</sup>

Notwithstanding the general rule of article 8(1), the lessor incurs liability to the lessee for non-conformity of the equipment if he (as an exception) has played a role in the selection of the supplier or the equipment and the lessee has relied on the lessor's skill and judgment when doing that. This would normally be the case where large sums of lessor's money are involved.<sup>(88)</sup> In such a case, the lessor shall be liable to the extent he has intervened. By so providing, the leasing convention requires a direct causal relationship between the lessor's intervention and the damage resulted therefrom. It also makes it clear that the damages recovered by the lessee are properly related to the lessor's intervention and the lessee's reliance thereon.<sup>(89)</sup> The leasing convention does not however determine when the lessor intervenes in the choice of the equipment or the supplier. It is therefore applicable law that decides this question.<sup>(90)</sup> Also, this exceptional lessor's liability may be varied at will.<sup>(91)</sup>

Notably, the leasing convention does not determine whether the lessor shall also be liable if he knows of any defects in the equipment chosen by the lessee, but does not inform the lessee of this.

**2. Lessee's Duty to Take Care of the Equipment:** Under the financial leasing transaction, the lessee uses the equipment. In so doing, he shall - under the leasing convention, article 9(1) - take care of the leased equipment. He may only use it in a reasonable manner.<sup>(92)</sup> He has to keep it in good condition, namely in the condition in which it is delivered to him. However, wear and tear resulting from reasonable use of the equipment is permissible. This is also true concerning modification of the equipment to which the parties have agreed.

(87) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 700. Dagefoerde, *Internationales Finanzierungsleasing*, p. 140. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 84, p. 177. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 108, p. 281. Under article 670(1) of the Russian civil code (which, namely its second part, is in force since March 1, 1996), the lessor does not generally incur liability for non-conformity of the leased equipment. He may however be liable to the extent he has chosen the seller, i.e., the supplier. In such a case, the lessee may - under article 670(2) thereof - bring his action against the lessor or against the supplier.

(88) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 68, p. 237.

(89) Mr. Mooney, representative of the United States of America, in: *Diplomatic Conference*, Vol. II, p. 129.

(90) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 86, p. 179. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 102, p. 275.

(91) Dagefoerde, *RIW* 1995, p. 266.

(92) It should be mentioned that article 8(1) of the 1987 draft convention used the term "normal use". The authors have substituted it by the term "use ... in a reasonable manner". This makes it clear that the reasonableness of the use depends upon the type of equipment leased, (Mr. Goode, the representative of the United Kingdom, in: *Diplomatic Conference*, Vol. II, p. 142).

The lessee's duty to take care of leased equipment begins with his taking over the equipment and ends with returning it to the lessor. When returning the equipment at the time the leasing agreement comes to an end, the equipment shall - under article 9(2) - be in the condition mentioned above, i.e., in good working order. This will however not apply if the lessee, by virtue of a contractual provision, buys the equipment or holds it on lease for a further period of time (regardless of whether this lease is financial or normal bailment<sup>(93)</sup>).

The leasing convention only recognizes the contractual clause often used by the parties in this regard.<sup>(94)</sup> It does not address cases in which the equipment is damaged or completely destroyed. Nor does it include any rule on passing of risk. The drafters justify this by saying that the value of the equipment is normally covered by insurance and such rules are therefore unnecessary.<sup>(95)</sup> In addition, the leasing agreement most often includes a provision under which the lessee accepts the risk of damage to the leased equipment by an extraneous cause.<sup>(96)</sup>

This argument is not convincing to me: rules on the passing of risk are not always the same under domestic laws. Besides, it is not clear who has to arrange for insurance, who is the beneficiary of the insurance, and who has to pay insurance premiums. Briefly, this question should have been addressed by the leasing convention, not left to be settled by the parties in their contract.

Finally, the leasing convention does not address other duties of the lessee, such as the duty to take over the equipment delivered in conformity with the supply agreement terms, or the duty to notify the lessor of any claim made by a third party in relation to the equipment. Thus, these duties are to be regulated by applicable law.

## **B. Non-Conformity of Equipment:**

Non-conformity of equipment is one of the important aspects of financial leasing which the leasing convention addresses. Non-conformity means non-delivery, late delivery or defective delivery of the equipment.

(93) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 81, p. 253.

(94) Dagefoerde, *Internationales Finanzierungsleasing*, p. 128.

(95) Dagefoerde, *Internationales Finanzierungsleasing*, p. 149. Stanford, *revue de Droit Uniforme* 1984 II, Nr. 88, p. 181. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 114, p. 289.

(96) Dagefoerde, *Internationales Finanzierungsleasing*, p. 142. Basedow, *RIW* 1988, p. 8. It is worth by the way mentioning that this is also the case under article 699 of the Russian civil code.

1. **Lessor's Right to Remedy:** In cases of non-conformity of the equipment, the lessor may - under the leasing convention, article 12(1)(b) - "remedy its failure to tender equipment in conformity with the supply agreement". Instead of non-conforming equipment already delivered, the lessor may therefore deliver equipment which satisfy the specifications defined by the lessee. He may also repair the defect in equipment delivered to the lessee. The lessor normally does that through the supplier.<sup>(97)</sup>

The important question in this regard is whether the right of the lessor to remedy prevails over the rights the lessee may claim under article 12 (which will be discussed soon). In other words, what will happen if, in cases of non-conformity, the lessee claims termination of the leasing agreement under article 12(1), while the lessor is ready to remedy the non-conformity of equipment delivered to the lessee?

The leasing convention itself does not settle this question. It only provides that the rights of the lessor and the lessee mentioned above "shall be exercisable in the same manner and shall be lost in the same circumstances as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement", article 12(2). Obviously, this question is first settled according to contractual provisions of the supply agreement, if any. In the absence of such provisions, this question must be settled according to applicable law. As the leasing convention does not include conflict-of-law rules in this respect, the law applicable shall be determined by virtue of the conflict-of-law rules of the forum state.

I believe such an essential question should have been addressed by the leasing convention itself. A unified rule in this regard could have served a lot. It is right that CISG, which forms a uniform law on contracts on international sale of goods, will likely apply to the supply agreement, i.e., the sale contract<sup>(98)</sup>. But, CISG itself does not actually provide a good solution in this regard. That's why the commentators of CISG are still disputing which right prevails over the other:

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(97) Dagefoerde, RIW 1995, p. 266.

(98) According to some writers, the leasing convention should clearly have provided, in this regard, for rules similar to those set out in CISG, (see: Basedow, RIW 1988, p. 7. Dagefoerde, Internationales Finanzierungsleasing, p. 136). However, the provision of article 12(2) is actually made to ensure conformity with CISG "whilst obviating the need to set out the detailed rules contained in that Convention", (Goode, J. Bus. L. 1988, p. 348. Goode, the representative of the United Kingdom, in: Diplomatic Conference, Vol. II, p. 150).

the buyer's right to terminate the sale contract or the seller's right to remedy the non-conforming performance.<sup>(99)</sup>

However, the leasing convention - unlike the 1984 preliminary draft, article 9(1)(b) and the 1987 draft, article 10(1)(b)<sup>(100)</sup> - does not define the time in which the lessor may remedy. Nor does the leasing convention require the lessee to notify the lessor in such cases.<sup>(101)</sup> Thus, these questions should be settled according to article 12(2) mentioned above.

**2. Lessee's Rights:** In a financial leasing transaction, the lessee has rights against both the lessor and the supplier.

a. Lessee's Rights Against the Lessor: Despite the general immunity of the lessor under article 8(1), the lessee may - under the leasing convention, article 12 - claim the following remedies against the lessor in cases of non-conformity of equipment: Rejection of the equipment, or termination of the leasing agreement. This actually reflects the fact that a financial leasing transaction involves three parties.<sup>(102)</sup>

aa. Rejection of Equipment: Under article 12(1)(a) the lessee may reject non-conforming equipment.<sup>(103)</sup> When doing that, the lessee may also withhold

(99) For the supremacy of the buyer's right to terminate the sale contract, see, for example: Reinhart, G., UN-Kaufrecht, Kommentar zum Uebereinkommen der Vereinten Nationen vom 11. April 1980 ueber Vertraege ueber den internationalen Warenkauf, Heidelberg 1991, article 48, n. 4. Karollus, M., UN-Kaufrecht, eine systematische Darstellung fuer Studium und Praxis, Wien. New York 1991, p. 142. Magnus, U., Wiener UN-Kaufrecht (CISG), in: von Staudingers Kommentar zum Buergerlichen Gesetzbuch mit Einfuehrungsgesetz und Nebengesetzen, 13th ed, edited by: Honsell, H, Berlin 1994, article 48, n. 17, 22, 30.

