

The Legal Regulation of Leasing

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A leasing contract, as a new form of capital investment in the economy, first appeared in the middle of the nineteenth century in the United States and the middle of the twentieth century in Western Europe. A lease means the conveyance of property temporarily, for a specified term.

Leasing evolved as a consequence of the development of railroad transport. Upon a beneficiaries' request a financial company would purchase the means of transportation and other equipment from a manufacturer to transfer property on lease in the future. The first leasing companies were established in a type of partnership with US commercial banks. A similar process developed in Europe and Japan.

Today leasing agreements are applied in almost every country. Some countries have adopted special normative acts to regulate leasing relations (e.g. France adopted a special law on 2 July, 1966, England in 1965). In most cases leasing is considered as a variation of a lease contract and is thus regulated by the norms of a Civil Code stipulated in a Chapter on Contractual Law. In countries with no special legislative norms, special rules governing leasing were introduced through court practice (e.g. Germany, Japan).

There is an opinion that leasing has an ancient history. Economists trace leasing back to the Sumerian state of the third millennium B.C. and the Code of Hammurabi (1792-1750 years B.C.). They also believe that Justinian's institutions codified the norms that regulate leasing relations. However, this opinion is wrong, as they focus upon the lease in terms of rental of property, moreover, they consider leasing as it concerns all property relations related to the temporary possession of property. This wrong opinion is caused by misunderstanding of the notion of leasing and identifying it only with a lease contract.¹

Legislations in numerous countries provide specific signs that a lease agreement is a variation of a lease contract. For instance, Section 2A-103 of the US Uniform Commercial Code provides characteristic features of a leasing contract, as one of the variations of a contract. A leasing mean a lease with respect to which the lessor does not select, manufacture, or supply goods but acquires them or the right to their possession and use in connection with the lease. In the arrangement one of the following occurs: (a) the lessee

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¹ *Gazman*, Leasing: Theory, Practice, Comments, Moscow, 1997.

receives a copy of the contract by which the lessor acquired the goods or the right to their possession and use before signing the lease contract; (b) the lessee's approves the contract by which the lessor acquired the goods or the right to their possession and use as a condition of the effectiveness of the lease contract; (c) the lessee, before signing the lease contract, receives an accurate and complete statement designating the rights and duties, provided to the lessor by the person supplying the goods in connection with the contract by which the lessor acquired the goods or the right to their possession and use; (d) if the lease is not a consumer lease, the lessor, before the lessee signs the lease, informs the lessee in writing of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to their possession and use from that person.²

In the Civil Code of Quebec enacted in January 1994 and which unified both common and civil law systems, leasing is considered as a separate type of civil-law contract (together with the contract of rental of property) and dedicates a separate Chapter III (Articles 1842-1850) to leasing. According to this code, under the contract of leasing the lessor puts movable property at the disposal of the lessee for a fixed term in return for a payment of rent. The lessor acquires the property that is the subject of leasing from a third party at the demand of and in accordance with the lessee's instructions. Leasing may be entered into for business purposes only. Property that is the subject of the lease even if attached or joined to an immovable, retains its movable nature for as long as the contract is in force, provided that it does not lose its individuality. The lessor shall disclose the contract of leasing by deed of purchase. Furthermore, under a sales contract the seller is directly bound towards the lessee by legal and conventional warranties inherent to the contract of sale. The lessee assumes all risks for the loss of property, even by superior force, from the time he takes possession of it. He likewise assumes all maintenance and repair expenses. If the property is not delivered to the lessee within a reasonable period after the conclusion of the contract or within the time fixed in the demand for delivery, the lessee may require a termination of the contract. At the end of the lease terms the lessee is bound to return the property unless it has exercised an option to purchase (such a right may be granted under the leasing contract to the lessee).³

It should be noted that in civil law contracts regulating leasing relations are named under different titles. For instance, sometimes leasing is considered as a "lease-credit". This means that the lessor conveys material value to the lessee for temporary possession and use and the lessee pays to the lessor a fee for the service and interest. In France the contract of "lease-credit" [credit-bail] covering both the elements of rental as well as credit relations is used and is believed to be a specific type of leasing. The compulsory condition of a "lease-credit" contract is to grant to the lessee the right of purchase of the

² Uniform Commercial Code of the USA, Moscow, 1998.

