

FINANCE LEASING IN INTERNATIONAL TRADE

by

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ABSTRACT

The thesis is on “Finance Leasing in International trade”. It considers the question “How well does English law recognise and encourage the use of finance leasing in equipment trade?”

The discussion shows that, on the one hand, English law has recognised the financing nature of finance leasing. It sees the lessor in a finance leasing arrangement merely as a financier, who steps into a sale of equipment which might otherwise take place between the supplier and the lessee. In addition, English law recognises that there are two agreements between the parties: a sale between the supplier and the lessor and a finance lease between the lessor and the lessee. Although English law does not view the transaction as a triangular relationship, it entitles the lessee to a cause of action against the supplier in various circumstances. It also allows the lessor to exclude from liability for the quality of the asset and to secure his commercial interests in the transaction by retaining ownership of the asset.

On the other hand, however, English law fails to provide solutions to some problems arising from the financing nature of the transaction. For example, it is difficult for the lessor to be completely free of responsibility for the condition of the asset, which is imposed by the Supply of Goods and Services Act 1982. His obligation to ensure the lessee’s quiet enjoyment of the lessee is also obscure. In addition, the lessee does not have a proprietary right over the asset at law and this has led to distortion of some of the legal principles regarding ownership and property.

The discussion leads to the conclusion that the law pertaining to finance leasing is on the whole satisfactory to facilitate equipment trade but reform is called for in some areas. The following suggestions are proposed to improve the use of finance leasing in the trade of equipment, both domestically and internationally. Firstly, the law should define finance leasing by providing explicit pronouncement of its financial nature and the triangular relationship. Secondly, the obligations and rights of the parties should be more specific. For example, the lessor's responsibility for the lessee's quiet enjoyment under the 1982 Act should be clarified as follows: "the lessor ensures that he has the right to lease the asset so that the lessee may enjoy exclusive possession of it free from disturbance by a person whose title is paramount to the lessor's, unless the disturbance stems from actions of the lessor". But the lessor should be excluded from all the obligations as to the condition of the asset under the Supply of Goods and Service Act 1982. The supplier should be liable to the lessee for the condition of the asset and, at his default, the lessee should be able to resort to a cause of action against him, being a third party to the supply agreement under the Contract (Third Party Rights) Act 1999. In addition, the lessee should be responsible for the payment of the total rentals irrevocably and his right over the asset should be recognised as a legal proprietary right.

Table of Contents

| | | |
|---|---|----|
| Chapter 1 | Introduction | 4 |
| Part one – Background | | 9 |
| Chapter 2 | The nature of finance leasing | 10 |
| 2.1 | Introduction | 10 |
| 2.2 | History | 10 |
| 2.3 | Advantages and disadvantages | 14 |
| 2.3.1 | Introduction | 14 |
| 2.3.2 | The taxation benefits to the lessee | 14 |
| 2.3.3 | An expanded financial resource to the lessee | 14 |
| 2.3.4 | Profitable return and security to the lessor | 16 |
| 2.3.5 | Increase of the supplier’s outright sale | 16 |
| 2.3.6 | Summary | 17 |
| 2.4 | Finance leasing in disciplines other than commercial law | 18 |
| 2.4.1 | Introduction | 18 |
| 2.4.2 | Accounting | 18 |
| 2.4.3 | Taxation | 20 |
| 2.4.4 | Security registration | 22 |
| 2.4.5 | Summary | 24 |
| 2.5 | Finance leasing from the legal perspective | 26 |
| 2.5.1 | Introduction | 26 |
| 2.5.2 | The concept used by the English courts | 26 |
| 2.5.3 | The concept under the UCC of the US | 29 |
| 2.5.4 | The Unidroit Convention and Model Law | 31 |
| 2.6 | Concluding remarks | 37 |
| Part two – The Contractual relationship | | 38 |
| Chapter 3 | The lessee’s obligations | 39 |
| 3.1 | Introduction | 39 |
| 3.2 | The lessee’s obligation to pay the rentals | 40 |
| 3.2.1 | Introduction | 40 |
| 3.2.2 | The rule against penalties | 41 |
| 3.2.3 | The rule against forfeiture | 46 |
| 3.2.4 | Penalty or forfeiture? | 56 |
| 3.2.5 | A clause providing payment on occurrence of an event | 64 |
| 3.2.6 | An acceleration clause | 67 |
| 3.2.7 | A clause under which an obligation to duly pay is a condition of the contract | 70 |
| 3.2.8 | Proposals to draft the liquidated damages clause | 75 |
| 3.2.9 | An irrevocable and independent obligation to pay the total rentals at law? | 77 |
| 3.2.10 | Summary | 85 |
| 3.3 | The lessee’s obligation to maintain and to return the asset | 87 |
| 3.4 | Concluding remarks | 89 |
| Chapter 4 | The lessor’s obligations | 90 |
| 4.1 | Introduction | 90 |
| 4.2 | The lessor’s obligation to transfer possession | 90 |
| 4.2.1 | Introduction | 90 |
| 4.2.2 | English law | 91 |