For the supremacy of the seller's right to remedy his failure to perform, see, for example: Will, in: Bianca, C.M. / Bonell, M.J., Commentary on the International Sales Law, the 1980 Vienna Sales Convention, Milan 1987, article 48, n. 2.1.1.1.1. Honnold, J., Uniform Law for International Sales under the 1980 United Nations Convention, 2nd ed., Deventer. Boston 1991, article 48, n. 296. Huber, in: v. Caemmerer, E. / Schlechtriem, P. (Editors), Kommentar zum Einheitlichen UN-Kaufrecht, Das Uebereinkommen der Vereinten Nationen ueber Vertraege ueber den Internationalen Warenkauf - CISG-Kommentar, 2nd revised ed., Muenchen 1995, article 48, n. 15.

(100) According to both articles, the lessor could tender fresh remedy "within a reasonable time after the delivery date stipulated in the leasing agreement or, if none, that stipulated in the supply agreement or, in the absence of any stipulation as to date, within a reasonable time after the making of the leasing agreement". Emphasis added by the present writer.

(101) Both the 1984 preliminary draft, article 9(2) and the 1987 draft, article 10(2) provided for this lessee's duty.

(102) Dagefoerde, Internationales Finanzierungsleasing, p. 134.

(103) This is true in relation with the defects of the equipment appear at the time of delivery. Concerning the hidden defects, the lessee may not reject the equipment against the lessor at the time of discovering such a defect.

rentals he would otherwise pay to the lessor under the leasing agreement. According to article 12(3), he may do that "until the lessor has remedied its failure to tender equipment in conformity with the supply agreement". The lessee may not withhold payable rentals if he has lost his right to reject the non-conforming equipment. (This is the case, for example, when the lessee chooses termination of the leasing agreement).

Unlike article 10(4) of the 1987 draft convention, article 12(3) does not make rejection of the equipment a condition for withholding rentals.<sup>(104)</sup> It suffices under the leasing convention that the lessee still has the right to reject the equipment. But, he shall not necessarily use it in order to withhold rentals.

The lessee normally demands this remedy, i.e., rejection of the equipment, when he wants to hold on to the transaction. This is, for instance, the case when the leasing conditions offered by the lessor are very good for the lessee.

Under the leasing convention, the lessee may clearly use his right against the lessor to reject the equipment. He may not do that vis-à-vis the supplier. With this rule, the authors safeguard the lessor's security in the transaction, i.e., his title to the equipment.<sup>(105)</sup> Also, as the lessee is not under obligation to pay the price to the supplier, he has actually no need to be entitled to reject the equipment against the supplier.<sup>(106)</sup> Concerning the latent defects of the equipment, the lessee can however ask all remedies the buyer may claim under the terms of the supply agreement, article 10.

bb. Termination of the Leasing Agreement: It should first of all be mentioned that the lessee could terminate the leasing agreement under the 1987 draft, article 10(4) only if he had rejected the equipment.<sup>(107)</sup> This is not the case under the leasing convention. If the lessee does not want to keep the leasing agreement on foot in cases of non-conformity of equipment, he may terminate it. So long as the parties do not agree otherwise,<sup>(108)</sup> this rule shall apply even if the lessor has not been at fault.<sup>(109)</sup>

In this respect, one may argue that termination of the leasing agreement in

(104) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 717.

(105) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 124, p. 299.

(106) Mr. Goode, the representative of the United Kingdom, in: *Diplomatic Conference*, Vol. II, p. 147.

(107) Besides, the supplier should, before the termination of the leasing agreement by the lessee, have been given the opportunity to make a fresh tender of the same equipment or a tender of other equipment, article 10(4) thereof.

(108) Dagefoerde, *RIW* 1995, p. 266. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 123, p. 297.

(109) Knebel, *RIW* 1993, p. 540.

such cases would contradict the interests of the lessor, who is in effect a financier.<sup>(110)</sup> But, beside being a financier, the lessor is actually the owner of the equipment. In this capacity of his, the lessor therefore contributes in one way or another to causing non-conformity of the equipment.<sup>(111)</sup> Also, the lessee's possibility to terminate the leasing agreement against the lessor is necessary for adjusting the interests of the parties, which is one of the main purposes of the leasing convention declared in its preamble.

In any event, the lessee, when terminating the leasing agreement, may also recover rentals and sums already paid. But, he can not generally ask for other rights.

i) Recovery of Rentals and Sums already paid: When terminating the leasing agreement, the lessee may logically return rentals and other sums paid in advance, as he does not use the equipment any more. The period of time in which the lessee has already used the equipment (this is the case concerning partly defective equipment) should also be taken into account when making a decision on rentals already paid. Under article 12(4), "a reasonable sum for any benefit the lessee has derived from the equipment" should be reduced from rentals and other sums the lessee recovers from the lessor.

ii.) Other Claims: In principle, the lessee may not demand any other claim against the lessor in cases of non-conformity of equipment. Nevertheless, claims resulting from "the act or omission of the lessor" can be asked for by the lessee, article 12(5).<sup>(112)</sup> This could be the case, for instance, where the lessor did not pay the supplier the price of the leased equipment. In such a case, the lessee may also recover any additional damages he sustained through non-conforming delivery by the supplier. However, the judgment shall be otherwise if the lessor does not pay the price due to control regulations.<sup>(113)</sup>

Once again, regarding remedies the lessee may claim against the lessor, the leasing convention uses "a legal fiction and a reference to the applicable

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(110) In this context, May argues that the lessor should be protected in such a case as long as the nonconformity is not his fault, (May, Columbia J. Trans. L. Vol. 22 (1984), p. 348).

(111) For this opinion, see: Knebel, Der Aufwendungsersatzanspruch, p. 63. Knebel, RIW 1993, p. 540.

(112) Under the 1984 preliminary draft, article 11(2) second sentence, the lessor's liability was based on his responsibility.

(113) Dagefoerde, Internationales Finanzierungsleasing, p. 137. Compare: Basedow, RIW 1988, p. 8, (who argues that the leasing convention should have included a provision on exemption like that of CISG, article 79). By the way, the authors had, at the Ottawa Conference, rejected a proposal made by the Colombian delegation to make a provision on the so-called *rebus sic stantibus*, i.e., the changed circumstances, (Diplomatic Conference, Vol. II, p. 185 - 186).

law",<sup>(114)</sup> the lessee may - under article 12(2) - ask for his remedies, i.e., rejection of the equipment or termination of the leasing agreement only under the terms of the supply agreement under which the lessor may do the same thing against the supplier.<sup>(115)</sup> This clearly safeguards the lessor's interests. Otherwise, invoking the remedies of the lessee would lead to an unreasonable outcome. The lessee could sometimes reject the equipment or even terminate the leasing agreement, whereas the lessor, whose interest under the leasing transaction is merely financial, receives no more rentals.

On the other hand, the lessee will in no way be prejudiced by the terms of the supply agreement between the lessor and the supplier. When concluding the supply agreement, its terms should be approved by the lessee "so far as they concern its interests", article 1(1)(a). Also, the subsequent variation of the supply agreement terms made by the lessor and the supplier should be subject to the consent of the lessee so far as this affects his rights, article 11.<sup>(116)</sup> This rule clearly has dual purposes: It safeguards the lessee's interests and, at the same time, acknowledges the autonomy of the parties to the supply agreement.<sup>(117)</sup>

In this respect, an opinion<sup>(118)</sup> argues that the lessee's consent would be not necessary if the variation of the supply agreement terms are to the benefit of the lessee. This could be the case concerning the buy-lack arrangement according to which the lessee will pay lower rentals. In my view, this opinion lacks the authorization of the leasing convention. Under article 11, the lessee's consent is actually necessary to any variation of the supply agreement terms which negatively or positively affects his rights.