³ Quebec Civil Code Translation from English and French, Moscow, 1999.

leased property. In the Belgian legislation is used the term “the contract of hire-leasing” (location-financement), as well as the term “lease” (leasing).⁴

An analysis of foreign legislation reveals specific clauses that are typical to a leasing contract. These are:

a) Unlike an ordinary lease (rental of property), under a leasing contract equipment is conveyed to the lessee for possession and use, which will be specially purchased or manufactured for the lessee by the leasing company (lessor) upon its request;

b) The leasing contract, as a rule, is concluded for a specified term as prescribed by the contract. In addition, the lease is granted long-term, often for the entire useful life;

c) Rent payable for possession and use of leased equipment comprises the whole cost of the equipment including amortization and the cost of lessor’s service. Thus the rental should exceed the income of the lessor. Furthermore, the amount, rule and time frame of instalments should be prescribed in the leasing contract so that expenses incurred by the lessor with regard to purchase of the property are reimbursed to the latter as soon as possible;

d) At the end of the lease term the lessee has the right to purchase the equipment unless the contract is ended with full amortization. In case of purchase the amortization should be taken into account. However it is not excluded that after expiry of the term of the contract either the contract will be prolonged for a specified period or the property will be returned to the lessor;

e) In a leasing contract, unlike a lease contract, the rights and duties of the parties to the contract are allocated in a different manner the basic implication of which is that the lessor is released from some duties of lessor under the lease contract, such as capital repairs of the subject of leasing, payment of expenses of maintenance. This factor underlines the predominantly financial nature of the lessor’s duties and its particular role in leasing relations;

f) The lessee may be granted with certain rights with regard to the seller of the property (e.g. before complaining to the lessor, the lessee must require satisfaction from the supplier), although the party to sales contract is not him but the lessor.⁵

The application of leasing operations throughout the world and the plurality of opinions with regard to the legal regulation of a leasing contract led to the adoption of the Convention on International Financial Leasing in 18 May 1988 in Ottawa. This Convention defines which law should regulate the conflict of regulations with regard to international leasing relations.⁶

⁴ *Kharitonova*, Finance Lease (leasing), Moscow, 1998.

⁵ *Kabatova*, Leasing: Concept, Legal Regulation, International Unification, Moscow, 1991.

⁶ Civil, Commercial and Family Law of Capitalist Countries, Collection of Normative Acts, Moscow 1989.

Pursuant to Article 1 of the Convention, a financial leasing transaction is a transaction in which one party (the lessor), on the specifications of another party (the lessee), enters into an agreement with a third party (the supplier) under which the lessor acquires plant, capital goods or other equipment on terms approved by the lessee so far as it concerns his interests, and enters into an agreement with the lessee granting to the lessee the right to use the equipment in return for the payment of rent. The Convention also stipulates the scope, the specification of leasing agreements, the subject of the agreement and the form, rights and duties of the parties as well as the grounds for the termination of a contract.⁷

As we have already mentioned, in most countries leasing is considered as a variation of the lease (rental) contract. The Georgian Civil Code in Articles 576-580 envisages a leasing contract as one of the types of contract (variation of rental contract). Under the leasing contract the lessor (leasing company) shall convey to the lessee certain property (movable or immovable) for possession and use for a period fixed in the contract by retaining the right of ownership on the conveyed property.

Parties to the leasing contract are the lessor (leasing company) and the lessee to whom property was conveyed for temporary possession and use. The lessor's activity has commercial purposes. The lessor may be any leasing company established in the organizational-legal form in accordance with the law. Usually, these are legal entities established in the form of a Joint Stock Company.

Under the leasing contract the lessor shall manufacture or purchase the property and convey it to the lessee for a period fixed in the contract. This process can be imagined in the following way. A potential lessee not having any financial resources applies to the lessor (leasing company) with a business proposal in order to have a certain type and amount of valuable property manufactured by the latter or to acquire the property from another person and give it to the lessee for temporary use (e.g. aircraft, ship, train, enterprises and equipment). In both cases the owner of the subject of leasing remains the lessor. Under the leasing contract the right to choose the manufacturing company of the subject of leasing shall be granted to the leasing company as well as the lessee.⁸

The wide application of leasing operations in Georgia led to the adoption of the law on the Support of Leasing Activity by the Parliament of Georgia on 7 May 2002. This law consists of a preamble, six chapters and 14 articles.

