

THE UNIDROIT MODEL LAW ON LEASING
Background, foundation and application

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THE UNIDROIT MODEL LAW ON LEASING	1
Background, foundation and application	1
Foreword	3
The Grounds for Leasing	6
Provisions of the Model Law	7
Chapter I: General Provisions	9
Article 1 Sphere of Application	9
Article 2 Definitions	11
Article 3 Other laws	24
Article 4 Interpretation of this Law	26
Article 5 Freedom of contract	26
Chapter II: Effect of leasing agreement	27
Article 6 Enforceability	27
Article 7 Lessee under financial lease as beneficiary of supply agreement.....	29
Article 8 Priority of liens	31
Article 9 Liability for death, personal injury or	32
property damage caused to third parties	32
CHAPTER III: PERFORMANCE.....	33
Article 10 Irrevocability.....	33
Article 11 Risk of loss.....	34
Article 12 Damage to the asset	36
Article 13 Acceptance.....	37
Article 14 Rejection	37
Article 15 Transfer.....	39
Article 16 Warranty of quiet possession.....	40
Article 17 Warranty of acceptability and fitness	42
Article 18 Lessee’s duties to maintain and return the asset	42
CHAPTER IV: DEFAULT.....	43
Article 19 Definition of default.....	43
Article 20 Notice.....	44
Article 21 Damages.....	45
Article 22 Liquidated damages	46
Article 23 Termination.....	47
Article 24 Possession and disposition.....	48
Summary and Conclusions	49

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Foreword

In April 2005, the Governors Committee of UNIDROIT (the International Institution for the Unification of Private Law)¹ decided to undertake a program to prepare a Model Law on Leasing.

The purpose of a Model Law is to have a set of rules for law makers to follow in participating countries. Usually a Model Law is prepared based on the best practices within an industry, offering a uniform and predictable legal framework for countries adopting the Model Law. Model Laws help facilitate international trade of goods and services because parties from different countries have the security of knowing that the same legal and commercial rules are applied in participating countries.

Three organizations have been involved in the creation of Model Laws worldwide: UNIDROIT, UNCITRAL (the United Nations Commission on International Trade Law)² and the Organization of American States (OAS)³.

UNIDROIT's Model Law on Leasing was the byproduct of an initiative by the UNIDROIT Secretariat that was embraced by the International Finance Corporation (IFC), an affiliate of the World Bank, which invests in the private sector in developing countries. IFC has invested in 181 leasing companies in more than 50 countries, with mostly unsatisfactory experiences. The lack of predictable, uniform laws based on leasing best practices has been identified as one of the main causes of IFC's problems and frustrations.

Since then, IFC has published several studies highlighting the importance of adopting a uniform legal framework in all developing countries and emerging markets⁴.

Why is a Model Law so important? What does a Model Law have that is not already contained in a local legislation?

¹ UNIDROIT (International Institution for the Unification of Private Law) is an international organization founded within the former League of Nations, based on the privileges conferred to the said League by the Paris Conference in 1919. After the League of Nations was dissolved, the Institution was re-established in 1940 and its Statute was adopted by a great number of countries, Italy acting as the main country.

UNIDROIT's mission is the harmonization of private laws, mainly commercial laws to ease the global trade of goods and services.

² i.e., UNCITRAL has issued Model Laws for International Conciliation and Arbitration, International Insolvency, International Electronic Transfer of Funds, e-commerce, Digital Signatures, Official Purchase of Goods, Construction Services and Private Participation on Infrastructure Projects..

³ Among the Model Laws issued by OAS it is important to mention the Movable Assets Model Law.

⁴ It is important to mention IFC Publication (November 2005) called "Leasing in Development: Guidelines for Emerging Economies" prepared by Matthew Fletcher, Rachel Freeman, Murat Sultanov and Umedjan Umarov.

A Model Law on Leasing is important because leasing is a valuable tool for improving general welfare. Both Western and Eastern legal tradition concur that the objective of the law is the achievement of general welfare, which can be defined as “*a set of social conditions that promote and allow human beings their personal development*”⁵ The United States Declaration of Independence, for example, states that one of the objectives of a country, and therefore of its governments, is the pursuit of happiness⁶ of its inhabitants.

Leasing helps to improve the general welfare because it constitutes a legal mechanism that allows almost any individual with a desire to work to have access to the capital goods, machinery and equipment necessary to fulfill his or her economic interest. Therefore, a country with a legal regime favorable to the development of leasing has better opportunities to achieve the general welfare if its laws are based on best practices that ensure the above-stated theory can become a sustainable reality.

Real life has proved that the lack of legal rules on leasing has (i) made leasing inaccessible for small and medium entrepreneurs, (ii) confined leasing to finance only a limited number and type of assets (mainly vehicles); and (iii) restricted leasing’s contributions to the required infrastructure for growth in developing countries. The reason for this is that lessors tend to be careful in countries with poor legislation, avoiding sectors that entail high risks because the legal system does not help them to prevent or mitigate such risks. If, for example, the legal system does not provide a method to enforce the compliance of enterprises using equipment, by efficiently recovering the money owed or quickly repossessing leased assets, then such leasing companies would not be willing to approve deals with small, low-income clients who do not have credit experience.

To finish answering this first question, it seems necessary to answer another question: What is the advantage of a Model Law versus a law developed by each country under its own initiative? There are two answers to this question: best Practices and uniformity.

Best practices are usually understood as the set of programs, initiatives and activities which reflect the top leadership in an industry. They are used as role model to follow, and are prepared based on the experiences of other countries where the industry has been successful, and has failed. Best practices are not definite, they are relative, and that is because their application depends on the environment and culture prevailing in each country. The above-mentioned fact requires that a Model Law be flexible.

⁵ This definition is from Pope John XXIII and it is found within his Encyclical Mater et Magistra, available in internet at http://www.vatican.va/holy_father/john_xxiii/encyclicals/documents/hf_j-xxiii_enc_15051961_mater_sp.html

⁶ In its original version, the Declaration of Independence states: “We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. — That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed,” (Available in internet at <http://www.ushistory.org/declaration/document/index.htm>)

Uniformity makes it easier for international investors to enlarge their operations because they understand that the laws applied in one country are similar to those applied in other locations where their operations are oriented. This facilitates the flow of capital to developing countries.

A Model Law is welcome when the current legal system of a developing country is not applicable or not strong enough to promote best practices on leasing.

With respect to the above, the members of the Committee exchanged information about the legal environments of numerous countries. The following characteristics were found:

- The legal systems of developing countries are based on three types of legal inspirations: (a) the Civil Law system which reflects the Napoleonic Code (1804). Among the countries following this system are all the developing countries that were Spanish colonies or were influenced by Spain, Portugal, France, and Germany. This includes all the countries in Latin America, Africa and the majority of Asia; (b) the Common Law system, which includes mainly British colonies and those that are members of the “Commonwealth”; and (c) the Communism system, which is fading in influence but has had an impact on countries in Eastern Europe and Central Asia.;
- Some countries have ad-hoc leasing laws. Usually, these laws have emerged within countries following the Civil Law system after their own civil codes and commercial codes have failed to provide a legal framework that promotes the development of leasing. The first and most important example is France, which had to issue its first leasing law as a result of a contradictory decision from the French Court of Appeals in 1964;
- Even Common Law countries with advanced development have had to compile best practices. One good example is the issuance of article 2A of the Uniform Commercial Code of the United States;
- No country has a legal framework for leasing that is effective enough to become a universal role model. The Model Law has to incorporate the best of all the laws and discard their negative parts.
- Among other aspects considered by the Advisory Board as relevant were globalization, and the worldwide expansion of the Islam culture. Globalization refers to the growing interconnections among countries, and the impact of First World economic trends on the almost 4 billion people who live in developing countries and emerging markets. This has contributed to the outstanding commercial growth of China and India, which could influence the regulation of financial mechanisms such as leasing. The expansion of Islam is self-evident in Europe, due to migrations and the expansion of the European Union with the potential addition of Turkey. The same phenomenon is happening, in a less evident way, in the Western Hemisphere, and Islam is already part of the African social reality. Therefore, any Model Law on

Leasing has to contain rules which are not offensive to Islam, especially to “Shari’ a,” and that was one of the goals of the Advisory Board.

Summarizing, a Model Law on Leasing can incorporate the best practices and uniformity that local legislation lacks, providing a framework that allows all countries to have a well-developed, sustainable leasing industry which contributes to the general welfare.

The Grounds for Leasing

In several publications we have commented that leasing originated from the natural trend of human beings to use goods as a source of progress.⁷ Adam Smith supported this idea in his book “The Wealth of Nations,” stating that the accumulation of capital is not a consequence of the ownership of goods, but rather of their productive use.

Legal rules have been created around the principle of treating private property rights as the king of all rights. All constitutions of the world have rules that guarantee private property⁸, and all of them indicate the privileges of the owner to enjoy such goods, to extract their products, to recover their possession when lost and to freely dispose of them. However, in the late 19th century and early 20th century, when the trend to accumulate goods and to have them as “dead capital” started to threaten the survival of societies, the idea began to prevail that private property rights must be subordinated to a social objective.

Lawyers from my generation in Latin America studied Constitutional Law with a focus on the social function of property, without really understanding its essence, only thinking that this theory was the motivation of an interventionist government in order to deprive of their private property rights those owners whose properties were not devoted to social functions. And that is why those constitutional tools terrified our parents, because they were the reason for the so-called “Agrarian Reforms” or “Urban Reforms,” which never succeeded because no one benefited from them (neither the government, nor the owners deprived of their assets, nor those who received those expropriated assets).

But, what really justifies the social function of private property is leasing. This is true because the owner of the good moves the capital as live capital, allowing a third party (an entrepreneur who does not have the economic resources or interest to invest in the property) to use such goods to produce other goods or services and to pay a rent to the owner. What really makes leasing important for the social function of private property is that there is enough room for everyone to win: (a) the leasing entrepreneur who is

⁷ Whoever can be patient enough can review the following: “Leasing: Mecanismo Financiero del Futuro”, Editorial Hojas e Ideas, Bogotá, Colombia, 1994, ISBN-958-9337-04-X, “Legal Aspects of Equipment Leasing in Latin America”, Kluwer Law International” La Haya, Holanda, 2001. ISBN-90 4118 866 5

⁸ For those who want to have fun reviewing all constitutions, visit the following web site:
http://www.law.harvard.edu/library/services/research/guides/international/web_resources/foreignC.php

generating income based on his/her investments in capital goods, (b) the business entrepreneur using the leased assets, who is benefiting from another's capital and, if successful, can pay for the use of the goods and generate greater value, (c) the country, because the production of such goods will increase job creation and generate more goods and services, and (d) finally, governments, because greater production and employment will increase fiscal income while reducing social burdens and obligations.

Provisions of the Model Law

I intend hereafter to present and analyze each of the articles of the Model Law. This analysis is almost a confession of the motives of those who participated in the process of drafting and discussing the Model Law and it can be considered as a research source if someone wants to know how the law was created. However, I shall reiterate the disclaimer already made. All opinions inserted herein are solely the author's opinions and do not represent an official position from UNIDROIT or any other member of the Advisory Board.

I do not pretend to agree fully with the rationality of each of the articles of the Model Law. I do not pretend everyone who reads the Model Law will share the majority opinion of the Advisory Board and the Rapporteur.. I can state without doubt that all the members of the Committee were inspired by the desire to be right and by the desire to create for the world a legal tool that would contribute to general welfare.