| | | |
|--|---|-----|
| 4.2.3 | The Unidroit Convention and Model Law | 93 |
| 4.2.4 | Summary..... | 99 |
| 4.3 | The lessor's obligation to ensure quiet enjoyment | 100 |
| 4.3.1 | Introduction | 100 |
| 4.3.2 | English law | 100 |
| 4.3.3 | The Unidroit | 104 |
| 4.3.4 | Summary..... | 105 |
| 4.4 | The lessor's obligation to ensure sound condition of the asset | 107 |
| 4.4.1 | Introduction | 107 |
| 4.4.2 | Fitness for purpose | 107 |
| 4.4.3 | Satisfactory quality | 108 |
| 4.4.4 | Correspondence with description | 109 |
| 4.4.5 | Correspondence with sample..... | 110 |
| 4.4.6 | Why were not finance leases excluded from the scope of the 1982 Act? | 111 |
| 4.4.7 | Can the lessor be excluded from the implied obligations by contract under English law?..... | 113 |
| 4.4.8 | How can the English law be changed? | 122 |
| 4.4.9 | Summary..... | 125 |
| 4.5 | Concluding remarks..... | 127 |
| Chapter 5 A Triangular relationship?..... | | 129 |
| 5.1 | Introduction | 129 |
| 5.2 | The lessor and supplier relationship | 132 |
| 5.3 | Is the supplier the agent of the lessor?..... | 134 |
| 5.4 | Any relationship between the lessee and supplier? | 140 |
| 5.4.1 | Introduction | 140 |
| 5.4.2 | The rule of privity..... | 140 |
| 5.4.3 | The Contracts (Rights of Third Parties) Act 1999..... | 141 |
| 5.4.4 | A contractual relationship | 143 |
| 5.4.5 | Assignment | 145 |
| 5.4.6 | Restitution..... | 147 |
| 5.4.7 | Summary..... | 148 |
| 5.5 | The Unidroit Convention and Model Law | 150 |
| 5.6 | Concluding remarks..... | 153 |
| Part three – The Proprietary Rights | | 158 |
| Chapter 6 The lessor's proprietary right | | 159 |
| 6.1 | Introduction | 159 |
| 6.2 | The lessor's repossession right in the case of the lessee's insolvency | 160 |
| 6.2.1 | Introduction | 160 |
| 6.2.2 | Liquidation and bankruptcy..... | 161 |
| 6.2.3 | Receivership | 164 |
| 6.2.4 | Administration..... | 166 |
| 6.2.5 | Summary..... | 171 |
| 6.3 | The lessor's right when the asset is affixed to the land | 173 |
| 6.4 | The lessor's right in the case of wrongfully dealings with the asset | 177 |
| 6.5 | An ownership or a security interest? | 186 |
| 6.6 | Concluding remarks..... | 191 |
| Chapter 7 The lessee's proprietary right | | 193 |
| 7.1 | Introduction | 193 |
| 7.2 | A proprietary right at law? | 196 |
| 7.2.1 | Introduction | 196 |
| 7.2.2 | Possession..... | 196 |