The preamble reads that "this law aims at developing the relations that have arisen under the leasing contract envisaged by the Civil Code and promoting leasing activity".

⁷ *Braginski/Vitryanski*, Contractual Law, Book Two, Moscow 2000.

⁸ *Kakhadze*, Leasing Contract, Comments of the Civil Code, Book IV I, 2001.

Chapter I – General Provisions – consists of two articles. Article 1 – “Definitions” – provides the meanings of the terms used in the Law:

a) leasing - under a sales contract the lessor of the subject of leasing (hereinafter lessor) purchases (or manufactures) the subject of leasing from the owner or manufacturer of the subject of leasing for a term, in return for consideration in the possession and use of the lessee of the subject of leasing (hereinafter lessee), with the right or obligation to its redemption;

It should be noted that the term used in the law “right or obligation to redemption” is fully incompatible with the essence of leasing, as well as Article 576 (3) of the Georgian Civil Code. Under a leasing contract the lessor conveys the subject of leasing in the temporary possession and not ownership of the lessee. Thus it is not clear how a lessor can be entitled or obligated to redeem the subject of leasing from the lessee, whereas the owner is the lessor himself. The law has a serious shortcoming and instead of redemption it should read as purchase, which would come into compliance with the Section 3 of the Article 576 of the Civil Code, pursuant to which a leasing contract may obligate or entitle the lessee to either purchase or rent the subject of leasing upon the expiration of the term of the contract unless the contract ends with a total depreciation of the thing.

Thus the legislator entitles or obligates the lessee, being the temporary possessor and user of the subject of leasing, to purchase the subject of leasing on the basis of a relevant agreement with the lessor. Whereas the lessor can in no way purchase the subject of leasing since it is itself the owner of the subject of leasing.

b) The subject of leasing – any kind of property subject to depreciation (the question of leasing contract are differently solved in different country’s legislation. As for the mentioned Law and Article 576 of the Civil Code of Georgia, their contents reads that the subject of a leasing contract may be any kind of property (both movable and immovable) that can be owned, possessed and used by natural and legal entities and purchased freely unless prohibited by the Law);

c) The nominal price of the subject of leasing – the price of subject of leasing at the moment of its transfer (e.g. a new “Boeing 747” assessed, for instance, at 10 million US Dollars);

d) The total cost of the leasing contract – total amount of rental;

e) Rental – the amount of periodic payment payable under the leasing agreement by the lessee to the lessor (or in-kind contribution equal to this sum) during which the lessee shall gradually payback to the lessor the nominal price (minus residual value) and leasing benefit (in other words, rental may be determined in various forms: in a fixed sum, that may be payable periodically within certain time limits, by defining the lessee’s share receivable as a result of the use of leased property in the form of a product, yield or income; including expenses incurred for improvement of property transferred by the lessee under the leas-

ing agreement. The leasing agreement may provide for various forms of payment of rental by the lessee, namely, by security deposit, in advance payment);

f) Leasing benefit – the difference between the total cost of the leasing agreement and the nominal price of leasing (minus residual value of the subject of leasing);

g) Grace period – the inception period of leasing during which the lessee is not paying rent;

h) Subleasing – the transfer of the right on possession and use of subject of leasing by the lessee to the third party under the leasing agreement;

i) Seller – a natural or legal entity - the owner or producer of subject of leasing, who transfers the subject of leasing under the sales contract to the lessor or lessee.

Article 2 of the Law – Types of Leasing – provides for the following types of leasing:

a) Direct leasing means when the lessor himself is the owner or the producer of the subject of leasing (during direct leasing the manufacturing-selling company transfers the property specified under the contract in the possession and use of the lessee without a mediator. Although the law is silent about indirect leasing, Article 576.2 of the Civil Code provides for a type of leasing when the lessor is obliged to purchase from the manufacturing company the property needed for the lessee and transfer it);

b) Compensational leasing means when the lessee makes rental payment in kind (goods, works, services);

c) Full service leasing means when the leasing agreement provides for administration, insurance, guaranteed technical maintenance and repair works of the subject of leasing by the lessor or a person invited thereby;