Allow me to introduce each of the members of the Committee of UNIDROIT for the drafting of the Model Law on Leasing:

As Rapporteur, UNIDROIT appointed Mr. Ronald DeKoven. Mr. DeKoven is a United States citizen who graduated from the University of Stanford, with a Ph.D. in Law from the University of Chicago. With a brilliant professional practice in International Commercial Law, particularly in cases of international insolvencies, Mr. DeKoven accumulated important legislative experience as the head Rapporteur of the commission that drafted Article 2A of the Uniform Commercial Code of the United States. He was also appointed by the State Department of the United States as its treaties international representative, and at the same time he represents the interests of the National Commission of Insolvency. To add to his achievements, Mr. DeKoven was admitted in the United Kingdom for the professional practice as "Barrister" by the Gray's Inn, and he belongs to 3/4 South Square, a well known division of the Chambers of English Barristers. Mr. DeKoven maintained in every moment a very positive and creative attitude that contributed to generating a text that considered the rational suggestions of all the members and achieved the general consensus of the Advisory Board.

In representation of the World Bank (from IFC), Ms. Rachel Freeman, deputy director of the Program for the development of the Private Enterprise (PEP) in Africa, and Mr. Murat Sultanov, legal advisor of IFC for PEP in the Middle East and North Africa (MENA), participated in the meetings. Additionally, Ms. Freeman is the legal

adviser of IFC in Tanzania, Moyo, where she participated in one of the reunions of the Advisory Board.

The Equipment Leasing Association (the lease association of the United States) was represented by Mr. Robert Downey, director of the Legal Group of ELA, and an international lawyer for Caterpillar Financial. During his absences, Mr. Ralph Petta of the ELA and Ms. Isabell Cassidy, a member of the ELA's Legal Committee and lawyer for HP Financial Services in Europe, attended the meetings.

The European region was represented by (a) Fritz Peter, a recognized executive of the European leasing industry. The former president of the Board of Directors of the European Confederacy of Lease and honorary president of LEASEUROPE, Mr. Peter was for many years a leasing business executive, gaining valuable experience. He has worked as a consultant to the World Bank on various legislative projects, such as the establishment of leasing legislation in the countries of Central Asia and China; (b) LEASEUROPE sent its own delegation while the Italian Association of Lease participated as an observer. The spokesman of LEASEUROPE was Renato Clarizia, professor of the University of Rome, and consultant of the Italian Association of Lease (Assilea).

North Africa was represented by Mr. Mokhtar Bey, a notable lawyer from Tunisia who also represented France. Mr. Bey accumulated broad experience as the lawyer of several leasing companies in France and legal advisor of LEASEUROPE.

The Russian Federation was represented by Nikolai Zinoviev and Anna Normantovich from the Europlan, the largest leasing company in Russia.

The African continent was represented by the Tinuade Oyekunle, a lawyer from Lagos, Nigeria. Ms. Oyekunle is honorary vice president of the International Counsel of Commercial Arbitration. She was appointed as chairwoman of the Advisory Board, moderating the discussions in professional way.

China was represented by Professor Yanping Shi of the University of International Business and Economy of Beijing. Professor Shi is also the president of the Lease Investigation Committee of the [Chinese Popular Republic](#) and she directs the commission drafting the new leasing law in China.

Latin America was represented by the undersigned, Rafael Castillo-Triana. Please see the end note that describes my background.

UNCITRAL, the Commission of United Nations on International Commercial Law, sent its observers, whose participation made the experience even more interesting.

UNCITRAL delegates included the following: Mr. Renaud Sorieul, leader of the Legal Division, and Mr. Spyridon Bazinas, lawyer for UNCITRAL and the last secretary of the Working Party on Security Interests.

And, finally, the hosts were mainly the general secretary of UNIDROIT, Mr. Herbert Kronke, and the deputy secretary, Mr. Martin Stanford, who has been the main promoter of the Advisory Board's works.

This was the team of lawyers and experts that discussed the articles that are presented in the next pages.

As a methodological warning, and perhaps as the first confession, is important to mention that my goal as a member of the Advisory Board was to enhance the economic success of the leasing industry with a judicial framework that generates benefits for all the participating parties. I believe:

- All businessmen (that is to say, every person with an idea or economic initiative or business) should have access to the capital goods that are required to realize his or her initiative.
- In order for such access to exist, there should be stable and economically solvent leasing companies with satisfied shareholders, well paid personnel, and companies willing to assume greater business risks;
- In order for such stable and economically solvent companies to exist, it is required that the operating and legal conditions of the leasing business allow investments in leased assets to be easily recoverable. In the event that business decisions have been wrong or mistaken, the solution shall allow a quick and efficient correction to such errors, fast exit and winding up of non-viable businesses, and a quick recovery and realization of the collateral assets.

Perhaps to achieve those ambitious purposes, it is necessary to break certain paradigms that exist within the Western legal culture as axioms, which today do not have a sustainable base.

The following are the articles of the Model Law:

Chapter I: General Provisions

Article 1 Sphere of Application

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

It is important to note that in this aspect, the law suggests three criteria to define the application of its norms. Two criteria relate to territoriality, and the third one relates to contractual freedom.

Based on that, if two or more companies with residence in the same country undertake a leasing transaction, undoubtedly the applicable law will be the law of that country (and in the event that said country adopts the Model Law, this law will be applicable). But if one of the parties has multiple residences, (for example, it is a branch office of a foreign company, an international leasing operation or a leasing operation with importation), which would be the applicable law in these cases? According to the Model Law the answer must be the following: the law where the leased asset is located ("*lex res situ*"). And if the asset is moveable and it goes from one country to another (i.e., transportation equipment such as aircrafts, ships, trains, cars, lap tops, and portable telecommunication equipment, among others)? In these cases, the criterion that applies is related to the law of the State where the lessee has his/hers/its "Centre of Main Interests." This term is defined in the Second Article as the place where a person (natural or physical, and/or legal or moral) carries out the administration of its interests on a regular basis. The Model Law does not refer to the social headquarters, or the State of incorporation, but to the place where the administration of its business is based. This criterion corresponds to a modern tendency produced by globalization, which has multiplied the diverse places where a person or company carries out its businesses, and has contact with multiple jurisdictions and territories. A typical example is Wal Mart, a company that before the spectacular increase in the international prices of oil was the world's largest. Wal Mart operates in many different places. Its manufacturing factories are located in China; its stores are located throughout the world. But the place where it carries out the administration of its interests is in Bentonville, Arkansas, a small town located in the south of the United States. With this criterion, the Model Law acknowledges the regulatory complexity associated with law enforcement in a global environment.

But the final prevailing criterion is the determination of law enforcement by contractual stipulation. This is a very controversial legal point. The old school of jurists would argue that this type of stipulation would be against procedural laws that are Public Interest laws of higher hierarchy than private parties' stipulations, which individuals do not have the right to negotiate. Some people would go further and say that said stipulations are against the constitution of their nation because they imply an implicit resignation to the sovereignty and to the right to be judged by someone's peers, and therefore the due process of law would be violated as well. At the moment when they are strangled with the cord of their own rhetoric, they have to begin to understand that the application of the rules of a legal business shall only be determined by the parties involved and they will only have limits to their freedom to stipulate those rules, when they threaten against the same solidity and national stability or when they violate the rights of third parties. None of this happens if they consent to the application of foreign law.

Article 2 Definitions

In this law:

“Asset” means all property used in trade or business, including plant, capital goods, equipment, future assets, specially manufactured assets and living and unborn animals. The term does not include money or investment securities but no asset shall cease to be an asset for the sole reason that the asset has become a fixture to or incorporated in land.

The previous definition has important consequences and applications. I am going to refer to the most critical ones:

Software: During the discussion of the Model Law, several proposals, including mine, submitted during the second meeting, and related to the concept of including “software” within the term “asset”. The draft submitted to the Advisory Board after the first meeting had excluded software ("logiciel" in French) as susceptible assets to be financed by a leasing transaction.

During the second meeting, I was given the opportunity to summarize the growing importance of software to the development of the world economy. Currently, many technological developments related to the production of goods and services are fueled by software. Modern equipment has more software than before: cars, for example, have complex software to regulate their performance indicators, internal equipment, temperature, and monitor their precise position by satellite detection ("global positioning systems" or "GPS"). The music industry has been revolutionized by the introduction of software that enables unique sound formats (as the one incorporated in Apple’s i-Pod). Businesses improve their efficiency by virtue of information systems that are used throughout a company, from process management systems ("Enterprise Resource Schedule" or "ERP"), to systems streamlining their contacts with clients ("Customer Relationship Management" or "CRM"). Many processes that were once clerical or labor-intensive in nature are now managed by software. There is no doubt that software is a tool of production.

Various members of the Advisory Board asked me, “Although it is certain that software can be appreciated as a tool of production, how can financing software be similar to financing equipment or cars? Furthermore, how can we agree that similar legal proceedings used for all other assets, which lessors should have the right to repossess, can be applied to software?”

The answer to both questions is found within the international legal norms that regulate the protection of intellectual property. It is important to observe that in a uniform way, all the countries have agreed to grant software the same legal protection that is conferred to copyrights⁹. This legal protection has given software the same protections, developed throughout time, as those given to musical, literary, and artistic works. Articles 10 and 11 of the Agreement On The Aspects Of The Rights Of Intellectual Property Related to The Commerce (TRIPS) provide software the protection that the Berne Convention of 1971 grants to film, musical, artistic, and literary works; Article 11 explicitly foresees the possibility to lease software, with the previous authorization of the owner.

The best definition of software found in legislation describes it as "a set of instructions in words, codes, formulae or in any other format that should be capable, when incorporated to an information reading machine, to produce that a computer — or an electronic or similar machine with information processing aptitudes- to carry out a given task." ¹⁰ [Carla's note: please check the definition. The phrase "to produce that a computer" sounds like it is missing wording.]

The legal protection of software under the same rules of protection of artistic and literary works generates the duplicity of rights inherent in the said property rights: (i) moral rights of the author, and (ii) economic rights.

It is well known that moral rights confer to the author the possibility to claim authorship of the creation, but they do not represent per se a potential for economic exploitation.

However, an author's economic rights permit him/her/it to obtain an economic advantage from others' use of such intellectual product. As a general rule, the holder of the software confers its use to third parties by means of a license agreement, which usually is not for free. Besides the granting of use by means of licenses, the holder of the software can authorize other forms of distribution to third parties, by authorizing its leasing. This is exactly what is stated in the above-mentioned Article 11 of the TRIPS.

Therefore, if software owners desire to offer end users access to asset-based financing, such software holders can confer to third parties the right to lease the software. Based on the above, the software should be included as a category of "assets," according to the Model Law.

⁹ For detailed information and to review legal sources of laws about software, property rights, and related matter, it is recommend to visit: <http://www.wipo.int/about-ip/en/ipworldwide/index.html>

¹⁰ WIPO Intellectual Property Handbook: Policy, Law and Use, en www.wipo.int . Visited on August 6, 2006

It is important to observe that the leasing law of Argentina¹¹ already includes software as an asset suitable to be financed by lease.

According to the above, access to software can legally be financed through leasing. But this is not enough. It is important to establish if this legal possibility has only academic value, or if it offers a business opportunity to generate greater economic development.