Nevertheless, article 11 is not mandatory in nature and can therefore be varied at will; by virtue of an exclusion clause in the leasing agreement, the lessor may be entitled to modify any supply agreement term without the lessee's consent.<sup>(119)</sup>

(114) Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 56.

(115) In principle, the right to withhold rental payment is not subject to the terms of the supply agreement. However, it depends upon the supply agreement terms to the extent this right is lost when the lessee has lost the right to reject the equipment (Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 56, 57).

(116) The 1987 draft convention included a restrictive rule in this regard article 4 thereof provided: "The supply agreement may not be varied without the consent of the lessee". Under this rule, the subsequent variation of any term of the supply agreement should be consented to by the lessee regardless of whether or not it affected any of the rights he has under the leasing convention against the supplier. Fortunately, this provision is not adopted at the Ottawa Conference.

(117) Dagefoerde, *Internationales Finanzierungsleasing*, p. 145.

(118) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 85, p. 257.

(119) Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 54.

In any event, the rights discussed above that are conferred upon the lessee by article 12 may not affect the claims the lessee has against the supplier under the leasing convention.

b. Lessee's Rights Against the Supplier: According to a financial leasing transaction, the supplier shall deliver equipment conforming to specifications given by the lessee. The supply agreement is made between the lessor and the supplier, so that there is generally no contractual relation between the lessee and the supplier. In order to avoid problems resulting from this situation, namely those problems concerning the lessee's remedies in case of the non-conformity, the leasing convention gives the lessee direct right of action against the supplier.<sup>(120)</sup> It deals with the lessee as if he were the buyer. Under article 10(1), "the duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee". This means that the lessee may directly ask against the supplier for rights that normally result from the supply agreement.<sup>(121)</sup> By doing that, the leasing convention actually acknowledges the financial function of the leasing transaction<sup>(122)</sup> (which involves three parties). According to this transaction, it is actually the lessee who directly conducts negotiations with the supplier.

The supplier is not prejudiced by this rule as he is - according to article 1(2)(b) - aware of the leasing agreement.<sup>(123)</sup> Thus, from the beginning the

(120) It is worth mentioning that the authors discussed other alternatives in this regard, namely the assignment by the lessor of his claims against the supplier to the lessee and the enforcement by the lessor of his rights as a buyer for the lessee's benefit, or else the lessor contracts as an agent for the lessee as well as on his own behalf. Under this assignment solution the lessor may recover the loss that the lessor could normally recover, but nothing more. However, the interests of lessee and those of lessor in cases of non-conformity of equipment are not always the same. Once the supplier knows of the particular use of the equipment by the lessee, then the supplier's liability in damages may be broader against the lessee than against the lessor. Thus as the assignment solution is not actually completely satisfactory, the authors had abandoned it, (Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 116, p. 219. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 91, p. 185. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 54. Knebel, *RIW* 1993, p. 539).

(121) In so doing, the leasing convention completely differs from most domestic laws, (Dagefoerde, *Internationales Finanzierungsleasing*, p. 142. Dagefoerde, *RIW* 1995, p. 267. May, *Columbia J. Trans. L.* Vol. 22 (1984), p. 335).

However, this does not apply to article 670(1) of the Russian civil code under which the lessee may, in cases of non-conformity of equipment, bring an action against the supplier directly.

(122) Dagefoerde, *Internationales Finanzierungsleasing*, p. 134.

(123) Compare: Knebel, *RIW* 1993, p. 539.

supplier knows of the existence of another creditor, i.e., the lessee. Also, the supplier does not have to compensate for the same cost twice.<sup>(124)</sup> He may not be liable "to both the lessor and the lessee in respect of the same damage", article 10(1) second sentence.<sup>(125)</sup>

Vis-à-vis the lessee, the supplier may in addition involve all defenses and objections which he may have had in relation to the lessor.<sup>(126)</sup> For example, the supplier may object against the lessee that he (the supplier) did not yet receive the complete price for the equipment. Needless to say, the lessee may, in such a case, ask for damages from the lessor.

Nevertheless, some of the lessee's rights against the supplier are restricted. According to article 10(2), the lessee may not "terminate or rescind the supply agreement without the consent of the lessor". It is worth here mentioning that Mr. Santos, the representative of Philippines suggested, at the Ottawa Conference, the deletion of article 9(2) of the 1987 draft<sup>(127)</sup> (equivalent to article 10(2) of the leasing convention). Also Mr. El-Kattan, the representative of Egypt, argued that the rule of the second paragraph of this article is inconsistent with the first paragraph of the same article under which the lessee is dealt with as a party to the supply agreement.<sup>(128)</sup> Fortunately, the authors retained this rule, as otherwise the lessor's rights would be affected.<sup>(129)</sup> If the supply agreement simply be terminated or rescinded by the lessee, the lessor would lose his rights in the equipment,<sup>(130)</sup> in particular his title to the equipment which is actually his security in the transaction.<sup>(131)</sup> In addition, the

(124) The authors discussed requiring any action against the supplier to be brought jointly by lessor and lessee. As this forms interference with the different national rules of procedure, the authors abandoned it, (Diplomatic Conference, Vol. II, p. 147. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 93, p. 187, 189).

(125) In fact, this is understandable according to the general principles of law. Pursuant to proposals by the Colombian and Philippines delegations (see: Diplomatic Conference, Vol. I, p. 234), the authors however clearly provide for this rule in article 10.

(126) Dagefoerde, *Internationales Finanzierungsleasing*, p. 146.

(127) Diplomatic Conference, Vol. II, p. 146.

(128) Diplomatic Conference, Vol. II, p. 149.

(129) The committee of government experts also discussed whether or not the variation of the supply agreement terms by the lessee should be subject to the lessor's consent. However, they finally decided to leave this question to be regulated by the parties themselves and by the applicable law, (Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 84, p. 255, Nr. 121, p. 295, 297).

(130) Dagefoerde, *Internationales Finanzierungsleasing*, p. 150. Knebel, *RIW* 1993, p. 540.

(131) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 124, p. 294.

rule of article 10(2) does not prejudice the lessee, as he may - under article 12(1)(a) - terminate the leasing agreement in cases of non-conformity of the equipment. By doing that, the lessee brings to an end the complete leasing transaction so far as his interests are concerned.

Briefly, taking into account the provision of article 10(2), the lessee does not have against the supplier all rights the buyer normally has under the sale contract. This is actually due to the special nature of financial leasing governed by the leasing convention which adjusts the rights of the three parties.

Notably, the leasing convention only entitles the lessee to ask the supplier for the claims resulted from the supply agreement. It does not itself regulate these claims. Accordingly, they should be determined under applicable law. Moreover, the leasing convention does not include conflict-of-law rules in this respect. The law applicable shall therefore be determined by the conflict-of-law rules of the forum state. This approach actually raises problems, as domestic laws settle this question in different ways. Besides, it is still controversial amongst writers regarding the choice of a connecting factor for the determination of the law that governs the lessee's claims against the supplier. (Some argue for the application - in such a case - of the law governing the supply agreement<sup>(132)</sup>, others would apply the law governing the leasing agreement.<sup>(133)</sup>)

Thus, the lessee does not, at the time when the leasing agreement is made, normally know the law applicable to his claims against the supplier. Even if he knows it, it would be difficult for him to demand his claims under this law because it is generally a foreign one. This problem may be alleviated by the fact that CISG will likely<sup>(134)</sup> apply to the supply agreement, which is mostly a sale of goods contract.

### C. Lessee's Default:

This is the second important aspect of financial leasing with which the convention deals. It is addressed by article 13.

1. Lessee's Default in General: First of all, it should be mentioned that the leasing convention does not define the term "default" at all. Nor does it determine the concept of substantial default.<sup>(135)</sup> Thus, these questions should be defined according to the provisions of the leasing agreement. In the absence of such provisions, tribunals should determine under the

(132) For this argument, see the records of the Ottawa Conference in: Diplomatic Conference, Vol. II, p. 154.

(133) Compare: Dagefoerde, Internationales Finanzierungsleasing, p. 148.

(134) Dagefoerde, RIW 1995, p. 267.

(135) The authors justified this by saying that the objectives of both article 13 and the leasing convention in general is limited to the creation of a basic legal framework of leasing transactions, not an exhaustive one, (Stanford, Revue de Droit Uniforme 1987 I, Nr. 133, p. 307).

applicable law whether or not the lessee is in default and if yes whether the default is substantial.