| | | |
|-----------|---|-----|
| 7.2.3 | The rule of <i>nemo dat</i> | 198 |
| 7.2.4 | The rule of <i>numerus clausus</i> | 199 |
| 7.2.5 | Special property..... | 202 |
| 7.2.6 | Summary..... | 205 |
| 7.3 | A proprietary right in equity?..... | 207 |
| 7.3.1 | Introduction..... | 207 |
| 7.3.2 | A restrictive covenant running with the asset..... | 208 |
| 7.3.3 | Specific performance..... | 218 |
| 7.3.4 | An equitable right resulting from the third party's own conduct..... | 222 |
| 7.3.5 | Summary..... | 224 |
| 7.4 | Why not a proprietary right over the asset?..... | 226 |
| 7.5 | How to confer on the lessee a legal proprietary right over the asset?..... | 231 |
| 7.5.1 | Introduction..... | 231 |
| 7.5.2 | An estate by analogy to land leases..... | 231 |
| 7.5.3 | A proprietary right separated from the lessor's ownership..... | 235 |
| 7.5.4 | An ownership by the means of reclassification..... | 236 |
| 7.5.5 | Summary..... | 239 |
| 7.6 | Concluding remarks..... | 241 |
| Chapter 8 | Conclusion..... | 244 |
| 8.1 | Conclusions on English law..... | 244 |
| 8.2 | Limitation of the thesis and further research..... | 252 |
| Appendix: | | |
| | “Leasing Agreement for Equipment Including Motor Vehicles” for use outside the scope of the Consumer Credit Act 1974..... | 253 |
| | Bibliography..... | 258 |

CHAPTER 1 INTRODUCTION

Finance leasing is a financing device in the form of a lease. It has been used as an effective alternative to the purchase of equipment. Usually a finance leasing transaction works in the following way. At the request of the lessee, with his specification of the asset and selection of the supplier,¹ the lessor enters into a supply agreement with the supplier. The lessor acquires the asset from the supplier, who receives outright payment from the lessor. Then, the lessor leases the asset to the lessee for a term which is usually most of the useful life of the asset, in return for the lessee's payment of rental. This rental is calculated to cover the capital outlay of the lessor and also to give him a margin of profit. During the lease period, the lessee enjoys the possession of the asset and the profits resulting from the use of it. He also undertakes to maintain it in good order and is responsible for loss or damage to it. At the end of the lease period, either the lessee would continue to hire the same asset for a secondary period and pays a peppercorn rental toward it, or the asset would be sold, often by the lessee on behalf of the lessor, and the lessee would share a substantial proportion of the proceeds of the sale.

In order to encourage the use of finance leasing internationally and nationally, the International Institute for the Unification of Private Law ("Unidroit")² prepared the Unidroit Convention on International Financial Leasing 1988 (the "Convention") and

¹ For example, the prospective lessee might specify that he wishes to have the use of "a 40 ton Mercedes truck from Gerard Mann Limited Incheape South Midlands".

² Unidroit was founded in 1926 by the League of Nations for the purpose of examining ways of harmonizing and co-ordinating the private law of States and groups of States, and to prepare gradually for the adoption by the various States of uniform legislation in the field of private law. It is an autonomous international organisation whose offices are in Rome. Article 1 of the Statute of the International Institute for the Unification of Private Law (Rome, March 15, 1994).

the Unidroit Model Law on Leasing 2008 (the “Model Law”).³ But the UK has neither ratified the Convention nor adopted the Model Law.

This thesis will examine the law pertaining to finance leasing in England and Wales, aiming to assess whether it is fit for the purpose of facilitating trade of equipment.

A few concepts will now be explained and the points on which the discussion will focus will be highlighted.

The term “finance leasing” will refer to the whole transaction involving the three parties and the term “finance lease” will refer to the specific agreement made between the lessor and the lessee.