The end of the 20th century marked an important transition related to technological developments and their impact on life. Software is increasingly becoming part of our daily routine at home, business and leisure. To promote the evolution of software and to allow its creators to have economic incentives to continue developing and perfecting it, payments for the use of it must flow and the tendency to use unauthorized software must be discouraged. Again, leasing is the answer to that need. The authorization should support the right to lease use of the software, as conferred by the holder of the software, generally in exchange for a price; and the lessor should have the right to confer use and to withdraw such rights to use in the event of a breach by the lessee.

This leads us to the second question that was formulated: is it possible for a lessor to recover the possession of software? The answer is affirmative, backed by technological and legal support. The grantor or lessor has the right to grant the use of software to the lessee, and the lessor can also produce a legally valid prohibition to such lessee should the latter have breached the contractual terms. The technical answer is that the software can contain instructions that limit its operation, which can be activated legally, triggered in the event of breach, to make physically possible a legal prohibition¹².

Based on the previous arguments, a majority of the Advisory Board approved the inclusion of "software" as an asset that can be financed through a leasing transaction.

Capital goods and future goods: The definition seems too generic, and in fact, the intention of the Advisory Board was to leave it as generic as possible. The members used some examples that are worthwhile to note, since they represent an immense potential for leasing companies in the developing world. The first example, not so important, but very common, refers to goods imported by means of advance purchase to their manufacture[from their manufacturer?], which is a practice in international trade. The second example, more important still, involves infrastructure projects: freeways ("autobahn"), railroad tracks, power and water plants, telecommunications networks and similar structures would be "assets" under the definition of the Model Law. Even when they have not been built yet, leasing companies can finance their construction, and

¹¹ Ley 25.248, "ARTICLE 2° — Object. It can be leased movable and immovable assets, trademarks, patents, industrial models and software owned by the lessor or over which such lessor has the right to lease".

¹² For a detailed study of the technical interaction with the legal prohibition to use software, please see COPYRIGHT AND THE JURISPRUDENCE OF SELF-HELP, By Julie E. Cohen †; Originally published 13 BERKELEY TECH. L.J. 1089 (1998).

deliver them to companies in the public or private sector. As the structuring of infrastructure projects financing becomes simpler, it makes it easier to finance and build even more infrastructure, just as development in emerging countries demands it.

Financing of infrastructure projects already has precedents¹³. The use of leases has been possible for some time, although erratic in practice and with very high structuring costs. The Model Law could help reduce structuring costs by eliminating the need to re-invent the wheel every time there is an opportunity to lease a freeway, a railroad track, an airport or any other infrastructure project.

Live or unborn animals: In several markets, leasing innovation has led to the consolidation of the practice of leasing live animals, and sometimes even their embryos. For example, a company called Leasing Colombia in Colombia has successfully leased dairy herds through a highly modernized structuring of the business. Additionally, the practice of leasing beehives has been successful in territories of Kenya.

Clearly the development of agriculture can be promoted through leasing, and because of it, the Model Law includes these goods among the ones that are capable of being financed through leasing transactions.

Centre of main interests means the place where a person conducts the administration of its interests on a regular basis. In the absence of proof to the contrary, the person's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the person's main interests.

We already explained the effects of this definition. This definition is only relevant to determine where this law shall be applied.

¹³ For example, in his own practice, the author has structured and negotiated leases for various infrastructure projects: the construction of an oil pipeline in Colombia in 1985, and the financing of information technology infrastructure for all public schools in Mexico in 2006, among others.

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

- (a) the lessee specifies the asset and selects the supplier;**
- (b) the lessor acquires the asset or the right to possession and use of the asset in connection with a lease and the supplier has knowledge of that fact; and**
- (c) the rentals or other funds payable under the leasing agreement take into account the amortization of the whole or a substantial part of the lessor's investment.**

Lease means a transaction in which a person grants a right to possession and use of an asset to another person for a specific term in return for rentals. Unless the context indicates otherwise, the term includes a sub-lease.

We have arrived at the point when we must discuss two definitions that are, in my opinion, the backbones of the law, and which have motivated misunderstandings and dissatisfaction on behalf of some members of the Advisory Board.

The previous definitions are not completely satisfactory, and they are not because they were the product of a discussion where various members of the Advisory Board seemed polarized, and therefore the above-mentioned definitions reflect compromise positions rather than definitions. In my opinion, it was not so much a problem of polarization, but of gigantic confusion about the concept of operating leasing on the part of the drafting group and some other members, who had not dealt with operating leasing except in pure theory. But the time was not sufficient to undertake an educational process that improved this definition.

It is necessary to clarify that the purpose of the Model Law is to regulate leasing in its present and future developments. The Model Law cannot regulate situations or structures from the past, but must provide the judicial framework for situations and structures pertaining to capital goods of the future. The Equipment Leasing Association of the United States (ELA) expressed this opinion in all of its comments to the drafts of the Model Law, and in all the discussions where representatives were present. Some members of the Committee, including me, agree on this point, although not all do.

To understand the abovementioned disagreement, is it helpful to observe business practices in various countries where operating leases were first established and, therefore, confronted difficulties with the existing legal framework. For example, the main pioneers of operating leases were leasing companies in the United States. When leasing companies began to perceive that it was sometimes better business for a lessee to not take advantage of the purchase option, they started offering operating or "residual value based" leasing, whereby the lessor could offer lower rentals, with the aspiration of recovering his investment in the secondary market, retaining a greater residual value. This new way of doing business implied a substantial change in the distribution and allocation of risks and benefits among the parties. The lessor assumed greater economic risks related to the assets than had been assumed within the context of financial leasing. But there were fiscal and accounting benefits. In fact, the only rules that distinguished financial leases from operating leases when the practice developed were related to taxation (IRS 55-540), and accounting (FASB No.13), shortly after the elimination of fiscal benefits enjoyed by leasing before the tax reform of the Reagan Administration in 1986.

That is why article 2A of the Code of Uniform Commerce of the United States was introduced to the UCC in 1987. Before then, there was no legal regulation that stipulated assets related to operating leases could be the property of the lessor and be treated as off-balance sheet by the lessee for all legal effects.

When the practice of operating leases began to cross borders, countries such as Mexico and Colombia made significant efforts to accommodate operating leases within regulations contained in their respective civil codes related to rental agreements. And with it, they gave rise to "pure leasing" or "simple leasing" as an intermediate form, without legal regulation, as opposed to the traditional rental agreement, (where the lessor confers the enjoyment and does not intend to lose the assets leased) In operating leasing, the lessor recovers its investment in the asset in two ways: on the one hand, by the flow of incomes from the leasing contract, and on the other hand, by the values or revenues after resale or re-location of the assets. Clearly, this is the difference: operating leasing cannot be submitted to the regulations of rental agreements contained in civil codes, because in operating leasing, the lessor may be purchasing the equipment commissioned by the lessee, and because the repayment of its investment in the assets is not sourced only through the flow of rents, but through the combination of the rents with the revenues arising out of the so-called "terminals options" of the contract (namely, return the equipment to lessor, or extend the possession for an additional term in consideration of the payment of further rentals, or exercise the lessee's option to purchase the asset paying its fair market value). Because of this the lessor assumes risks of obsolescence or of secondary market that the lessee may not want to assume.

Due to the shortage and ineffectiveness of existing civil legislation for operating leasing, the ELA delegation and other members of the Advisory Board, including myself, demanded to include operating leasing within the definition. This is clearly the intention of the Model Law legislators, just as it was explained in the aforesaid Explanatory Notes

of the Model Law. Sadly, the definition of "Lease" is clearly insufficient, and because of that, any interpreter, and perhaps legislators, will need to work toward a better definition.

Beyond the observation about the interpretation of the term "lease," in contrast with the definition of the "financial lease" that becomes a type of lease, it is important to recall the characteristic elements of as specified by the Ottawa Convention, 1988.

According to the definition used by the Ottawa Convention, the following are essential elements of a financial lease:

- (a) The selection of the asset and of the supplier corresponds to the lessee;
- (b) The cause, or determinant motive of the acquisition of the asset on the part of the lessor (situation that shall be known by the supplier) is exactly such leasing agreement that shall be entered into by and between lessor and lessee by virtue of which the lessee is going to economically use the leased assets; and,
- (c) The rents are calculated based on the amortization of all or substantially all the costs associated to the acquisition of the asset¹⁴.

These characteristic elements of the financial leasing transaction bear the following legal consequences:

- The lessor cannot be subject to claims, exceptions or judicial defenses related to the legal consequences of the election of the asset or of the supplier. In other words, the errors, omissions or breach of the supplier or the lack of suitability or good operation of the asset can not limit the exercise of the lessor's rights against the lessee;
- After the supplier is aware that the contractual position of the lessor as purchaser of the asset has as cause the leasing agreement, it should be understood that in the execution of the sale contract the lessor is acting not directly, but on behalf of lessee. Therefore, all the accessory terms and conditions of a sale related to the use or operation of the goods should correspond to the lessee and not to the lessor. It is a common practice by suppliers to pretend that lessors should be bound by the general terms and conditions of sale set forth by the supplier. This agreement should not be binding to lessor but to lessee. And that should be clear for suppliers, if they really desire to make effective such general conditions of sale;
- Once it is understood that the intention of lessor is to recover its investment or obtain the repayment of its investment in the equipment

¹⁴ Based on the authorized non-official version of the UNIDORIT Convention on Cross Border Lease, its article 1 states the following: "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 amortization of the whole or a substantial part of the cost of the equipment. ". Complete version available at <http://www.unidroit.org/english/conventions/1988leasing/1988leasing-e.htm>. Last visit: August 11, 2006.

by means of the flow of rents, it should be concluded that one of the substantial and indisputable aspects of the lease is the unconditional support of the obligation of payment of the rents owed by lessee, that is to say, the principle that is known in Anglo-Saxon Law¹⁵ as "hell or high water."

After analyzing the characteristics of a financial lease, the characteristics of operating leasing can be summarized as those characteristics common to both forms of leasing (the selection of the asset and the cause of the sale contract entered into by and between supplier and lessor), and the third characteristic, applicable only to operating leasing, related to rents. For operating leasing, rents are calculated based on the amortization of a non-substantial part of equipment cost and the assumption of a residual value of the cost of the assets, which represents for the lessor the alternatives that (i) the lessee decides to exercise an option to purchase the asset by paying its "fair market value"¹⁶ as of the date when such option is exercised (in the event such option was granted), or (ii) the lessor manages to re-lease to the same lessee or to a third party the same asset, and the additional sums will tend to pay off an additional portion of the cost of the assets, or (iii) the lessor sells the asset in the market to a third party, or (iv) the lessor decides, seeking tax benefits or similar benefits, to donate the asset.