In fact, the leasing convention has been criticized for not defining these terms.<sup>(136)</sup> When determining the kind of default at issue, the tribunal actually decides at the same time the remedy the lessor may demand. Such an important question should not have been left to the parties' will. Because the lessor is normally in a powerful bargaining position, he may impose contractual clauses to the detriment of the lessee.

In any event, the lessor may, in any case of default committed by the lessee (i.e., regardless of the seriousness of the default), "recover accrued unpaid rentals, together with interests and damages". If the lessee's default is not substantial, the lessor may according to the leasing convention ask neither for the termination of the leasing agreement nor for the acceleration payment of future rentals. However, there is nothing in this convention that prevents the lessor from providing for this in the leasing agreement.<sup>(137)</sup> Moreover, the lessor is not required to give notice under article 13(2), as the scope of application of this article is limited only to situations where the default is substantial, (see infra, soon).

2. Substantial Default: In cases of substantial default committed by the lessee, the lessor may also ask for acceleration of the payment of future rentals or for termination of the leasing agreement. But, he can not claim both remedies together.

a. Accelerated Payment of Future Rentals: In cases of substantial non-payment by the lessee, the lessor may -under the leasing convention, article 13(2) - demand immediate payment by the lessee of all outstanding rentals. The lessor may do that beside asking for the remedies mentioned in article 13(1). However, the right of acceleration may only be exercised under the following two conditions. First, the leasing agreement should provide for this right. This means that this right is not conferred upon the lessor by the leasing convention.

(136) For this opinion, see: Basedow, RIW 1988, p. 9. Dagefoerde, Internationales Finanzierungsleasing, p. 131. May, Columbia J. Trans. L. Vol. 22 (1984), p. 348, 349. Comment on the 1987 draft by the Spanish government and by the Asian Leasing Association, in: Diplomatic Conference, Vol. I, p. 158, 172, respectively. Mr. Guitard, the representative of Spain to the Ottawa Conference, in: Diplomatic Conference, Vol. II, p. 171 (who suggested to make the "lessee's default in the payment of two (or three) rentals" a substantial one). Mr. Beraudo, the representative of France to the Ottawa Conference, in: Diplomatic Conference, Vol. II, p. 172 (who suggested to make the less serious default repeated by the lessee equivalent to the substantial default; both of them should entitle the lessor to terminate the leasing agreement).

(137) Cuming, Arizona J. Int'l & Comp. L., Vol. 7:1 (1989), p. 62, fn. 79.

This convention only acknowledges the clause on payment acceleration often used by parties to the leasing agreement.<sup>(138)</sup>

This rule is open to critique. Leaving the parties free to regulate this subject is actually dangerous. This clause could be invoked to the detriment of the lessee. This is normally the case when the lessor has stronger bargaining power and/or the lessee necessarily needs the equipment. In short, the leasing convention should have governed this question.

Second, the lessor should notify the lessee of substantial default. This notice should give "the lessee a reasonable opportunity of remedying the default so far as the same be remedied", article 13(5). By so providing, the leasing convention maintains the leasing agreement as far as this is still possible. Accelerated payment of future rentals may therefore only be granted when the lessee - despite the notice - does not remedy his substantial default or when this default can in no way be remedied.

b. Termination of the Leasing Agreement: In cases of substantial non-payment by the lessee, the lessor may - under the leasing convention, article 13(2) - terminate the leasing agreement. However, the lessor shall give notice under article 13(5), mentioned above.

When terminating the leasing agreement, the lessor is entitled to "recover possession of the equipment" article 13(2)(a). Thus, the lessor's right of repossession can not - under this provision - be used as a means to exercise pressure on the lessee to pay rentals.

Besides, the lessor may - when terminating the leasing agreement - claim damages for non-performance committed by the lessee, that is to say, the damages which "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", article 13(2)(b). In light of the special character of leasing transactions, this rule is realistic. As the main role of the lessor is financial, it is upsetting to him to find himself obliged to repossess the equipment, which he probably cannot sell or release as it was made according to particular specifications defined by the lessee.<sup>(139)</sup>

Should the leasing agreement be terminated pursuant to the lessor's request, the lessor may not ask for the payment of future rentals as such. However "the value of such rentals may be taken into account in computing damages under paragraph 2(b)", article 13(4). The parties may in no way agree to the contrary of this rule.

(138) Dagefoerde, Internationales Finanzierungsleasing, p. 132.

(139) Stanford, Revue de Droit Uniforme 1987 I, Nr. 137, p. 311.

Thus, when computing damages, the court would consider the fact that the lessor could have received all rentals had the lessee performed his duties under the leasing agreement. By doing that, the court should, of course, take into consideration (future) rentals. However, the value of repossessed equipment will also be considered; it should be reduced when assessing damages.<sup>(140)</sup>

It should be mentioned that the 1987 draft did not provide for the possibility of considering the value of future rentals when computing damages. Article 11(4) thereof only provided: "Where the lessor has terminated the leasing agreement it shall not be entitled to enforce a term of the leasing agreement accelerating payment of the rentals". Clearly, the authors of the leasing convention protect the interests of the lessor in article 13(4). By so doing, they actually recognize the contractual clause to this effect often used by parties to the leasing agreement.<sup>(141)</sup>

Besides, article 13 addresses two special situations, namely: agreement on damages and mitigation of loss.

aa. Agreement on Damages: Under article 13(3)(a), parties to the leasing agreement may agree on the manner in which damages for non-performance by the lessee are to be computed. Such an agreement may - under article 13(3)(b) - be enforceable only if damages agreed upon by the parties do not substantially exceed damages for non-payment by the lessee. The leasing convention does not however define when the liquidated damages clause substantially exceeds damages for non-performance provided for in this convention. In any event, the contractual clause shall be invalid if it provides for payment of all future rentals when terminating the contract.<sup>(142)</sup> Otherwise, the lessor could - contrary to article 13(2) and (4) - claim both accelerated payment and termination of the leasing agreement.

This rule is obligatory in nature so that the parties may not agree otherwise. Thus, it clearly safeguards the lessee's interests.

Once again, the lessor may not use his right of acceleration when he terminates the leasing agreement. However, the value of future rentals may be taken into account when computing damages under article 13(3)(b), article 13(4).

bb. Mitigation of Loss: article 13(6) provides for the lessor's duty to

(140) Goode, the representative of the United Kingdom to the Ottawa Conference, in: Diplomatic Conference, Vol. II, p. 178, 179.

(141) Poczobut, *RebelsZ*, Vol. 51 (1987), p. 718.

(142) Dagefoerde. *Internationales Finanzierungsleasing*, p. 133. Dagefoerde, *RIW* 1995, p. 267. Goode, *J. Bus. L.* 1987, p. 401. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 62, 63.

mitigate the loss resulting from non-performance by the lessee. In mitigating loss, the lessor is obliged to take reasonable steps only. But he shall do his best to take all<sup>(143)</sup> reasonable steps. If he fails to do that, damages will be reduced to that extent. In other words, the lessee shall not pay damages for the loss the lessor could have mitigated had he taken reasonable steps. Also, the loss that the lessor has actually mitigated can not be recovered from the lessee. Otherwise, there would be double recovery by the lessor.

Under the 1987 draft, article 11(2)(b), in contrast, the lessor was obliged to mitigate the loss resulting from substantial default of the lessee only.

## V. Effect of the Leasing Convention on Third Parties<sup>(144)</sup>

Under the leasing convention, article 5(2), the parties can derogate from or vary the effect of most provisions of this convention. In fact, many matters addressed by this convention are normally dealt with by parties to the leasing transaction. But, the rights of others may not be altered by the parties to financial leasing. Thus, it is actually of particular importance that the leasing convention addresses the rights of third parties.

In the following section, these situations will be discussed: Bankruptcy of the lessee, damage caused by the equipment to third parties, transfer of rights, and return of the equipment incorporated in real property of others.

### A. Protection of Lessor's Rights in the Equipment Against Third Parties:

1. Lessee's Bankruptcy: Normally, the equipment is considered the only security of the lessor in a financial leasing transaction. Accordingly, the leasing convention protects the real rights of the lessor in the equipment on the lessee's insolvency.<sup>(145)</sup> According to article 7(1)(a), the lessor's real rights in the equipment shall be valid even in cases where the lessee is declared bankrupt. In particular, these rights should be protected against "the lessee's trustee in bankruptcy". Under article 7(1)(b), this term has wide meaning. It encompasses any "person appointed to administer the

(143) At the Ottawa Conference, a proposal by the Pakistani representative to delete this word "all" was rejected, (Diplomatic Conference, Vol. II, p. 173).