The finance leasing transaction discussed in this thesis involves three parties: the supplier, lessor and lessee. The supplier may be the manufacturer, a wholesale merchant, an agent, or anyone who is chosen by the lessee to supply the specific asset for his use. The lessor is usually a finance company, or a finance house, or anyone who can provide the finance and is prepared to acquire the asset specified by the lessee for his use. The lessee is the actual user, who selects the supplier and the asset, and, providing specifications of the asset, requests the finance. He is responsible to the lessor for the payment of rentals and the proper use of the asset. As technology has developed to the extent that it is now possible for many consumers to participate in international trade, they might choose to get involved in finance leasing but their

³ The Unidroit Model Law on Leasing was completed by the Unidroit in December 2008 and officially ready for countries all over the world to take as a basis of their domestic legislation on leasing. Unidroit, ‘Completion of Unidroit’s Project for the Establishment of a Model Law on Leasing’ <<http://www.unidroit.org/English/new/model-law-leasing.htm>> accessed 30th April, 2009.

rights attract special protection.⁴ Aiming to elucidate the parties' rights and obligations to each other, particularly reflecting the financial feature of the transaction, the thesis will focus on the transactions where the three parties are dealing in the course of business, rather than dealing as a consumer.

The involvement of a financier provides practical benefits to all three parties.⁵ This thesis seeks to investigate the specifics of the financial lessor's involvement in the tripartite transaction, which makes finance leasing a financial mechanism. Financial arrangements offered by the supplier directly to the user, including those in the form of leasing, are not the object of this study.

Finance leasing transactions concern chattels, which are of the nature of moveable property. Although some commercial leases of land have a financing function, they are imprinted by the immovable nature of the real property and are subject to land law. Therefore land is excluded from the scope of this thesis, although some principles of land law, particularly with regard to mortgage, could, to some extent, shed light on the law applicable to finance leasing by analogy.

In general, the terms "lease" and "hire" are used interchangeably when chattels are concerned. But when the discussion refers to land specifically, the term "lease" is chosen to differentiate it from the hire of goods.

The research question of the thesis is: "How well does English law recognise and encourage the use of finance leasing in equipment trade?" It will examine the characteristics of finance leasing, in order to identify the legal principles applicable to

⁴ For example, the Consumer Credit Act 2006 and Unfair Terms in Consumer Contracts Regulations 1999 would usually apply under English law.

⁵ See Chapter 2.3 below.

it, and to uncover any ambiguities, problems or difficulties which might occur.

Suggestions for reform will be made where applicable.

The thesis will consist of eight chapters and consider three sets of issues, namely: the background of finance leasing, the contractual relationships of the parties and their rights over the property.

Part One aims to answer the question: “What is the nature of finance leasing?” It introduces the history of finance leasing, its commercial advantages and disadvantages and the conceptual differences in various economic fields and at law.

Part Two, comprises three chapters, the first of which considers the contractual relationships of the parties in the finance leasing transaction. Chapters 3 and 4 discuss the key relationship – the finance lease between the lessor and lessee and examine their obligations to each other. The aim is to answer the question: “Does English law recognise the needs of both lessor and lessee in the transaction and lay down appropriate conditions so that both lessor and lessee treat each other fairly?” Chapter 5 considers the relationship between the lessor and supplier and also the relationship between the lessee and supplier. It aims to find out whether the law of England regards the relationship between the three parties of a finance leasing transaction as a triangular relationship.

Part Three, consisting of Chapters 6 and 7, considers the property aspect of finance leasing. Chapter 6 asks how effectively the lessor’s ownership of the asset would enable him to repossess the asset when needed. It also attempts to evaluate the Law Commission’s proposal to regard the lessor’s interest in the asset as a security interest, from the point of protection to the lessor’s right. Chapter 7 endeavours to explain the

nature of the lessee's interest in the asset and examines the proposals to confer on the lessee a legal proprietary right.

Chapter 8 is the Conclusion.