One of the main sources of confusion for people who have not been involved with the business of operating leasing, is that they tend to identify the operation of car rental agencies as similar to operating leasing. Though it is certain that such companies function as operating lessors, the phenomenology of their business has elements that are more similar to civil rental agreements than to operating leasing. It is believed, for example, that the final client does not have any involvement in the discussion and engagement of the sale contract entered into by these companies and their suppliers. However, that assumption is not true because most of the rental companies operate by virtue of their market research, which allows them to anticipate the decisions of their potential lessees, and the assumption ignores the fact that every person who rents vehicles has diverse options to choose from among the vehicles in stock. Another element that most analysts ignore, is that car rental companies withdraw rental vehicles when they

¹⁵ A hell or high water clause is a clause in a contract, usually a lease, which provides that the payments must continue irrespective of any difficulties which the paying party may encounter (usually in relation to the operation of the leased asset). The etymology of the expression strongly point to cattle ranching as the origin, in particular the driving of cattle to railheads in the mid West in the latter part of the 19th century. In 1939 Paul Wellman published a book with the title "Trampling Herd: the Story of the Cattle Range in America" in which he wrote: " 'In spite of hell and high water' is a legacy of the cattle trail when the cowboys drove their horn-spiked masses of longhorns through high water at every river and continuous hell between".

¹⁶ The most frequent definition of fair market value is the following one: "The price at which a good can be sold in the open market. That is to say, the price that should agree a salesperson that want to sell and a buyer that want to buy, without being submitted to any pressure, and both having reasonable knowledge about all the prominent facts of the business". This definition is at the same official definition brought by the American Appraisal Association and the Internal Revenue Service of the United States. "The IRS defines fair market value as the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, nor both having reasonable knowledge of the relevant facts").

reach a certain mileage (say 20,000 or 25,000 miles) and sell them in the open secondary market. Finally, few people perform an economic analysis of the repayment of investments in vehicles made by these companies. It is clear that when a car rental company (of this kind) acquires vehicles, the supplier is aware that the vehicles will be leased to third parties, even when the lessor decides to retain certain additional risks inherent to the position of buyer.

In the modern world, the importance of operating leases is growing. This type of transaction is becoming more frequent, especially in situations where the bargaining power of businessmen is strong, their intention to freeze capital in fixed assets is decreasing, and the economy tends to be based on low overhead costs or low cost of capital. Leasing companies are, and will continue to be, pressured to offer lower rents and to retain higher residual values. The Model Law should foresee the adequate regulation of operating leases. In my judgment, it does not, which makes it necessary to interpret the given definition as noted above.

Lessee means a person who acquires the right to possession and use of an asset under a lease. Unless the context indicates otherwise, the term includes a sub-lessee.

Please note that in the definition of lessee, the emphasis is on the acquisition of rights to possess and to use goods, according to the terms of the leasing agreement.

It is worthwhile to stop for a moment to analyze these rights, because out of this analysis will flow an understanding of the correlative obligation of the lessor.

The first thing that shall be forgiven by traditional Civil Jurists is that the definition uses the term "right to the possession," when we have been taught that possession is a fact, not a right. The reason this is phrased this way is because what is being delivered to the lessee is the material possession of the assets, without the attitude of an owner. In terms of the German doctrine, that possession without the attitude of an owner is called "possession in someone else's name." That is, the lessee recognizes that he/she/it does not have the right to his/hers/its asset by its mere exploitation and physical possession because such lessee recognizes that another person (the lessor) has the ownership, and by virtue of such recognition the lessee agrees to pay the lessor rentals.

Therefore, it is clear that the correlative obligation of the lessor is to confer quiet and uninterrupted possession (the "quiet possession" mentioned by Anglo-Saxon Law). And this obligation requires the lessor to exercise all the actions and not omit the necessary steps preventing third parties from legitimately stopping possession. Therefore, the obligation of the lessor is to prevent third parties from affecting the lessee's possession, which would occur if the lessor pledges the leased asset to third parties, or allows, under any other form, creditors to take the assets away from the lessee.

The right to use the goods means that the lessee shall be able to extract from such goods or assets all their economic potential according to their nature. Generally, this right to use should be regulated since the use of the goods involves greater social responsibilities. For example, construction equipment should be operated with care to avoid accidents to third parties or combustion, be kept as environmentally clean as possible, and be maintained using best practices. Therefore, at the same time the lessor provides the lessee economic use of the asset, without interference, it is clear that this right imposes on the lessee certain obligations which should be regulated in the leasing agreements.

Lessor means a person who grants the right to possession and use of an asset under a lease. Unless the context indicates otherwise, the term includes a sub-lessor.

One of the points discussed inside the Board was whether the Model Law should require that a lessor be a financial institution, subject to the inspection and control of a government agency. This was an idea that the European delegation proposed with great strength.

The majority of the members of the Board, including myself, agreed that each country or state should regulate the conditions for market access, the freedom to operate, and the inspection and control that should be imposed.

Several members who have studied the evolution of leasing companies (including the undersigned) agreed that leasing companies professionally devoted to the exploitation of the leasing business should follow the best practices of corporate governance. But experience shows that inspection and control by the state, and restrictions or market access barriers, do not necessarily reflect best practices of corporate governance.

On the contrary, analyzing the experience of countries such as the United States, where leasing is more developed, and where the activity of leasing does not have market entry barriers nor mandatory inspection and control of the state, and comparing it with countries such as Venezuela or Ecuador where the leasing industry was submitted to the strict control of the state, with adverse consequences, the following conclusions can be made:

- The best practices of corporate governance advise that it is better to have less restrictive market access barriers, unless the market is at its initial stages of development and it proves necessary to educate participants, particularly potential lessees and suppliers of financing for leasing companies¹⁷. In countries with financial and capital markets that are not

¹⁷ A lease company essentially exists to serve the lessee, its sources of financing and its own shareholders. While a company is not providing adequate benefits and securities to said parties, its existence in the market is compromised: without lease business demand or without financial resources, the lease company dies of starvation. Therefore, there are lessees and suppliers of resources who have the power to condition

well developed, where there is a tendency to obtain funds from unsophisticated public sources, or where lessees are not familiar with the best practices of leasing, it seems justifiable that the state should impose barriers to market access, and should exercise some kind of inspection and control over its operation. But, once the leasing industry has reached a level of maturity, it is better to let leasing companies be ruled by market forces. A sophisticated market with well informed players tends to select the best players and eliminate the bad ones;

- In fact, leasing companies rely on their ability to finance assets in a competitive way. To achieve this goal, some companies in the United States go to banks to obtain financing or they issue commercial papers among private investors, which means they are submitted to the scrutiny and contractual conditions that are imposed by such banks or private investors. Other, more sophisticated leasing companies issue debt securities or participation certificates over their assets and they place them in public capital markets. This places these companies under the scrutiny of the open market, which must be kept informed about their financial and economic situation, and the supervision of the Securities and Exchange Commission. But it is perfectly clear that this governmental entity does not have the powers to intervene in offering licenses for access to the market, nor to assume the management of mismanaged companies;
- One of the most controversial aspects of the rules for good corporate governance is the requirement that the legal system must provide for an efficient and fast market exit of inefficient companies. In many Latin American countries this is considered a heresy, and strict protectionists may argue that this is equivalent to allowing the extinguishment of job sources for the economy. The truth is that these assertions do not withstand serious analysis in an environment where all workers are submitted to the forces of global competition. Job sources should be sustainable, and therefore, even when the disappearance of a company produces temporary unemployment, it also produces an educational process that requires other companies to adjust their practices, forcing them to be more careful in the design and execution of their business model. It also teaches businesses the right time to say "enough is enough," if the strategic orientation of a company goes wrong. That is why the liquidation or exit of inefficient leasing companies are issues best left to the legal norms of the country or respective state. What the members of the Board, myself included, agreed on stating was that, whatever the regulatory orientation (toward control of leasing companies by the state, or toward the rules of free market competition) it is recommended to have in place other laws and regulations that shall make possible the liquidation of leasing companies without delay. Conditions for a

the good behavior of the leasing companies, and their action promotes the development of leasing companies or their exit from the market.

secondary market should also exist in order to permit other leasing companies to acquire quickly the assets of failing companies.

- As I am writing these lines, in the Summer of 2006, a financial reform has been published in Mexico which will create new entities named SOFOMES (Financial Companies of Multiple Object), whose main purpose is to free financial leasing companies from the supervision of the Office of the Secretary of Finance and Public Credit and of the Banking and Securities and Exchanges National Commission. The main argument supporting this reform is that the state can be released from the obligation of offering governmental guarantee to the leasing companies which formerly were Ancillaries Credit Organizations because the market can provide for their effective self-control, and the Mexican Insolvency Law permits the fast liquidation of inefficient companies. This is an interesting development in the transition toward a stadium of freer competition. The question still to be answered is whether the Mexican market is sufficiently educated and mature to absorb such change. Only history will tell us.

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

In this aspect, the Model Law leaves open access to the market by individuals with business activities dedicated to leasing transactions, or by public or private companies.

Likewise the simple definition of the term "person" does not prevent certain countries or states from imposing restrictions to access, for example, those that do not allow individuals to act as lessors.

Supplier means a person from whom a lessor acquires an asset for lease under a financial lease.

In this aspect the definition failed and the Drafting Committee did not reflect faithfully the consensus of the Advisory Board by restricting the intervention of the supplier only in the cases of financial leases. As already explained in this document, a supplier also intervenes in operating leases.

Nevertheless, the above definition of supplier complies with the goals pursued by the law, i.e., to include suppliers as a necessary party in the definition of leasing, since, even when it appears initially that suppliers play a passive role inside the operation, their roles actually tend to be very active in certain businesses.

In fact, one of the main sources of growth for leasing companies in recent years has been the establishment of business strategies by suppliers. This is particularly true for suppliers that create their own subsidiaries which operate as leasing companies (captives), or execute agreements with leasing companies known as vendor programs to deliver new financing options to their end-customers.

Throughout the years, new modalities of businesses, such as the "pay-per-use" lease¹⁸, or "utility computing"¹⁹, or "managed services", or "bundled services,"²⁰ have engaged lease structures where suppliers and leasing companies are involved more intensely in generating new products and services for suppliers' customers. Clearly, these modalities are gaining popularity, involving suppliers as necessary parties to leasing transactions.

Supply agreement²¹ means an agreement under which a lessor acquires an asset for lease.

The definition intends to cover all those contractual forms by which a lessor acquires property on behalf/from a supplier. Typical examples are the purchase and sales agreement, the kind for kind exchange²², the capital contribution to companies, corporations or partnerships, and many other modalities.

¹⁸ Highly used in the lease of aircrafts or copy machines, these structures contained contractual terms of payment that become a combination between fixed payments and variable payments. Within the "pay per use", the user only pays rents or part of them, based on the use of the equipment, whether by the hour or by the number of copies. The business creativity and the financial sophistication make possible these structures.

¹⁹ It is called "utility" by the assimilation to the services of public utility or "utilities", such as the supply of water or of energy. They are a modality of "pay-per-use", and it is an assimilation to what occurs when water is consumed only when the faucet is opened and closed. Well, in the case of the "utility computing", the collection of rents is produced based on the number of hours during which a computer or a data processing system is used.

²⁰ In "managed services" or "bundled services" the supplier involves within the obligations of payment of the end user, not only the rent that pay the right to the possession and use of the equipment, but also the value of the services that the supplier provides post sale. These structures are very complex because they involve many legal and accounting aspects that are not easy to resolve in all the countries

²¹ We have been especially cautious to translate the term "Supply Agreement". The reason for this caution is that not always does a lessor acquire the asset by virtue of a contract of sale. Many other contractual modalities exist that produce the acquisition of the control by the lessor. In the authorized non-official translation by UNIDROIT of the Ottawa Convention, the term is translated like "contract of supply". This translation is unfortunate since it confuses a familiar term in the majority of the Spanish speaking countries where the contract of supply refers to a contract of successive and repeated execution by means of which a supplier supplies in continuous form goods and services to a buyer. The contract of acquisition is, nevertheless, a contract of instantaneous execution and of extension very limited in the time. What the writers of the Ottawa Convention wanted to say by defining the "supply agreement", was that it was the contract by virtue of which the lessor acquires the property of the goods, and we wanted to leave it open to the different species of contract. Nothing is opposed to the fact that the same contract of supply be an acquisition contract species, but they are not the same thing.