(144) The term third parties is used in this article to mean the outsiders of financial leasing. Thus, the fact that this transaction has three parties should raise no problem in this regard.

(145) It should be noted that the leasing convention speaks of lessor's real rights, not of his title to the equipment. With the present formula, protection under this convention embraces the sub-lessor who makes a sub-leasing under article 2, (Dagefoerde, Internationales Finanzierung-leasing, p. 153).

lessee's estate for the benefit of the general body of creditors", including the liquidator.<sup>(146)</sup> This formula has actually been drafted by the working group of technical experts (made of representative of several states)<sup>(147)</sup> in order to comply with different national legal procedures concerning bankruptcy.<sup>(148)</sup>

The lessor's rights in the equipment shall also be protected against the competing creditors of the lessee who have rights in the equipment according to an enforcement measure, e.g., attachment or execution. Nevertheless, the lessor's rights cannot - under article 7(5)(a)- prevail over the rights of any creditor who has "a consensual or a non-consensual lien or security interest in the equipment arising otherwise than by virtue of an attachment or execution". The protection of lessor's rights under article 7(1) also does not apply to situations where the lessee's creditor is secured, that is, the creditor has a right of arrest, detention or disposition particularly in ship and aircraft, article 7(5)(b).<sup>(149)</sup> The rights of such a creditor shall be determined under the law applicable by virtue of the rules of private international law.

Similarly, the supremacy of lessor's rights in the equipment against the lessee's trustee in bankruptcy and unsecured creditors does not, under article 5(4), affect the lessor's title to the equipment recognized under other international treaties, e.g., the 1948 Geneva Convention on the International Recognition of Rights in Aircraft "which provided for the mutual recognition of ownership rights duly registered in the appropriate state".<sup>(150)</sup>

Finally, the leasing convention does not address the acquisition of equipment by a third party in good faith.<sup>(151)</sup> This question should therefore be decided according to applicable law. Taking into account the matter of public

(146) It is worth mentioning that the 1987 draft did not include such a definition of the term :lessee's trustee in the bankruptcy".

(147) Diplomatic Conference, Vol. II, p. 78, 79.

(148) Dagefoerde, Internationales Finanzierungsleasing, p. 151.

(149) The reason behind the exclusion of this question is the existence of other international agreements dealing with liens and mortgages in ships and aircraft, (see: Working Group of Technical Experts on international financial leasing, in: Diplomatic Conference, Vol. I, Nr. 4, p. 124).

(150) Mr. Goode, the representative of the United Kingdom to the Ottawa Conference, in: Diplomatic Conference, Vol. II, p. 112.

(151) Because of the different ways in which this subject is addressed by national legal systems, the committee of governmental experts decided not to deal with it in the leasing convention, (Stanford, Revue de Droit Uniforme 1987 I, Nr. 89, p. 261).

notice often required under domestic law, the cases in which a third party acquires equipment from the lessee in good faith are actually quite seldom.

2. Compliance with Applicable Law: The supremacy of the lessor's real rights in the equipment was not questioned by the authors of the leasing convention. Rather, it was the question of public notice which was controversial.<sup>(152)</sup> According to the study group of UNIDROIT, the leasing convention should, like article 9 of the American uniform commercial code, adopt a system of registration.<sup>(153)</sup> This opinion did not prevail because not all states in the world know this system. Instead, the leasing convention provides for a compromise solution; it provides for a minimal requirement and leaves each contracting state free to choose its own modality. Under article 7(2), the lessor's rights in the equipment may only be protected vis-à-vis third parties if the terms of public notice under applicable law are satisfied. Thus, if the equipment is to be registered under applicable law, the lessor must meet these terms in order for his rights in the equipment to be good against the lessee's trustee in bankruptcy and unsecured creditors. By contrast, the lessor's title to equipment is enforceable against any third party if the law applicable provides for no public notice.

In fact, the public notice requirement forms a compromise between the lessor's real rights and the rights of third parties in the equipment.<sup>(154)</sup>

In article 7(3), the leasing convention provides for conflict-of-law rules according to which the applicable law may be defined. Concerning a ship, the applicable law is that of the state in which the ship is registered in the name of the owner.<sup>(155)</sup> As a ship that is bare-boat chartered may be registered in two states at the same time,<sup>(156)</sup> the authors make it clear that charterer is not an owner for the purpose of this provision.

(152) For this question, a working group of technical experts on international financial leasing was set up in 1988. (A report to the work done by this group is made by the UNIDROIT secretariat and published in: Diplomatic Conference, Vol. I, p. 123 - 130). However, most of the recommendations of this group have not been finally adopted by the Ottawa Conference, (for more details, see: Diplomatic Conference, Vol. II, p. 79 ff.).

(153) Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 21, p. 111, Nr. 77, p. 169.

(154) Dagefoerde, *Internationales Finanzierungsleasing*, p. 154.

(155) The connecting factor for the determination of the law under which the requirements of public notice are to be considered in relation to ships was debated at the Ottawa Conference. For example, the working group of technical experts suggested the flag state as a connecting factor; some representatives suggested the lessor's place of business; others suggested the lessee's place of business, (Diplomatic Conference, Vol. II, p. 79 ff.).

(156) Working Group of Technical Experts on international financial leasing, in: Diplomatic Conference, Vol. I, Nr. 11, p. 126.

In relation to aircraft which are registered under the 1944 Chicago Convention on International Civil Aviation, the law applicable shall be the law of the state in which the aircraft is so registered.

Concerning mobile equipment, e.g., an aircraft engine<sup>(157)</sup> or a motor vehicle, the requirements of public notice of the state in which the lessee has his principal place of business shall be respected. If the equipment is fixed, the lessor shall satisfy the conditions of public notice prescribed by the law of the state in which the leased equipment is situated. In other words, the leasing convention differentiates between whether the equipment is to be used in one or more places.

### **B. Damage Caused by Equipment to Third Parties and Claims of Third Parties:**

1. **Damage Caused by Equipment to Third Parties:** It is mentioned that the lessor, as a financier, is generally not liable under article 8(1)(a) for non-conformity of the equipment. Consequently, the lessor, who normally neither specifies the equipment nor chooses the supplier, may not, in his capacity as lessor, be liable for any death or personal injury caused by the equipment to third parties. He also does not incur liability for any damage to the property of others the equipment cruises, article 8(1)(b).

In fact, it would be difficult, even in the absence of article 8(1)(b), to hold the lessor liable for damage caused by equipment to third parties, because it is generally not easy to establish that the lessor was guilty of negligence, the term necessary under most domestic civil laws.<sup>(158)</sup> Also, in common law jurisdiction it is the lessee who incurs such liability, as the equipment is in his possession.<sup>(159)</sup>

However, the lessor's general immunity does not apply to the liability of the lessor as an owner of leased equipment, article 8(1)(c). This means that the leasing convention does not affect the liability of the lessor as an owner of the equipment according to applicable law, be it domestic or uniform. This rule is emphasized in article 17, which provides that the leasing convention does not have priority over other conventions. This means that the leasing convention does not in particular exclude the liability of the lessor under any other

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(157) The reason why this is not dealt with here as the aircraft itself is that the engine can easily be removed from an aircraft and attached to another, and as such, it is often financed separately from the aircraft, (Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 66, fn. 99. Working Group of Technical Experts on international financial leasing in: Diplomatic Conference, Vol. I, Nr. 17, p. 127, 128).

(158) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 111, p. 285. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 85, p. 179. Cuming, *Arizona J. Int'l & Com. L.*, Vol. 7:1 (1989), p. 63.