d) Net leasing – when under the leasing agreement the lessor does not provide maintenance and services on the subject of leasing (in legal literature according to the amount of service rendered on the subject of leasing by the lessor to the lessee there are net, full and partial leasing. Net leasing means a lease that under the leasing agreement maintenance and services of the subject of leasing shall be provided not by the lessor but by the lessee and all maintenance expenses is payable by the lessee. Full (sometimes called as “wet”) leasing is a lease when all maintenance and service expenses of the subject of leasing is payable by the lessor. As a rule, under such an agreement the lessor is the manufacturer of relevant equipment and/or its branch. Partial leasing is an intermediate step between the net and full leasing during which maintenance expenses of subject of leasing are divided between the lessor and lessee).

According to the composition of persons participating in the leasing operation there are indirect and leveraged leasing. During indirect leasing the supplier (seller) of equipment is the mediator-agent of the manufacturer of equipment. Leveraged leasing is used for

financing of highly valuable wide-ranging projects not by one but by several leasing companies and by using the credit resources of numerous banks.⁹

Leasing companies also apply a type of leasing such as operating lease. The specificity of an operating lease is that in it the leasing agreement is concluded for a shorter period than needed for the amortization of the leased property or other equipment. After the expiration of the term of the leasing agreement the subject of leasing shall be returned to the lessor, who is entitled to re-lease the same property. In case of re-leasing of the property the lessor assumes the obligation to keep the subject of leasing in a good operating condition (e.g. to perform capital repairs). This type of leasing excludes the lessee's option to purchase the leased property.¹⁰

Chapter II of the law – Leasing agreement – consists of three articles: article 3, 4 and 5. Article 3 – Leasing Agreement – consists of two parts:

1. A written agreement concluded by the parties for accounting purposes shall be deemed as a leasing agreement if it provides for one of the following conditions:

- At the end of the lease term the lessee becomes the owner of the property so that he does not pay additional money or pays a very low sum;
- The term of the leasing agreement is essentially equal to or is more than the term of economic life of the subject of leasing and the lessee becomes the owner of the property by paying a very low sum of money;
- The term of the leasing agreement is essentially equal to or is more than the term of economic life of the subject of leasing and the lessee does not have right to terminate the leasing agreement without fully paying the rental;
- Upon the expiry of one or several inception periods prescribed by the leasing agreement the lessee shall prolong the leasing for a full or essentially full term of economic life of the subject of leasing or purchase the subject of leasing;
- Upon the expiry of one or several inception periods prescribed by the leasing agreement the lessee has the right to decide whether to prolong the leasing without paying an additional sum for a full or essentially full economic life of the subject of leasing or by paying considerably less than the fair market value of the subject of leasing at the moment of the prolongation of leasing;
- Upon the expiry of one or several inception periods prescribed by the leasing agreement the lessee has the right to decide whether to become the owner of the subject of leasing without paying additional sum or by paying considerably less than the fair market value of the subject of leasing at the moment of prolongation of leasing.

2. Together with one of the conditions provided for in Paragraph 1 of this article, the leasing agreement shall, as a rule, indicate in what case the subject of leasing shall be deemed received and the term for receiving the subject of leasing.

⁹ Civil and Commercial Law of Capitalist States, Moscow, 1993.

¹⁰ *Pokrovskaya*, International Commercial Operations and their Regulation, Moscow, 1996.

Article 4 – Subleasing agreement – consists of two parts:

1. A subleasing agreement is a contract in the form of leasing agreement on the basis of which the lessee transfers the subject of leasing to a third party.
2. Subleasing is prohibited without lessor's written consent.

The transfer of the subject of leasing in the possession means its use directly by the lessee. This rule has an exception when the lessee transfers the subject of leasing in the possession and use of a third party with the lessor's written consent. This is where the subleasing agreement is concluded. Under subleasing agreements the lessee is the lessor for the third party whereas the third party is the lessee. Under the principal leasing agreement, the lessor is not in any contractual relationship with the lessee in the subleasing agreement. In every case of a transfer of the property in the possession of a third party the liability lies upon the lessee of the subject of leasing under the principal leasing agreement. Subleasing and leasing agreements tempt the same fate. If the leasing agreement is declared null and void then the subleasing agreement concluded on the basis of the former will be also null and void. The pre-term termination of a leasing agreement on any grounds causes the termination of the subleasing agreement concluded on the basis of it, no matter whether the term of the latter has expired or not. Termination of a leasing agreement due to the lessee's fault entitles the sub-lessor to require compensation caused by the termination of the subleasing agreement.