²² This is very common in leasing transactions of technology equipment under the form of "like for like Exchange", by virtue of which the lessor receives from lessee used equipment and they are substituted with new equipment, exchanging with supplier the old ones the new ones.

Today's leasing practice tends to focus increasing attention on these contracts due to the mounting requirements imposed by international accounting standards on the realization and recognition of sales revenues (Revenue Recognition).

Article 3 Other laws

A leasing agreement subject to this Law is also subject to any law of [this State] applicable to real property or public notice with respect to a leasing agreement or an asset subject to a leasing agreement. Failure to comply with such law has only the effect specified therein.

This article refers, perhaps, to one of the most interesting aspects of regulating leasing in the future; it refers on one hand to Real Property Registration Law, and on the other hand to the public recording of leasing contracts or leased assets, which is poorly regulated.

All members of the Advisory Board concurred on the need and convenience for countries that adopt the Model Law on Leasing, to make it compatible with other statutes that require data to be recorded in public information systems about the identity of individuals or entities having real rights on certain assets subject to the possession of use by lessees. The most relevant consequence of such public notice or public recording system should be to make enforceable "*erga omnes*," i.e., against every body the existence of a lessor's real rights pertaining to the leased assets, and that such public knowledge should entail the fast and efficient enforceability of a lessor's remedies to protect its investments.

There are a couple of interesting subjects discussed in the Advisory Board meetings that are worthwhile to mention:

- On one side, some delegations expressed concern that certain public recording systems in countries where they are in operation have created bureaucratic obstacles and cumbersome tasks that add cost and rigidity to the process of closing leasing transactions, without adding any value. This happens in countries where the registration of leasing agreements is mandatory by Statute Law (Ecuador, for example, and to certain extent, Argentina), even though public records are handled using archaic technologies and not Internet resources. The "public" nature of such recordings is no more than a chimera. For this reason, it has been suggested that registration requirements be eliminated and replaced by public information systems that can be implemented without needless

bureaucracy, accessible to the public, and operated by reliable private companies, and

- On the other side, UNCITRAL expressed its concern that the provisions of the Model Law would become redundant and eventually contradictory to the works that UNCITRAL is conducting in the context of its Draft Legislative Guide for Secured Transactions²³, currently in progress. For this very reason, the draft Model Law leaves open to each country the chance to adopt its own rules applicable to registration or public information systems for secured transactions. There are also other recent initiatives to consider. On one hand, the UNIDROIT Cape Town Convention 2001²⁴ has already set forth a universal public information system about leasing agreements and secured transactions on aircraft. It is currently pending the implementation of a similar system for rail equipment and for satellite equipment, all selected as high cost equipment items that justify investments in universal public information systems. On the other hand, with the extremely efficient guidance of the National Law Center for Inter-American Free Trade Law, associated with the University of Arizona in Tucson, the Organization of American States adopted a Model Law on Secured Transactions, which, unfortunately for Latin American capital markets, has not yet been adopted by any Latin American country. The OAS Model Law is about the creation of an information and legal security system that may enable, in an open market, all parties concerned or interested in leasing transactions (or in the good standing of their obligors) to have free, easy access to information about the legal status of certain goods. An obvious consequence of the above is that it should be easy to assign or negotiate rights or assets over such goods, and that the lessors' and other creditors' rights may be exercised in order to quickly recover their investments. It is important to note that such tendencies focus on the registration of assets and not on the registration of the leasing agreements. Agreements may be kept confidential and private, while only assets subject to such real rights should be reported.

It is interesting to observe that, since Article 9 of the Uniform Commercial Code of the United States became enforceable in 1978, credit systems in the United States have become more open and democratic. The role that Article 9 plays today in the United States is that of a “capital mobilizer,” following the line of thought of the well-known economist Hernando de Soto. He said the ability to mobilize live capital determines whether a country and its economy can develop.²⁵

²³ For further information about this UNCITRAL project, it is suggested to visit www.uncitral.org

²⁴ Further information about the Cape Town Convention can be found in <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm> Last visit August 12, 2006.

²⁵ An interesting detail and historical foundation of this assertion can be found in Hernando de Soto's book, “The Mystery of Capital: Why Capitalism triumphs in the West and fails everywhere else”, Basic Books, 2000. For those who love virtual videos, I highly recommend to take two hours of your time and sit down in front of your computer screen to listen to the interesting conference of Mr. De Soto at the World Bank a couple of years ago, accessible through the Internet at

So, the reference made by the Model Law on Leasing to laws regulating recording of real rights is not a casual reference. It is a strong suggestion to all legislators to adopt a legal system that extends beyond that of a public information system of leased assets, providing the economy with efficient information systems to mobilize capital..

Article 4 Interpretation of this Law

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

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

The rules of interpretation of the Model Law must obviously be the same general interpretation rules of any legal text. But, in addition, and as a general principle, it is the intention of the drafters that the Model Law be inserted into a universal regulatory framework that enables leasing to be regulated in the same manner throughout the world. This forces all who interpret the law to look into Comparative Law in order to understand the purpose of their regulations and to examine the better practices applied in other countries.

Having said this, it is critical to highlight the following: while the United States leasing industry is currently the most developed, that does not mean the country's leasing regulations are the best in all fields. Leasing regulation in the United States needs to evolve in a more progressive way. Notwithstanding this remark, however, most of the best practices in leasing can be found in the United States regulatory model.

Article 5 Freedom of contract

Except as provided in Articles 7(1), 16(1)(a), 16(2) and 22(3) and the law of [this State], the lessor and the lessee may derogate from or vary the

effect of this Law and are free to determine the content of a leasing agreement.

This article acknowledges that leasing has been developed as a result of private will initiative and autonomy, requiring freedom of contract. Leasing would not exist without the imagination of pioneers in the business who freely agreed upon contractual provisions that did not match a pre-stated statutory legal definition. And for that reason, the engine of leasing continues to be private will initiative and autonomy, which requires legislators to recognize the full legal effects of stipulations freely agreed upon by and between the parties.

However, the Model Law considers the following exceptions inspired in Public Social Interest (*Jus cogens*), which neither may be amended nor ignored by the parties to a contract:

- The direct remedy that the lessee must have against the supplier in order to enforce the supplier's obligations, as assets transferor. This is a great advance of the Law because it makes it unnecessary for a lessee to enforce a remedy against the lessor, forcing the lessor to turn to the supplier to satisfy the lessee's claims, as currently happens in several countries (Article 7(1));
- The quiet possession guarantee that the lessor must give to the lessee, which means the lessee's possession of leased assets should not be disturbed by a third party having or claiming to have a better title or right to such assets, provided that such claim shall emerge from the malicious or negligent act or omission by the lessor (Article 16(1)(a));
- The same guarantee of quiet possession above mentioned, but referred to in operating leases (Article 16(2));
- The enforceability of the liquidated damages clause up to the limit of the proportionate value of direct damages caused by default under the leasing agreement (Article 22).

All other terms and conditions of any leasing transaction are left to the sole discretion of the parties.

Chapter II: Effect of leasing agreement

Article 6 Enforceability

Except as otherwise provided in this Law, a leasing agreement is effective and enforceable according to its terms between the parties,

against purchasers of the asset and against creditors of the parties, including an insolvency administrator.

There are two relevant aspects of this provision:

- In first term, leasing agreements acknowledge their enforceability among parties, so that whoever is a creditor under an obligation arising out of a leasing agreement can just enforce its performance, without needing to litigate the scope of its terms and whether or not such obligation exists. Two relevant consequences emerge from this, namely:
 - It is not necessary to strengthen the documentary evidence of the parties' obligations with other documents such as promissory notes, because the leasing agreement, per se, created the same legal effect of any promissory notes. Perhaps what is missing in certain jurisdictions is to add the presumption of authenticity that signatures in promissory notes have by Statute Law. Should such presumption be added, leasing agreements would become more efficient in these jurisdictions;
 - It is neither necessary nor applicable for the parties to seek arbitration, since all obligations emerging from leasing agreements are enforceable without further debate other than about whether or not the concerned party defaulted or complied thereto.
- In second term, the rights of the parties under a leasing agreement are enforceable to third parties.
 - Perhaps, in order to make this provision effective and ethically grounded, countries adopting the Model Law on Leasing should put in motion a public information system of leased assets. This would provide equity in the event of an eventual allegation of good faith without neglect of any third party purchasers or creditors of lessees, who could refer to the information system if by mistake they assumed that the leased asset belonged to the lessee, and not, to the lessor. In other words, this provision should be complete insofar as taken in conjunction with such other laws imposing registration or public notice of leased assets.
 - One of the most relevant applications of this enforceability has to do with a lessee's insolvency. In such events, most countries have already evolved in applying insolvency law to leasing transactions, so that in the event that any insolvency proceedings, either for restructuring purposes, "*concordata*", "*concurso preventivo*", "*reglement des créanciers*" or reorganization (Chapter 11 of the United States Bankruptcy Law or similar) or that bankruptcy or liquidation of lessee should be declared (Chapter 7 of the United States Bankruptcy Law or similar), the following is the status of lessors:
 - All rentals that became due before the petition, shall belong to the insolvency estate;

- Effective since the petition date, or when the automatic stay is declared, all rentals that become due post-petition shall be payable as operating expenses of the insolvent lessee, with preference and priority vis-à-vis any other obligations, in the same manner as such business should pay all other ordinary operating expenses;
- The lessor keeps its right to repossess the leased assets at any time, in the event that the business under insolvency proceedings defaults in paying rentals during the proceedings.

Article 7 Lessee under financial lease as beneficiary of supply agreement

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

(b) The extension of the supplier's duties to the lessee under the preceding sub-paragraph does not modify the rights and duties of the parties to the supply agreement, whether arising there from or otherwise, or impose any duty or liability under the supply agreement on the lessee.

(c) Where the absence of privity of contract between the lessee and supplier prevents the lessee from enforcing the supplier's duties under the supply agreement, the lessor shall be bound to take commercially reasonable steps to assist the lessee. If the lessor does not take such steps, the lessor is deemed to have assumed such duties.

(d) The parties may not derogate from or vary the effect of the provisions of this paragraph.

2. The lessee's rights under this Article shall not be affected by a variation of any term of the supply agreement previously approved by the lessee unless the lessee consented to that variation. If the lessee did not consent to such variation, then the lessor is deemed to have assumed

the duties of the supplier to the lessor that were so varied to the extent of the variation.

3. Nothing in this Article shall entitle the lessee to modify, terminate or rescind the supply agreement without the consent of the lessor.

This article contains one of the cornerstone principles that justifies the existence of a special law for leasing in countries that adopt it. Without this law, the leasing transaction would typically be dissected into several types of regulated contract forms which, when merged into a single transaction, could lead -- and probably has led, in fact - - to confusion among courts and stakeholders.