(159) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 111, p. 285.

convention. This is, for example, the case concerning the International Convention on Civil Liability for Oil Pollution Damage adopted in Brussels in 1969 and amended in London in 1984, according to which the owner of the ship - which may be the subject matter of a financial leasing transaction - is liable for the pollution caused by his ship.<sup>(160)</sup> The leasing convention may also not exclude product liability of the lessor under domestic law.<sup>(161)</sup>

2. Claims of Third Parties: According to article 8(1)(a), the general rule is that the lessor is not liable for non-conformity of the equipment. However, leased equipment shall be free of any rights or claims of third parties. Under article 8(2) the lessor shall therefore be liable if the lessee's quiet possession of the equipment is "disturbed by a person who has a superior title or right, or who claims a superior right or title and acts under the authority of a court." The term "under the authority of a court" should make it clear that the lessor's warranty of lessee's quiet possession regarding claims of others is limited to serious claims; the vexatious claims of third parties are excluded.<sup>(162)</sup> Nevertheless, this rule may not apply if such title, right, or claim is derived from an act or omission of the lessee.

It should, in this regard, be mentioned that the drafters fortunately did not adopt the second alternative of article 7(2) of the 1987 draft, according to which the lessor was liable for the disturbance of the lessee's quiet possession by any title, right or claim of others only "where such title, right or claim is derived from an act or omission of the lessor".

Some writers criticize the present rule of article 8(2) by saying that the lessor, under this rule, risks liability for the claims of others although he has nothing to do with their grounds,<sup>(163)</sup> and as such this rule contradicts the established practice in this field under which the lessor is only responsible to the extent that the disturbance of the lessee's quiet possession results from his act or omission.<sup>(164)</sup> However, I believe this rule corresponds to the special character of

(160) Goode, *J. Bus. L.* 1988, p. 349. Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 63. Dagefoerde, *Internationales Finanzierungsleasing*, p. 158. Dagefoerde, *RIW* 1995, p. 367. Stanford, *Revue de Droit Uniforme* 1984 II, Nr. 82, p. 175.

(161) Dagefoerde, *Internationales Finanzierungsleasing*, p. 141, 159. Knebel, *RIW* 1993, p. 539. Knebel, *Der Aufwendersersatzanspruch*, p. 60. Goode, *J. Bus. L.* 1988, p. 349.

(162) Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 106, p. 279.

(163) Dagefoerde, *Internationales Finanzierungsleasing*, p. 139, and references cited. Comment on the 1987 draft by the Japanese and Pakistani governments and by the Asian Leasing Association, in: *Diplomatic Conference*, Vol. I, p. 154, 165, 170, respectively.

(164) Comment on the 1987 draft by the United States government, in: *Diplomatic Conference*, Vol. I, p. 155, 156.

financial leasing transactions under which the lessee shall be able to use leased equipment.<sup>(165)</sup> This rule also safeguards the interests of the lessor indirectly as non-disturbance of the lessee's quiet possession is a condition for the payment of rentals by the lessee.<sup>(166)</sup> In addition, this rule corresponds to the lessor's position under the leasing convention as the owner of the equipment.<sup>(167)</sup>

In addition, the rule set forth in article 8(2) is permissive and can in principle be varied at will. This would not however apply if the title, right, or claim of third party mentioned above "is derived from an intentional or grossly negligent act or omission of the lessor", article 8(3).<sup>(168)</sup> The 1987 draft did not include such a rule.

Under the leasing convention, the lessor may relieve himself of his own liability for negligence. By way of contrast, this infringes upon the fundamental principles of some domestic laws, e.g., the French law.<sup>(169)</sup> For this reason, the authors of the leasing convention made article 20, under which a contracting state may declare that its own law substitutes the provision of article 8(3). When submitting the instrument of ratification, France<sup>(170)</sup> made such a reservation. When applying the French law by a French court, the lessor's liability for the disturbance of the lessee's quiet possession indicated in article 8(2) may not accordingly be waived by the parties if this liability is attributed to the lessor's fault or negligence. However, the judgment should be otherwise if the French court applies the law of a non-reserving state or if the French law is to be applied by a non-French court.<sup>(171)</sup>

Under article 8(4), mandatory rules of the law applicable by virtue of the conflict-of-law rules, which makes the lessor's liability for the claims of third parties broader, may always apply. The leasing convention, article 8(2) and (3)

(165) Compare: Poczobut, *RabelsZ*, Vol. 51 (1987), p. 716.

(166) Poczobut, *RabelsZ*, Vol. 51 (1987), p. 716.

(167) Observation of the Delegation of the People Republic of China, in: Diplomatic Conference, Vol. I, p. 210, 211.

(168) To the contrary, you may see: Dagefoerde, *Internationales Finanzierungsleasing*, p. 126, (the lessor's liability under article 8(2) could only be excluded by the parties in the case where the rights, titles or claims of others derive from the lessee's act or omission. In all other cases, the lessor could not exclude his liability for the disturbance of the lessee's quiet possession by claims or rights of others).

(169) Diplomatic Conference, Vol. II, p. 21.

(170) The provision of article 20 has been made pursuant to the proposal of the delegations of France, Mexico and Philippines, (see: Diplomatic Conference, Vol. I, p. 293. Diplomatic Conference, Vol. II, p. 23).

(171) Cuming, *Arizona J. Int'l & Comp. L.*, Vol. 7:1 (1989), p. 60, fn. 74.

cannot exclude such rules and the lessor cannot contract out of them. In order to determine the extent of the lessor's warranty of the lessee's quiet possession, it is therefore necessary to look first to the exclusion clause, if any, and then to the mandatory rules of the applicable law.

**C. Transfer of Rights: Under the leasing convention, article 14, both the lessor and the lessee may transfer their rights.**

1. Transfer of the Lessor's Rights: In a financial leasing transaction, the lessor acquires equipment from the supplier. The lessor also makes the leasing agreement with the lessee. The lessor may transfer or otherwise deal with all or any of his rights in equipment resulting from the supply agreement. The same rule applies to the lessor's rights under the leasing agreement. In so providing, the leasing convention actually adopts the general rule of the civil law that the creditor may transfer his rights and claims to others even without the consent of the debtor.<sup>(172)</sup>

According to this rule, the lessor may conclude so-called "leveraged leasing".<sup>(173)</sup> This was actually the "fundamental idea" behind making article 14.<sup>(174)</sup> In addition to the three traditional parties of financial leasing, this transaction has as at least one more party, namely the lessor's lender. The fact that the lessor's successor has his place of business in a state in which the lessee has his place of business does not under article 14(1) affect the continued applicability of the leasing convention.<sup>(175)</sup> Similarly, a financial leasing transaction which is originally domestic in character cannot subsequently be governed by the leasing convention by virtue of the lessor's transfer of his rights.<sup>(176)</sup>

However, the transfer of the lessor's rights shall not affect the duties of the lessor under the leasing agreement. For example, the transfer of rights by the lessor does not relieve him from his responsibility that the leased equipment is

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(172) It should be noted that the 1984 preliminary draft, article 10 provided the lessee with a veto power against such transfer; the lessor's ability to deal with his rights was subject to the lessee's consent. But because this is not common in practice May, Columbia J. Trans. L. Vol. 22 (1984), p. 349), neither the 1987 draft nor the leasing convention holds this opinion.

(173) Dagefoerde, Internationales Finanzierungsleasing, p. 142. Stanford, Revue de Droit Uniforme 1987 I, Nr. 39, p. 211.

(174) Stanford, revue de Droit Uniforme 1987 I, Nr. 144, p. 319.

(175) Dagefoerde, Internationales Finanzierungsleasing, p. 142. May, Columbia J. Trans. L. Vol. 22 (1984), p. 345. Stanford, Revue de Droit Uniforme 1984 II, Nr. 103, p. 205. Stanford, Revue de droit Unfiorme 1987 I, Nr. 39, p. 211, Nr. 141, p. 317.

(176) Stanford, Revue de Droit Uniforme 1987 I, Nr. 143, p. 319.

free from rights or claims by third parties. Further, the transfer of the lessor's rights "shall not ... alter either the nature of the leasing agreement or its legal treatment as provided in this Convention", article 14(1).

2. **Transfer of the Lessee's Rights:** The main right of the lessee in a financial leasing transaction is the possession and use of leased equipment. In fact, this is the reason why the lessee enters into a leasing transaction. The question is whether or not the lessee may transfer this right.