A subleasing agreement shall not be concluded for a longer period than the leasing agreement is concluded for. Otherwise it shall not be valid. This rule derives from the common law principle that no one can assign more rights than he himself holds.

The lessor shall give his consent on subleasing in writing. In giving such consent the lessor can define the amount of rights and duties that the lessee shall transfer to the sub-lessor.

Subleasing should be distinguished from a case when the initial lessee is changed. In such cases all rights and duties of the lessee are assigned to the third party. In other words the lessee is changed.

Article 5 – Registration of a leasing agreement – consists of two parts:

1. The lessor can register a leasing agreement in a relevant public register (although the law does not restrict the lessor's right to register the leasing agreement, it would be expedient if registration were compulsory when the subject of leasing is an immovable property);
2. If a leasing agreement is not registered in a respective public register, this may not constitute grounds for declaring it null and void (i.e. this provision of the law bears an optional nature which means that failure of its fulfilment does not cause a nullity of leasing agreement).

Chapter III – Rights and Duties of the Parties to a Leasing Agreement – consists of 5 Articles.

Article 6 – Protection of the Lessor’s Ownership Right

The subject of leasing is the object of separate rights and no matter how it is linked with other movable or immovable things, the lessor’s ownership right on the subject of leasing remains valid until the conveyance of the subject of leasing in the lessee’s ownership in accordance with the leasing agreement. This provision once again shows that a leasing agreement implies the transfer of property in temporary possession, the lessor remains as the owner of the subject of leasing, the lessee’s debts should not be recovered from the subject of leasing.

Article 7 – Lessor’s Rights and Duties

1. The lessor can assign his rights or parts thereof, deriving from the leasing agreement to a third party. In addition the assignment of these rights does not release the lessor from obligations assumed under the leasing agreement and does not change the essence of the leasing agreement (so-called “cession”).

2. In case of a lessee’s default, the lessor has the right to terminate the leasing agreement. This could be the case if the lessee does not pay rental within the prescribed terms, does not purposefully use the property, has not performed repairs as determined by the agreement.

3. Before a termination of the leasing agreement the lessor shall send his duly signed written notice on termination of leasing agreement to the lessee’s address indicated in the leasing agreement and if there is no such address to any latest known one. This notice shall specify the responsibility for default of which the lessor intends to terminate the agreement and the time period given to the lessee for fulfilment of the duties. This time period shall not be less than 15 days. If the lessor performs the duty within the fixed time, the agreement shall not be terminated.

4. The lessor shall have the right not to fix the time period under Para. 3 of this Article to the lessee if it is obvious that:

- the lessee is not able to fulfil his duty;
- serious damage is threatening the subject of leasing;
- the location of the subject of leasing may be changed without lessor’s permission.

5. The lessor shall have the right to repossess the subject of leasing upon the termination of the leasing agreement.

6. In case of the lessee’s failure to fulfil the obligations assumed under the leasing agreement, the lessor shall have the right to demand the lessee pay the full amount of rental and reimburse costs related with the conveyance of the subject of leasing in the possession of the lessor, minus the fair market value of the subject of leasing, at the moment of acquisition of rights on possession and use of the subject of leasing under this Article and the sum already paid by the lessee in the form of a rental. If after such a calculation a positive number is left, the lessee shall pay to the lessor this exact sum whereas if a negative number is left, the lessor shall pay to the lessee the positive equivalent of this sum.

7. For the purposes of Para. 6 of this Article when calculating the fair market value of the subject of leasing, other factors should be taken into account including the price and terms of sale of the subject of leasing transferred on leasing by the lessor or the price and terms of remarketing of the subject of leasing.

Article 8 – Lessee’s Rights and Obligations

1. The lessee may assign his rights under the leasing agreement to a third party only with the lessor’s written consent. This opinion contradicts one of the key principles of Civil Law according to which another party’s consent is not necessary for cession. Consent is needed in a situation when duties (and not rights) are assigned.