In the old doctrine, i.e., prior to an ad-hoc leasing law²⁶, some boundaries were described as following different sequences throughout the leasing transaction, so that: (i) in a first phase (the proxy phase) the lessee should commission the lessor to purchase the assets, by implying that the lessor should subsequently enter into the supply agreement for the sake of the interest of the lessee; (ii) in the second phase, the lessor would enter into the supply agreement with the supplier, acting in its own name, pursuing its own economic goals and interests, but for the benefit of the lessee in order to comply with the proxy granted by such lessee to lessor, and (iii) the third phase would complete the transaction, would be the very same agreement whereby the lessor should grant to the lessee the right to possession and use of the leased asset, in return for the payment of rentals and the lessee's commitment to assume obligations related thereto.

In the old doctrine, such structure, based upon the Procedural Law concept called "*legitimatío ad causam*"²⁷, made it mandatory to file a sequence of claims and lawsuits from the lessee against the lessor and then from the lessor against the supplier.

The Ottawa Convention advanced the concept to the point of creating a direct legal link between lessee and supplier, but this article of the Model Law on Leasing reinforces the principle.

Insofar as the Model Law creates a direct link between someone who is not a party to the supply agreement, but is the party having an interest in such supply agreement, the drafters of the Model Law acknowledged that in certain jurisdictions the case may be made that Public Interest Law could impair or make ineffective such remedies for lack of privity (in the French version "*faute de lien contractuel*"). In such

²⁶ As an example, we can quote the old publication of professor Carlos Vidal Blanco called el "Leasing: Una innovación en la técnica de la financiación" (Tesis doctoral Universidad Complutense de Madrid, 1977)

²⁷ This term is addressed to define who are the appropriate persons or legal entities to demand to the courts to adopt certain decisions or orders. If such persons or legal entities lack legal interest and effective legal link to the matter sub-judice, then they rarely would be allowed to demand the intervention of the courts, for a breach of an agreement whereby they are not a party thereto.

an event, equity claims that whoever actually has “legitimatío ad causam”, i.e., the lessor, should undertake all commercially reasonable actions to allow the lessee to enforce its rights. If the lessor fails to cooperate with the lessee, then the lessor should be held subject to the law, which imposes its liability for damages suffered by the lessee because of lack of cooperation.

The article also regulates all amendments and changes to the supply agreement, requiring the lessee’s consent, in addition to the lessor’s and supplier’s.

Article 8 Priority of liens

1. A creditor of the lessee and the holder of any interest in land or personal property to which the asset becomes affixed take subject to the leasing agreement and cannot attach any interest belonging to the lessee.

2. Except as otherwise provided by the law of [this State], a creditor of the lessor takes subject to the leasing agreement.

This article offers the first significant improvement to United States Law. Under the legal system currently in force throughout most of the United States of America, whenever financing is granted on personal property that may become a fixture to the land (such as industrial equipment affixed or nailed in the land or any other equipment embedded in the walls), the landlord waiver is required for the creditor, and in particular for the lessor being able to exercise its rights and remedies on the secured personal property.

The Model Law also clarifies that, irrespective of whether or not the leased assets are attached to the land, or are dedicated to the service of the land (such as the case of a farm tractor in an agricultural business), the lessor’s rights regarding such assets must prevail over any right of the landlord or his/hers/its creditors.

This provision, besides not contradicting, clarifies all regulations currently in force in civil codes that state personal property belonging to a person other than the landlords must not be considered as a fixture to the land, even though they are physically attached thereto or dedicated to the use, cultivation or benefit of such land. The novelty here is that this principle becomes binding as well to all creditors of the landlord.

The second paragraph of Article 8 is an outstanding principle that will eliminate the doubts and worries of those who deal in secondary markets of leasing agreements,

either through syndication, securitization, participation or pledge of leasing agreements, which are all financial resources for lessors. Lessees are increasingly concerned that, whenever such assignments take place, or even whenever a lien is placed on the lessor's assets, it could jeopardize their right to a quiet possession. This concern shall be removed as soon as the Model Law becomes the law of the state, since the Model Law clarifies that the scope of the rights of a lessor's creditors may not go beyond the scope of the rights of such lessor under the leasing agreement. For example, if a lessor granted a purchase option to a lessee, the lessee must have the right to exercise the option vis-à-vis the assignee or any third party who takes the legal position that the lessor used to have in connection with the leased asset. In addition, the new title holder, either assignee or otherwise, is also bound to the quiet possession obligation that was the lessor's under the leasing agreement, in the same terms and conditions set forth there under.

Article 9 Liability for death, personal injury or property damage caused to third parties

In a financial lease, the lessor shall not, in its capacity of lessor, be liable to the lessee or third parties for death, personal injury or damage to property caused by the asset or the use of the asset.

This article confirms a principle that contractual customary law has imposed worldwide, in spite of the existence of laws and regulations in certain countries²⁸ and jurisdictions²⁹ which set forth "strict liability", a.k.a. "objective civil liability" or "vicarious liability," holding the owner of the assets liable for any damage caused by the asset or by use of the asset.

²⁸ Prior to the enactment of the Argentine Leasing Law, Law 25.248 , May 10, 2000, lessor was subject to the provisions of article 1.113 of the Argentine Civil Code which states: "Art.1113.- The obligation of any such person who has caused harm shall be extended to all damage caused by any of such who are under such person dependency, or by the goods that such person uses or keeps under his/her/its own care. (...) (Paragraph added by Law 17.711) In the event of damages caused by property, the owner or custodian shall prove total absence of negligence in order to be released from such liability, provided however, that if such damages were caused by a risk or defect of such property, such person may not be released of any liability unless it proves that the damage was caused due to the victim's or an independent, unrelated third party's entire fault.(...) Should such property been used against the explicit or implicit consent of such owner or custodian, then this one should not be held liable". The first Argentine Law that regulated leasing in Argentina, Law 24.448 ,1996, limited lessor's liability to the maximum value of the asset (Article 33), but it was only since the enactment of Law 25.248 where it was clearly stated that lessor may nor be held liable for any damages caused by the leased asset (Article 14).

²⁹ In certain States of the United Status of America, such as Massachussets, Michigan, New York, and others, vicarious liability is imponed to car owners, regardless of who possess or operate them. For such reason, in such States, most of the companies that used to lease vehicles, now they do not lease them, but provide financing using other legal structures.

To adopt this principle, most of the laws and regulations that can be found today in civil codes or in environmental protection statute law, or similar provisions, should be amended by this Model Law.

The said contractual customary law had evolved to the point where the parties agreed upon the lessee assuming in full the civil liability or damages obligation risk, on the grounds that it is the lessee who actually uses and operates the leased asset. However, this provision never changed the statute law, which provides that affected third parties should address their claims to the lessee instead of to the lessor. This article makes very clear that lessors may not be subject to claims or lawsuits by third parties as the result of damage caused by the operation of an asset.

Indeed, there is a further development: an asset may cause damage despite the fact that the lessee may not be operating it. This may happen in the event of spontaneous explosion, or emission of radiation by certain items of equipment, regardless of the lessee's actual involvement. Absent of any contractual provision transferring this risk to the lessee, the ultimate liability rested on the lessor.

Now, it is clear that Article 9 of the Model Law defines that it is the lessee who should be held liable for damages caused by the assets, regardless of any actual intervention by the lessee.

CHAPTER III: PERFORMANCE

Article 10 Irrevocability

1. (a) In a financial lease, the lessee's duties to the lessor become irrevocable and independent when the leasing agreement has been entered into.

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

2. A duty that is irrevocable and independent must be performed, regardless of any other party's performance or non-performance, unless

the party to whom the duty is owed terminates the leasing agreement or otherwise explicitly agrees.

This is one of the most important and radical provisions that will foster the development of leasing. Somehow it brings an exception to the long ago Civil Law institution of the defense called “*exceptio non adimpleti contractus*,” which is based upon the principle that a party shall not be deemed to default if the other party has already breached its duties toward the first party.

Prima facie, it may seem unfair to deprive lessees of the privilege to invoke the defense “*exceptio non adimpleti contractus*,” or defense of agreement not performed. However, the parties acknowledge at the inception of the deal that the contractual position of lessor is that of an investor in the asset, and that the lessor should be entitled to recover its investment through the flow of rentals, which should not be disturbed or interrupted by the lessee’s allegations about supposed breach of lessor’s obligations. Furthermore, this article of the Model Law is grounded in legal security, since in the event that rental streams are assigned to third parties, the stream of rentals must not affect third parties assignees on the grounds of a supposed breach of lessor’s obligations.

This does not imply that lessees do not have remedies or legal actions to enforce when necessary. It is important to remember that the main obligation, if not the unique one of lessors, (once equipment has been acquired and received by lessees) is to guarantee the quiet possession and use of the assets by lessees. The breach of said obligation by a lessor shall give rise to what the equity really demands, which is to compensate the damages suffered by lessees and caused by lessors. To stop the payment of rents does not generate any compensation in favor of lessees but it rather may cause damages to third parties acting in good faith. The compensation of damages, caused by lessor’s default, should leave lessees fully unharmed.

It must be highlighted that this principle will remain implicit in every financial leasing agreement and that it is suggested to explicitly insert it in every operating leasing agreement. The logic of this provision is also based in the need and importance of providing a secondary market to leasing documents.

Article 11 Risk of loss

- 1. In a financial lease, risk of loss passes to the lessee. If the time of passage is not stated, the risk of loss passes to the lessee when the leasing agreement has been entered into.**
- 2. In a lease other than a financial lease, risk of loss is retained by the lessor and does not pass to the lessee.**
- 3. When an asset is not delivered, is partially delivered, is delivered late or fails to conform to the leasing agreement and the lessee invokes its**

remedies under Article 14, then the lessee, subject to Article 18(1), may treat the risk of loss as having remained with the lessor or, in a financial lease, the supplier from the beginning.

This article is related to a very important business issue present in every leasing transaction. In essence, the leasing transaction is based on an asymmetric distribution of risks among the different parties of the operation, and this distribution is justified by the goals of the business and the motivation of the parties. The main principle is that if the lessee is the one who starts the sequence of contracts in order to obtain use of a capital good, or asset, then what the equity indicates is that the risks of loss of equipment due to situations of *force majeure*, or to the acts of third parties, shall be assumed integrally by the lessee. The contractual practice had been consistent but little understood in the legal scenario and sometimes in the judicial scenario. The fact that the Model Law mentions this principle is a great legislative advance because it allocates the corresponding burdens and benefits.

For operating leases, if the parties do not agree otherwise, the Model Law states that the lessor shall assume the risks of loss of the goods, which is generally consistent with the assumption of residual value risks. Nevertheless, the law leaves the door open to allow parties to agree otherwise, thus a lessee could agree to assume the risks of loss of the assets in events of force majeure or acts of third parties.

There is a sanction established in the third paragraph, consisting in penalizing the lack of delivery of the asset to the lessee or the non conforming delivery. This penalty is inspired in equity, and makes liable for the risk of loss to the person responsible for such lack of delivery of the asset to the lessee or such non conforming delivery.

Article 12 Damage to the asset

1. In a financial lease, when an asset subject to a leasing agreement is damaged without fault of the lessee or lessor before the asset is delivered to the lessee, the lessee may demand inspection and at the lessee's option either accept the asset with due compensation from the supplier for the loss in value but without further right against the supplier or, subject to Article 10, seek such other remedies as are provided by law.