In principle, the lessee may transfer any of his rights in a leasing agreement, including his right to use and enjoy leased equipment. However, the validity of this transfer is subject "to the consent of the lessor". This rule is actually understandable in light of the fact that article 14(1) does not - unlike article 14(2) - provide that the lessee's assignment of his right will not affect his duties vis-à-vis the lessor in a leasing agreement. Thus, the agreement of the lessor to the lessee's assignment of his rights is very necessary to safeguard the lessor's interests, because the lessee's ability to pay periodic rentals is very important for the lessor.<sup>(177)</sup>

The transfer of the lessee's rights under the leasing agreement may not also affect the rights which others already have in the equipment. For example, a third party who has real rights in the land in which the leased equipment is incorporated may not be prejudiced by the lessee's transfer of his rights.

#### **D. Return of Equipment Incorporated in Real Property of Others:**

Normally, the lessor returns the equipment when the leasing agreement comes to an end. But what happens if the equipment has become a fixture to or incorporated in land? This is normally the case when the equipment is used in a factory.

In this regard, it should, first of all, be mentioned that the lessor could under the 1984 preliminary draft, article 6<sup>(178)</sup> return the equipment already incorporated in the real property of others. The leasing convention, by contrast, does not include such a rule. Under article 4(1) however, the leasing convention

(177) Dagefoerde, Internationales Finanzierungsleasing, p. 141. Dagefoerde, Internationales Finanzierungsleasing, p. 142. Stanford, *Revue de Droit Uniforme* 1987 I, Nr. 143, p. 319.

(178) The first sentence of this article provided as follows: "Where the equipment has become a fixture and to the extent that the lessor has priority, under the law of the State where the fixture is situated, over the claim of any person having an interest in the real property concerned, the lessor may, in the conditions prescribed by the leasing agreement, remove the fixture from the real property".

will apply even if the equipment is incorporated in land. But this only means that the convention rules are to be applied to the lessor's rights against the lessee.

Nevertheless, the leasing convention does not define when the equipment becomes a fixture to or incorporated in land. Nor does it address the effect of such fixture or incorporation on the rights inter se of the lessor and a person having real rights in the land. All these question must be decided under applicable domestic law, i.e., the law of the state in which the land is situated, article 4(2).

In short, the leasing convention does not determine whether or not the lessor may return equipment which has become a fixture to or incorporated in land of others. Rather, it is applicable law which decides this question. This law may prejudice the lessor's interests.<sup>(179)</sup>

## Conclusion

**In conclusion, it is worth emphasizing the following remarks:**

1. According to article 3(1)(b), the geographical sphere of application of the leasing convention is broad. It applies not only when the parties to the leasing transaction have their principal places of business in different contracting states (article 3(1)(a)), but also when the supply agreement and the leasing agreement are governed by the law of a contracting state (article 3(1)(b)). Moreover, the contracting states of this convention cannot declare that they will not be bound by subparagraph 3(1)(b).
2. The leasing convention recognizes the distinctive economic character of financial leasing transactions which involve three parties. However, it only governs certain aspects of financial leasing. It mainly deals with non-performance of this transaction by the supplier and by the lessee.

This convention adjusts the rights of the parties involved: On one hand, it recognizes that the main role of the lessor in the leasing transaction is purely financial. Thus, it generally precludes the lessee from suing the lessor, it protects the lessor against third party claims for personal injury or damage to property; it also recognizes the lessor's title to equipment when the lessee goes bankrupt.

On the other hand, the leasing convention gives the lessee the right to bring legal proceedings in his own name against the supplier of the equipment if it proves to be non-conforming to the terms of the supply agreement.

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(179) Dagefoerde, Internationales Finanzierungsleasing, p. 157

3. Unfortunately, this convention does not address some important aspects of financial leasing transactions, e.g., passing of risk, lessee's protection from the effects of an adhesion contract, and reimbursement of costs incurred by the lessor.
4. Apart from articles 4(2) and 7(3), the leasing convention does not include (uniform) conflict-of-law rules. Thus, applicable law shall be defined according to the forum's conflict-of-law rules, with the difficulties and uncertainty attached to this approach.
5. Finally, the leasing convention may, in any event, be a model to be used by states when making or developing their own laws concerning domestic financial leasing.

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## Appendix

# UNIDROIT Convention on International Financial Leasing\*

### THE STATES PARTIES TO THIS CONVENTION,

RECOGNISING 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,

AWARE of the need to make international financial leasing more available,

CONSCIOUS of the fact that the rules of the law governing the traditional contract of hire need to be adapted to the distinctive triangular relationship created by the financial leasing transaction,

RECOGNISING therefore the desirability of formulating certain uniform rules relating primarily to the civil and commercial law aspects of international financial leasing,

HAVE AGREED as follows:

### CHAPTER I - SPHERE OF APPLICATION AND GENERAL PROVISIONS

#### Article 1

- 1 - This Convention governs a financial leasing transaction as described in paragraph 2 in which one party (the lessor),
- (a) on the specifications of another party (the lessee), enters into an agreement (the supply agreement) with a third party (the supplier) under which the lessor acquires plant, capital goods or other equipment (the equipment) on terms approved by the lessee so far as they concern its interests, and
  - (b) enters into an agreement (the leasing agreement) with the lessee, granting to the lessee the right to use the equipment in return for the payment of rentals.

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\* The text of this convention has been taken from Diplomatic Conference, Vol. I, p. 331-339.

- 2 - The financial leasing transaction referred to in the previous paragraph is a transaction which includes the following characteristics:
  - (a) the lessee specifies the equipment and selects the supplier without relying primarily on the skill and judgment of the lessor;
  - (b) the equipment is acquired by the lessor in connection with a leasing agreement which, to the knowledge of the supplier, either has been made or is to be made between the lessor and the lessee; and
  - (c) the rentals 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.
- 3 - This Convention applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental.
- 4 - This Convention applies to financial leasing transactions in relation to all equipment save that which is to be used primarily for the lessee's personal, family or households purposes.

## Article 2

In the case of one or more sub-leasing transaction involving the same equipment, this Convention applies to each transaction which is a financial leasing transaction and is otherwise subject to this Convention as if the person from whom the first lesser (as defined in paragraph 1 of the previous article) acquired the equipment were the supplier and as if the agreement under which the equipment was so acquired were the supply agreement.

## Article 3

- 1 - This Convention 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.
- 2 - A reference in this Convention to a party's place of business shall, if it has more than one place of business, mean the place of business which has the closest relationship to the relevant agreement and its performance, having agreed to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that agreement.

#### **Article 4**

- 1 - The provisions of this Convention shall not cease to apply merely because the equipment has become a fixture to or incorporated in land.
- 2 - Any question whether or not the equipment has become a fixture to or incorporated in land, and if so the effect on the rights inter se of the lessor and a person having real rights in the land, shall be determined by the law of the State where the land is situated.

#### **Article 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).

#### **Article 6**

- 1 - In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.
- 2 - Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

## **CHAPTER II - RIGHTS AND DUTIES OF THE PARTIES**

#### **Article 7**

- 1 - (a) 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.

- (b) For the purpose of this paragraph "trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors.
- 2 - Where by the applicable law the lessor's rights in the equipment are valid against a person referred to in the previous paragraph only on compliance with rules as to public notice, those rights shall be valid against that person only if there has been compliance with such rules.
- 3 - For the purpose of the previous paragraph the applicable law is the law of the State which, at the time when a person referred to in paragraph 1 becomes entitled to invoke the rules referred to in the previous paragraph, is:
- (a) in the case of a registered ship, the State in which it is registered in the name of the owner (for the purposes of this sub-paragraph a bareboat charterer is deemed not to be the owner);
- (b) in the case of an aircraft which is registered pursuant to the Convention on International Civil Aviation done at Chicago on 7 December 1944, the State in which it is so registered;
- (c) in the case of other equipment of a kind normally moved from one State to another, including an aircraft engine, the State in which the lessee has its principal place of business;
- (d) in the case of all other equipment, the State in which the equipment is situated.
- 4 - Paragraph 2 shall not affect the provisions of any other treaty under which the lessor's rights in the equipment are required to be recognised.
- 5 - This article shall not affect the priority of any creditor having:
- (a) a consensual or non-consensual lien or security interest in the equipment arising otherwise than by virtue of an attachment or execution, or
- (b) any right of arrest, detention or disposition conferred specially in relation to ships or aircraft under the law applicable by virtue of the rules of private international law.