2. As soon as the lessee receives the subject of leasing the liability on damage and loss of the subject of leasing shifts to the lessee. This provision needs clarification. It certainly means that the lessee’s culpable commission, which has caused damage or loss of the subject of leasing. However, as for the risk of incidental damage or loss of the subject of leasing, pursuant to the general rule, it lays upon the owner i.e. the lessor. This general rule may have exceptions too. There are cases when incidental damage or loss of the subject of leasing occurs without due consideration of the destination and terms prescribed by the agreement, in case of transfer of the thing to other person without the lessor’s permission. Besides, the same situation will occur if the lessee, with due consideration of facts, could avoid incidental damage or loss of the subject of leasing at his own property’s expense but did not do so and preferred to keep his property. In such cases, the lessor ought to have the right to require compensation of damages caused by incidental damage or the loss of the thing from the lessee. Parties may agree to shift the risk of incidental damage or loss of the thing on the lessee.

3. If the changes made in the sales contract without the lessee’s consent cause damage to the lessee or if parties declare the sales contract null and void, the lessee has the right to require compensation of damages. This is the situation when the lessor is not the manufacturer of the subject of leasing but on the basis of a sales contract purchases certain property from the seller and transfers it on the basis of leasing agreement to the lessee.

4. A lessee may lodge in court a claim for compensation of damages caused to him by returning of the subject of leasing by the lessor in violation of Georgian legislation and the terms of the leasing agreement. The lessee is not entitled to require restitution of the subject of leasing in his possession.

Article 9 – Lessee’s Rights in relation to the Seller of the Subject of Leasing

1. All duties of the seller of the subject of leasing are specified under the sales contract concluded between the lessor and the seller. In addition, all types of warranties given by the seller to the lessor are executed in favour of the lessee, as if the lessee were the party to the sales contract, unless otherwise provided for by the leasing agreement. This regulation applies in a case when the lessor is not the manufacturer of the subject of leasing but

purchases it from the third party. In such a case Article 578.2 of the Civil Code may be applied in addition to this regulation. Parties to the leasing agreement may agree that the lessee, prior to asserting a complaint against the lessor, must claim satisfaction from the supplier of the property.

2. The lessor shall provide the lessee with a copy of the sales contract concluded with the seller or notify him of the duties and warranties under this contract in some other way before the lessee becomes liable under the leasing agreement.

Article 10 – Lessee's Duties During Control by the Lessor

1. The lessor has the right to exercise control over the fulfilment of the terms of leasing agreement and other supplementary contracts by the lessee. This is a check whether the lessee uses the subject of leasing purposefully.

2. Under the leasing agreement or other supplementary contract the parties shall define the objective and manner of exercise of control over the fulfilment of terms of this same contract.

3. The lessee shall ensure the lessor's free access to the subject of leasing and corresponding technical documents.

4. The lessor shall be entitled to request the lessee in writing to provide information necessary for the exercise of control and the lessee shall satisfy this request.

Chapter IV – Rule of Settlement – consists of one Article with two parts:

1. The rental amount, the manner of payment and its periodicity shall be specified in the leasing agreement. If the lessee and lessor make a settlement in kind then the price of goods shall be fixed by the parties' agreement or by its fair market value.

2. The duty of payment by the lessee shall become valid upon receipt of the subject of leasing specified under the leasing agreement and in case of a grace period – from the date fixed in the leasing agreement.

Chapter V – Bankruptcy – consists of two Articles: Article 12 stipulates the lessee's bankruptcy, Article 13 – the lessor's bankruptcy. In case of a lessee's bankruptcy, the subject received under the leasing agreement shall not constitute a part of the bankruptcy. This provision is reflected in Article 7 of the Unidroit Convention on International Financial Leasing. This is because the lessor remains the owner of the subject of leasing and the lessee's debts should not be recovered from the subject of leasing.¹¹ In the case of a lessor's bankruptcy, his creditors may not have more rights on the subject of leasing than the lessor had under the leasing agreement.

The adoption of this law led to changes in the Civil Procedure Code as well as to the law on Enforcement Proceedings.

¹¹ Unidroit Convention on International Financial Leasing, Ottawa, 28 May 1988.