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

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

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

This article creates a new concept never regulated before, currently negotiated between the parties. It reinforces the importance of the delivery of the assets by the supplier. The supplier is assuming risks of damages to the leased assets during their transportation or transit, and the lessee has the right to reduce its economic obligations in case there is no better solution than accepting and operating the deteriorated assets.

It is clear, on the other hand, that the supplier's obligation can be transferred to an insurance company, but is still the supplier's responsibility if a portion of the risk is not covered by the insurance company.

For operating leases, even when it is not said explicitly, the same principle applies. If as a consequence of the application of the norm, the lessor is deprived of the expected rents, equity demands that the lessor shall recover the loss from the supplier. This is an issue that users of operating leases should be aware of, because the law itself does not protect them.

Article 13 Acceptance

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

2. (a) Once a lessee in a financial lease has accepted an asset, the lessee is entitled to damages from the supplier if the asset does not conform to the supply agreement.

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

This article brings some innovation with respect to previous regulations and particularly those contained in the Ottawa Convention. The first innovation is that it renders the acceptance action as being the triggering event of the lessee's obligations.

The law accepts the possibility of explicit acceptance (which is usually the case when the document called "D&A" or "Delivery and Acceptance" or "minutes of delivery and acceptance" is executed). And this implicit acceptance can consist of either of two facts: a negative one or a positive one. The negative fact is represented by the passage of time to reasonably perform a diligent inspection of the assets, without any claims on the part of the lessee against the conformity of the assets. The positive fact corresponds to the effective use of the assets, which leads to the presumption that such assets correspond to their specifications.

The second innovation should be studied simultaneously with an analysis of Article 14, since these two provisions substitute and amend similar provisions of the Ottawa Convention, which were influenced by the tendencies of the 1980 Vienna Convention on International Sales Agreements. We will refer to this subject later on.

Article 14 Rejection

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

2. (a) In a lease other than a financial lease, when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the leasing agreement, the lessee has the right to accept the asset, to reject the asset or, subject to this paragraph and Article 23, to terminate

the leasing agreement. Rejection or termination must be within a reasonable time after the nonconforming delivery.

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

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

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

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

3. If the lessee rejects an asset in accordance with this Article and the time for performance has not expired, the lessor or supplier has the right to remedy its failure within the agreed time.

As mentioned above, this article is also related to the rights of acceptance and refusal of the lease asset on the part of the lessee. The main principle, influenced by the European delegation, is that the lessee should be protected against any defect or non conformity with respect to the asset, whatever the source of such defect or non conformity.

The most notable advance is that the lessor remains released with respect to any contingency in financial leases, while this responsibility is placed on the supplier's shoulders. This is in line with the terms of the Vienna Convention of 1980 on International Sales Agreements; with respect to domestic law, it is in line with the presumed minimum guarantees and other consumer protections contained in the Consumers Defense Code, that Case Law has extended in its application to leasing transactions, in particular when the lessee is a small or medium business. In certain form, this corresponds to what it is called "Lemon Law" that protects buyers of vehicles in the United States.

In other words, the right to reject non conforming assets is a sacred right of any lessee, and whoever is responsible shall assume the consequences. In the case of a

financial lease, the Model Law clarifies that it is the supplier who shall assume those consequences.

By contrast, in an operating lease, this issue often involves a more complex set of circumstances and invites the parties to regulate this situation expressly within their agreements. The Model Law offers defenses (rights) to lessee against lessor, and permits the lessee to exercise the right to withhold rentals in case of non conformities, and also to recover any amounts paid in advance pursuant to the terms of the lease. All of this should take place provided that the parties have not waived those rights by means of contractual agreements. In addition, in operating leasing agreements it is convenient that the parties insert a definition in their agreements about what is understood as “conformity” and to define and specify which events should constitute non-conformity.

Article 15 Transfer

- 1. The lessor’s rights under the leasing agreement may be transferred without the consent of the lessee. The lessor’s duties under the leasing agreement may be transferred without the consent of the lessee except when a transfer would impair the lessee’s rights in the asset.**
- 2. The lessee’s rights and duties under the leasing agreement may be transferred only with the consent of the lessor, which may not be unreasonably withheld, and subject to the rights of third parties.**
- 3. The lessee, lessor and third parties may consent to such transfers in advance.**

The subject matter of transfer and assignment of rights is critical for the development of a healthy leasing industry. The development of leasing industries will depend in the future of an efficient legal framework that shall encourage and promote the use of mechanisms available in the capital markets. Some widely used funding structures such as syndication and securitization of leasing agreements and/or lease receivables find their grounds in provisions that make possible the transfer of rights arising out of leasing contracts.

On the other hand, the ability of lessors to offer leasing services that could satisfy other operational needs of lessees associated with equipment and capital goods, beyond just financial needs, will depend on the possibility that the lessor may assign its obligations to third parties. This takes place in cases in which the lessor’s offerings are full service leases, lease with maintenance and/or other services and may subcontract such services with third parties.

Why can the lessor assign rights and obligations to third parties, without requiring the consent of the lessee, while the lessee is required to obtain consent from the lessor to assign its rights and obligations? For the lessor, entering into a leasing agreement is an

“*intuitu personae*” decision, i.e., it is based on who the lessee is. It is a credit decision in financial leasing agreements and most operating leases as well, the result of a process of evaluation and deliberation by the lessor that takes in consideration the personal attributes and background of the lessee, and an assessment of whether or not the lessee is willing and able to pay the rentals and all other amounts due under the lease.

In practical terms, it does not matter who has disbursed the funds to acquire the assets, but is important to know who will operate the asset, and who will have the obligation to pay rents in return for its use.

The final paragraph contemplates what is called a "blanket authorization", i.e., an authorization generally contained in the body of the contract that will not require case-by-case consent of assignment. The Model Law assigns full force to such “prima facie” authorization contained in the leasing agreement in order to facilitate trade and businesses.

Article 16 Warranty of quiet possession

1. (a) In a financial lease, 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 derives from a negligent or intentional act or omission of the lessor. The parties may not derogate from or vary the effect of the provisions of this sub-paragraph.

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

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

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

Just as mentioned above, the obligation to guarantee the quiet possession of the assets leased by the lessee is the lessor’s obligation by excellence, and in most cases, the only obligation of the lessor that lasts during the whole term of the leasing agreement.

This obligation means that the lessor shall not permit that (i) a third party attaches the leased assets, depriving the lessee of the possession and use of the same assets, or (ii) that a third party claims the assets based on a right of property that should prevail over the rights that the lessor holds on the asset, or (iii) that competent authorities confiscate or seize the leased assets.

To materialize any lessor's breach of the contract, this article requires the following:

- That whoever deprives the lessee of the possession of the leased asset must have better rights than that of the lessor, or shall claim having better rights than the lessor, but in the latter case, such claim must be validated by a court or tribunal, and
- That the existence of better rights or claim of better rights shall result from any lessor's negligent or intentional actions or omissions.

In essence it assigns to the lessee the burden of proof in order to claim that the lessor has breached the contract; such burden of proof requires producing evidence about the existence of the above mentioned facts, actions or omissions. It must be noted, however, that under the general rules of civil law, with regard to the second issue, unless the lessee has proof of the lessor's malice, it should be enough for the lessee just to state the negligence of the lessor because it is the burden of the lessor to prove that he/she/it acted diligently.

Clearly the practical effect of the breach of this obligation is that the lessor shall compensate the lessee for damages suffered. Therefore, it is in this situation where the economic solvency of the lessor is most relevant, because in the case of an insolvent lessor, compensation of damages would be a theoretical illusion without any practical effect.

To this point, the requirements of suitability and access to the market that shall be applicable to lessors are inter-related with the obligations that the Model Law places on their shoulders. Clearly the lessee is encouraged to select the lessor among a universe of solvent companies, that is, the lessee should carry out its due diligence to research the potential and probability of insolvency of a given lessor before entering into the corresponding leasing agreement.

Besides the duplication of the rules for financial and operating leases, this article contains another rule that exonerates the lessor and allocates to the lessee the obligation to assume the consequences in connection with certain assets. This can happen when, for example, the specifications of the lessee breach the third party's patents, or when they breach any other type of third party's rights. In these cases, the lessee shall compensate not only the lessor, but also the supplier.

Article 17 Warranty of acceptability and fitness

1. In a financial lease, a warranty that the asset will be at least such as is accepted in the trade under the description in the leasing agreement and is fit for the ordinary purposes for which an asset of that description is used is implied in the supply agreement and is enforceable only against the supplier.

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

This article protects the lessee by ensuring that the leased asset complies with its technical and economic purpose. The presumption of implied warranty is part of most legislation that includes consumer protection laws. Therefore, financial leasing agreements that state the guarantee is offered by the supplier and not by the lessor mark an important step in simplifying and clarifying the applicable rules, any time a claim or complaint about the suitability or acceptability of the leased asset is filed or occurs.

In the case of operating leases, once again, important tasks are left subject to be regulated by the parties in furtherance of their freedom of contract, since the lessor in an operating lease shall specify if it regularly negotiates with the leased assets, or if the contract provides privity to the lessee as the beneficiary of the same implied warranties received from the supplier by contract or law.

Article 18 Lessee's duties to maintain and return the asset

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

(b) When a leasing agreement sets forth a duty to maintain the asset or the manufacturer or supplier of the asset issues technical instructions for the asset's use, the lessee's compliance with such agreement or instructions shall satisfy the requirements of the preceding subparagraph.

2. When the leasing agreement comes to an end or is terminated, the lessee, unless exercising a right to buy the asset or to hold the asset on

lease for a further period, shall return the asset to the lessor in the condition specified in the preceding paragraph.

This article contains a principle that settles the difference between the leasing transaction and the civil or common rental agreement. In the leasing transaction, clearly the obligation of maintenance and conservation of the assets shall correspond to the lessee and not to the lessor, as the latter is normally the case in rental agreements. The reason for this is very clear; the person interested in providing the right maintenance to the leased asset should be the lessee itself. Besides, generally speaking, in real life, the lessee has more technical resources to provide maintenance to the asset than the lessor, which usually is a financial institutions or professional investor without technical infrastructure.

The Model Law reiterates the regulation included in the Ottawa Convention, namely, the principle of the "fair wear and tear," or of the maximum tolerable physical deterioration that results out of the normal use of the leased asset, in the event that the lessee decides not to acquire the asset, since a larger deterioration would endanger the recovery of the investment of the lessor.

It is important to point out that the Advisory Board was unanimous about the decision related to this subject matter.

CHAPTER IV: DEFAULT

Article 19 Definition of default

- 1. The parties may at any time agree in writing as to the events that constitute a default or otherwise give rise to the rights and remedies specified in this Chapter.**
- 2. In the absence of agreement, default for the purposes of this Law occurs when one party fails to perform a duty arising under the leasing agreement or this Law.**

Based on the general legal theory of obligations, default happens whenever there is a non-compliance or lack of voluntary fulfillment of the obligations caused by the debtor. The contractual practice has generated diverse categories of breaches, according to the nature of the obligation.

There are tolerable breaches, provided that they can be remedied in a timely manner and do not affect the continuation and harmonic execution of the contracts. But there are also intolerable breaches, which affect the development of the contracts and make difficult, if not impossible, their continuation.