## Article 8

- 1 - (a) Except as otherwise provided by this Convention or stated in the leasing agreement, the lessor shall not incur any liability to the lessee in respect of the equipment save to the extent the lessee has suffered

loss as the result of its reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the equipment.

- (b) 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.
  - (c) The above provisions of this paragraph shall not govern any liability of the lessor in any other capacity, for example as owner.
- 2 - The lessor warrants that the lessee's quiet possession will not be disturbed by a person who has a superior title or right, or who claims a superior title or right and acts under the authority of a court, where such title, right or claim is not derived from an act or omission of the lessee.
- 3 - The parties may not derogate from or vary the effect of the provisions of the previous paragraph in so far as the superior title, right or claim is derived from an intentional or grossly negligent act or omission of the lessor.
- 4 - The provisions of paragraphs 2 and 3 shall not affect any broader warranty of quiet possession by the lessor which is mandatory under the law applicable by virtue of private international law.

### **Article 9**

- 1 - The lessee shall take proper care of the equipment, use it in a reasonable manner and keep it in the condition in which it was delivered, subject to fair wear and tear and to any modification of the equipment agreed by the parties.
- 2 - When the leasing agreement comes to an end the lessee, unless exercising a right to buy the equipment or to hold the equipment on lease for a further period, shall return the equipment to the lessor in the condition specified in the previous paragraph.

### **Article 10**

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

- 2 - Nothing in this article shall entitle the lessee to terminate or rescind the supply agreement without the consent of the lessor.

### **Article 11**

The lessee's rights derived from the supply agreement under this Convention shall not be affected by a variation of any term of the supply agreement previously approved by the lessee unless it consented to that variation.

### **Article 12**

- 1 - Where the equipment is not delivered or is delivered late or fails to conform to the supply agreement:

- (a) the lessee has the right as against the lessor to reject the equipment or to terminate the leasing agreement; and  
(b) the lessor has the right to remedy its failure to tender equipment in conformity with the supply agreement.

as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.

- 2 - A right conferred by the previous paragraph shall be exercisable in the same manner and shall be lost in the same circumstances as if the lessee had agreed to buy the equipment from the lessor under the same terms as those of the supply agreement.
- 3 - The lessee shall be entitled 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.
- 4 - Where the lessee has exercised a right to terminate the leasing agreement, the lessee shall be entitled to recover any rentals and other sums paid in advance, less a reasonable sum for any benefit the lessee has derived from the equipment.
- 5 - The lessee shall have no other claim against the lessor for non-delivery, delay in delivery or delivery of non-conforming equipment except to the extent to which this results from the act or omission of the lessor.
- 6 - Nothing in this article shall affect the lessee's rights against the supplier under Article 10.

### Article 13

1. - In the event of default by the lessee, the lessor may recover accrued unpaid rentals, together with interest and damages.
2. - Where the lessee's default is substantial, then subject to paragraph 5 the lessor may also require accelerated payment of the value of the future rentals, where the leasing agreement so provides, or may terminate the leasing agreement and after such termination:
  - (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. - (a) The leasing agreement may provide for the manner in which the damages recoverable under paragraph 2(b) are to be computed.
  - (b) Such provision shall be enforceable between the parties unless it would result in damages substantially in excess of those provided for under paragraph 2(b). The parties may not derogate from or vary the effect of the provisions of the present sub-paragraph.
- 4 - Where the lessor has terminated the leasing agreement, it shall not be entitled to enforce a term of that agreement providing for acceleration of payment of future rentals, but the value of such rentals may be taken into account in computing damages under paragraphs 2(b) and 3. The parties may not derogate from or vary the effect of the provisions of the present paragraph.
- 5 - 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.
- 6 - The lessor shall not be entitled to recover damages to the extent that it has failed to take all reasonable steps to mitigate its loss.

### Article 14

- 1 - The lessor may transfer or otherwise deal with all or any of its rights in the equipment or under the leasing agreement. Such a transfer shall not relieve the lessor of any of its duties under the leasing agreement or alter either the nature of the leasing agreement or its legal treatment as provided in this Convention.

- 2 - The lessee may transfer the right to the use of the equipment or any other rights under the leasing agreement only with the consent of the lessor and subject to the rights of third parties.

## **CHAPTER III - FINAL PROVISIONS**

### **Article 15**

- 1 - This Convention is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Unidroit Conventions on International Factoring and International Financial Leasing and will remain open for signature by all States at Ottawa until 31 December 1990.
- 2 - This Convention is subject to ratification, acceptance or approval by States which have signed it.
- 3 - This Convention is open for accession by all States which are not signatory States as from the date it is open for signature.
- 4 - Ratification, Acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary.

### **Article 16**

- 1 - This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the third instrument of ratification, acceptance, approval or accession.
- 2 - For each State that ratifies, accepts, approves, or accedes to this Convention after the deposit of the third instrument of ratification, acceptance, approval or accession, this Convention enters into force in respect of that state on the first day of the month following the expiration of six months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

### **Article 17**

This Convention does not prevail over any treaty which has already been or may be entered into; in particular it shall not affect any liability imposed on any person by existing or future treaties.

## Article 18

- 1 - If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may substitute its declaration by another declaration at any time.
- 2 - These declarations are to be notified to the depositary and are to state expressly the territorial units to which the Convention extends.
- 3 - If, by virtue of a declaration under this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purpose of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.
- 4 - If a Contracting State makes no declaration under paragraph 1, the Convention is to extend to all territorial units of that State.

## Article 19

- 1 - Two or more Contracting States which have the same or closely related legal rules on matters governed by this Convention may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral declarations.
- 2 - A Contracting State which has the same or closely related legal rules on matters governed by this Convention as one or more non-Contracting States may at any time declare that the Convention is not to apply where the supplier, the lessor and the lessee have their places of business in those States.
- 3 - If a State which is the object of a declaration under the previous paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which the Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under paragraph 1, provided that the new Contracting State joins in such declaration or makes a reciprocal unilateral declaration.

## Article 20

A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession that it will substitute its domestic law for Article 8(3) if its domestic law does not permit the lessor to exclude its liability for its default or negligence.

## Article 21

- 1 - Declarations made under this Convention at the time of signature are subject to confirmation upon ratification, acceptance or approval.
- 2 - Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.
- 3 - A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary. Reciprocal unilateral declarations under Article 19 take effect on the first day of the month following the expiration of six months after the receipt of the latest declaration by the depositary.
- 4 - Any State which makes a declaration under this Convention may withdraw it at any time by formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.
- 5 - A withdrawal of a declaration made under Article 19 renders inoperative in relation to the withdrawing State, as from the date on which the withdrawal takes effect, any joint or reciprocal unilateral declaration made by another State under that article.

## Article 22

No reservation are permitted except those expressly authorised in this Convention.

## Article 23

This Convention applies to a financial leasing transaction when the leasing agreement and the supply agreement are both concluded on or after the date on which the Convention enters into force in respect of the Contracting States referred to in Article 3(1)(a), or of the Contracting State or States referred to in paragraph 1(b) of that article.

## Article 24

- 1 - This Convention may be denounced by any Contracting State at any time after the date on which it enters into force for that State.
- 2 - Denunciation is effected by the deposit of an instrument to that effect with the depositary.
- 3 - A denunciation takes effect on the first day of the month following the expiration of six months after the deposit of the instrument of denunciation with the depositary. Where a longer period for the denunciation to take effect is specified in the instrument of denunciation it takes effect upon the expiration of such longer period after its deposit with the depositary.

## Article 25

- 1 - This Convention shall be deposited with the Government of Canada.
- 2 - The Government of Canada shall:
  - (a) inform all States which have signed or accessed to this Convention and the President of the International Institute for the Unification of Private Law (Unidroit) of:
    - (i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;
    - (ii) each declaration made under Articles 18, 19 and 20;
    - (iii) the withdrawal of any declaration made under Article 21 (4);
    - (iv) the date of entry into force of this Convention;
    - (v) the deposit of an instrument of denunciation of this Convention together with the date of its deposit and the date on which it takes effect;
  - (b) transmit certified true copies of this Convention to all signatory States, to all States acceding to the Convention and to the President of the International Institute for the Unification of Private Law (Unidroit).

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorised by their respective Governments, have signed this Convention.

DONE at Ottawa, this twenty-eight day of May, one thousand nine hundred and eighty-eight, in a single original, of which the English and French texts are equally authentic.