This article refers to intolerable breaches. Parties are invited to define which breaches are intolerable and will result in the exercise of legal remedies by the affected party against the defaulting party.

Article 20 Notice

Except as otherwise provided in the leasing agreement, an aggrieved party shall give a defaulting party notice of default, notice of fundamental default, notice of enforcement, notice of termination and a reasonable opportunity to cure.

I have to confess that I was not very enthusiastic in giving support to this issue, but that I did not fight it, hoping that at the moment of its adoption by countries it would be adapted in a fairly efficient form.

The reason for my lack of enthusiasm is the experience I have had through the years in handling this type of legal request. For example, the Napoleonic Civil Code contained the same requirement, and required the legal figure of the notice or request to constitute in default the debtor that has breached the contract. This request had a lot of formalisms and the subsequent Statute Law and Case Law set it forth as a judicial requirement, so that if someone wanted to enforce his/her/its rights, he/she/it was forced to follow a double judicial road; the relative inefficiency of the process, excess work for the judges and tactical delays of the defense lawyers made these obligations burdensome to enforce.

The default in payment of monetary obligations (or "money obligations"), provided that such had precise due dates, remained exempted of the requirement of request to constitute in default. It should be understood that the following obligation whose default is obvious should not require notification or notice: the lessee that knows it has to pay in a specific date and does not pay. In this case formal notice should not be required in order for the creditor to exercise its rights and remedies, since the sole ellapse of the date when the rent should have been payable is enough to constitute it in default if the lessee fails to pay.

Nevertheless, before the lessor exercises its actions to enforce the contract, the lessor should send direct notice to the defaulted lessee, without judicial intervention, since in the present world the evidence of the notice can remain expressed in clear and unmistakable form (records of the courier companies, such as UPS, DHL or Federal Express, permit us to track the written messages, and sometimes view the receiver's signature in a digital image format. This gives the endorsement of equity that provides the defaulted party the opportunity to remedy the default before repossessing the leased asset or before initiating remedies of enforcement that may generate damages to the lessee.

Having said this in connection with the default of a contract, and related notices, the author recommends properly regulating such defaults in agreements to avoid misunderstandings and the abusive misapplication of the Model Law.

Article 21 Damages

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

Although this is not an original point created by the Model Law, it is its clearest and one of its more progressive ones. The same principle was expressed in the Ottawa Convention. In general, it has been difficult for doctrine and universal jurisprudence to apply objective parameters for the compensation of damages caused by breach of contract. It has seemed simpler to evaluate damages caused by extra-contractual civil liability than by the contractual one.

This provision has the following practical benefits:

- It makes clear that in cases of default of obligations under leasing agreements, "punitive damages" or "exemplary damages" that often are applied in Anglo-Saxon countries do not apply. Such punitive damages are the result of court decisions or judicial orders that calculate damages on an emotional rather than rational basis in order to penalize anti-social conduct. Without this rule within the Model Law, it would still be necessary to negotiate the clauses waiving the above-mentioned punitive damages and the judgments by jury³⁰. With this definition, while the Model Law is adopted in the respective countries, it is no longer necessary to negotiate such waivers;

- In addition, it remains clear that the so called consequential or incidental damages or indirect damages are not included within the amount of the compensation;

- Due to the above, the work of the expert that evaluates the damages caused by the breach of the contract should be centered on quantifying the financial and economic situation of the affected party after the default versus the situation that the would have occurred if the contract had been fully complied. As an example, the appraisal of damages should keep in mind the expected profits for the lessor over the rentals payments in default plus the rentals cash inflows, the product of their reinvestment in similar deals, and the expenses which the aggrieved party incurred to enforce its rights (lawyer's fees, expenses, judicial fees, etc.). Just as the article in comment sets forth, within the evaluation of such damages it shall also be considered if the affected party exercises other legal resources, such as if the lessor exercises its right to repossess the assets and sell

³⁰ In Anglo-Saxon tradition, punitive damages are determined by a jury.

them. In this latter event the sums coming from the sale mentioned should be considered as part of the payment of the damages that the defaulting party should pay, either by way of mitigation, whenever the lessor has succeeded in repossessing, or by way of additional losses, should the lessor not being able to repossess.

Article 22 Liquidated damages

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

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

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

The present article represents good news and bad news for contractual freedom. The good news is that the parties can save the costs of experts and appraise in advance the damages that can be caused for the breach of the contract by one of the parties. And by means of the stipulation regarding total damages, or conventional estimation of damages, the parties can define the amount of money that should be paid in the event of a default or breach.

The bad news is that the contractual freedom has limits, and these limits are given by the principle of "gross disparity"³¹ or abuse of contractual dominant position. In the

³¹ The concept of "gross disparity" is inserted in number 3.10 UNIDROIT Principles of International Commercial Contracts. In its original version it states: ARTICLE 3.10 - (Gross disparity)

Article 3.10 - ()
660

(1) A party may avoid the contract or an individual term of it if, at the time of the conclusion of the contract, the contract or term unjustifiably gave the other party an excessive advantage. Regard is to be had, among other factors, to
661

(a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent needs, or of its improvidence, ignorance, inexperience or lack of bargaining skill, and
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(b) the nature and purpose of the contract.
663

(2) Upon the request of the party entitled to avoidance, a court may adapt the contract or term in order to make it accord with reasonable commercial standards of fair dealing.
664

(3) A court may also adapt the contract or term upon the request of the party receiving notice of avoidance, provided that that party informs the other party of its request promptly after receiving such notice and before the other party has acted in reliance on it. The provisions of Article 3.13(2) apply accordingly".

old civil law, the stipulated damages clause is subject to a maximum equivalent to the double of the principal obligation due³². This does not mean that “double” is the actual measure of the excess, but it conditions the rationale of those that have been educated under the Napoleonic Code.

Article 21 of the Model Law, in comment, allows the parties (first) and arbitrators or judges (second) to define if a stipulated damages clause is "too excessive." There is a degree of tolerance to any excess. What the Law proposes is that when the stipulated damages clause is too excessive, it can be reduced to a fair value, the thresholds of which “fair value” are set forth by Article 20 thereof.

The UNIDROIT Principles of International Commercial Contracts submits to the concept of reasonable commercial standards as the required reference framework for a fair negotiation (“*reasonable commercial standards of fair dealing*”).

Article 23 Termination

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

(b) The lessee in a financial lease may not terminate the leasing agreement upon another party’s fundamental default but is entitled to such other remedies as are provided by the agreement of the parties and by law.

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

Regarding this article, it is important to review history to understand its meaning. The principle at the essence of financial leasing agreements is that their terms are irrevocable. Therefore, sub-paragraph (b) was added, which is concordant with Article 10 of the Law.

However, the Board was aware of the existence of circumstances that should lead to the anticipated termination of the contract, and they are:

- Public Interest Laws with higher hierarchical enforcement enacted by the country or state that adopted the Model Law;

³² This can be found in Civil Codes such as the Mexican, Chilean and Colombian, inter alia.

- The loss of the leased asset, as foreseen under Article 12 of the Model Law, and that of course operates above all due to a lack of matter;
- The unilateral statement of the party affected by the breach of the contract, who can be either the lessor (in all cases) or lessee (only in the cases of operating leases).

It is very important to examine the effects of termination and to clarify concepts to avoid confusion: at the end of a leasing agreement, all executory obligations are extinguished, i.e., with respect to the lessor, its obligations to guarantee a quiet possession are extinguished, while for the lessee the obligations to pay future rentals should be extinguished as well³³. But it will trigger the due date of obligations that shall be due upon termination. For example, the agreement can state that an amount equivalent to the outstanding balance or to the summation of future rents will become due as a penalty amount for any non-compliance, and that this amount would be owed along with the corresponding stipulated damages clause. But it should be very clear that these are two different obligations even though their amounts may be the same.

In addition, the defaulting party must pay all the sums that already had become due and remain still unpaid, upon termination of the lease.

Article 24 Possession and disposition

- 1. After the leasing agreement comes to an end or is terminated, the lessor has the right to recover possession of the asset.**
- 2. After the leasing agreement comes to an end or is terminated, the lessor has the right to dispose of the asset.**

Article 24, the last one, perhaps is one of the most interesting rules in the Model Law, susceptible to controversy and in need of continuous improvement.

The first principle is that, in support of the property rights or title that the lessor holds, the Model Law allows the lessor to recover possession of the goods as a result of natural termination, or for accidental termination, which is caused by virtue of the law or as a consequence of any default.

What was not included within the final text was a paragraph that the draft of the Model Law had: "[The lessor may proceed without judicial process if it can be done without breach of the peace]".

Everyone understands the reason why this paragraph was not included in the Model Law: it could be considered as a "heresy" by archaic law, by those who promote the dogma of the due process without understanding where it applies, and that is

³³ Under Mexican Law, rentals under operating leases may be agreed upon as due at the inception of the deal, though lessor may grant lessee the right to pay such rental by installments.

appreciated even in the recent jurisprudence of constitutional courts. This is regretful because it condemns countries to remain in the past.

Lets now examine the principle of "self help," which is considered by some people as "justice by own hand," and for others as a legitimate form of autonomous management by private parties desiring to resolve conflicts.

It must be noted that individuals resorting to the state to solve their conflicts usually do so only when resolving conflicts among themselves peacefully is a practical impossibility. From there, some purists, statesmen and jurists argued that, without the state, there does not exist any possible conflict resolution among individuals, as if they do not have the capacity to solve disputes among themselves. Then, the constitutionalists extended to civil conflicts the guarantee of due process, which was established in criminal matters to defend individuals from excesses of the state.

But in other geographical regions, which by coincidence are the richest and most developed on the planet, the practice of finding private solutions to conflicts among individuals (or "self help") is well established and legal. Thus, for example, in the United States, Article 9-609 of the Uniform Commercial Code authorizes a creditor having a security interest duly filed (and therefore opposable "erga omnes", i.e., to everyone) to recover the possession without need of court order, as long as it does not break the peace. Jurisprudence has developed the concept of "breaking the peace"³⁴, but it has remained clear that the lessee who is deprived of the possession of a leased asset has legal remedies, and therefore it does not remain deprived of due process in such cases where the lessor had exercised abusive legal actions.

Clearly, if the law and constitutional interpretations continue the progressive path required for the future of new generations, the door must be opened for lessors to recover their investments efficiently, triggering greater investments in the leasing sector.

Now, the second paragraph of Article 24 offers another exit option for lessors: disposing or transferring the asset at the termination of the contract, even prior to repossession. This can open the door within countries where the principle of "self help" has not been adopted, to the possibility of negotiating assets while the final judgment of a repossession process is still pending, i.e., an interesting secondary market for distressed leasing portfolios.

Summary and Conclusions

The adoption of the Model Law by countries interested in increasing the formation of fixed capital in their economies should represent a very important advance. The Model Law contains a synthesis of the best practices of the leasing business in countries where the industry has developed.

³⁴ For instance, *Stone Machinery v. Kessler* (1 Wash. App. 750 (Wash. Ct. App. 1970)) and *Williams v. Ford Motor Credit Co.* (674 F.2d 717 (8th Cir. 1982))

Nevertheless, the interpretation and scope of the law should be supported by the concepts and history that have contributed to its current wording. That is the purpose of this white paper. In analyzing each of the articles of the Model Law, the author has contributed useful tools for understanding and applying the Model Law worldwide.

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