PART ONE – BACKGROUND

Part One will look at the historical, economical and conceptual backgrounds of finance leasing. It aims to explain the nature of finance leasing and its characteristics in order to prepare for the more specific examination on the contractual relationship and proprietary rights of finance leasing in Parts Two and Three.

CHAPTER 2 THE NATURE OF FINANCE LEASING

2.1 Introduction

In order to examine how well English law recognises and encourages the use of finance leasing in equipment trade, it is important to firstly understand the commercial and legal environments where finance leasing is used. The nature of finance leasing will be examined in this chapter, for the purpose of finding out what the parties expect to gain by the means of finance leasing.

This Chapter will firstly introduce the historical background of finance leasing and then discuss its commercial advantages and disadvantages, and next clarify the concepts used in various areas, before finally define its legal concept and explain its characteristics under English law.

2.2 History

This section explains how leasing has been used in the international sphere in history and particularly how finance leasing emerged to be a financial alternative to sale in England and Wales.

Leasing is a long-existing phenomenon throughout recorded history⁶ and widely used in various different parts of the world as a means to acquire capital equipment.⁷ Clay tablets discovered in 1984 from the ancient Samarian city of Ur are the first

⁶ Historical evidence suggests that leasing was widely used by the ancient Sumerians circa 5000 BC. I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 3, by reference to C-O Livijn, *5000 Years of Leasing* (Svensk Leasing AB, Stockholm 1970).

⁷ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 2.

documented farm equipment leases whereby priests leased out land and agricultural tools to farmers from the year 2010 BC.⁸ Later, Babylonian King Hammurabi, ancient Egyptians and the Greeks and Romans all engaged in leases of personal property.⁹ The knights of the crusades in the 10th century were known to have paid for their armour by instalments.¹⁰ Ships, chartered from the time of the ancient Phoenicians, were pure forms of equipment leases.¹¹ The Statute of Wales 1284 declared that the action of covenant was available for leases of movable property as well as land.¹² Leasing was widely accepted as a form of credit which allows a lessee to acquire the equipment necessary to carry out a trade without needing the resources to purchase it.¹³ But leasing of equipment, as opposed to leasing of land, occurred only on a limited scale due to the relatively little equipment available for leasing.¹⁴

It became particularly prevalent in England and Wales in the wake of the industrial revolution.¹⁵ With the introduction of power driven machinery and mass industrial production, leasing began to take off to match the demand for capital equipment and the need for financial resources with which to acquire.¹⁶ By the beginning of the 20th century, a wide range of industrial equipment was being acquired and operated by the means of leasing.¹⁷ In early 1950s, the modern leasing industry launched first in the

⁸ Jeffrey Taylor, 'The History of Leasing' <http://fbibusiness.com/history_of_leasing.htm#History> accessed 17 September 2007.

⁹ Quoted from <<http://www.leaseingsolutionsllc.com/why/history.shtml>> accessed 18 September 2007.

¹⁰ Quoted from 'History of Leasing'

<http://www.gmvleasing.co.uk/lease_types/history_of_leasing.asp> accessed 18 September 2007.

¹¹ Quoted from <http://www.leaseingsolutionsllc.com/why/history.shtml>, accessed 18 November 2009.

¹² Department of Trade and Industry, *ibid*, 2.

¹³ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 2.

¹⁴ Department of Trade and Industry, *ibid*, 2.

¹⁵ Iwan Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 3.

¹⁶ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 2.

¹⁷ Department of Trade and Industry, *ibid*, 2.

United States¹⁸ and then in the 1960s in the UK, initially with the participation of the US operators.¹⁹ Finance leasing has found wide acceptance as a means of financing capital goods in most modern economies.²⁰

Businesses in the United Kingdom started favouring finance leasing in the 1970s mainly because of the accounting and taxation advantages and the participation of financial institutions.²¹ From 1971 to the mid-1980s buyers of capital equipment were eligible for 100% tax allowances during the first year of ownership (the “first year allowances”) to be set against corporation tax.²² Difficult economic conditions of the time considerably depleted manufacturers’ resources for finance and the margin of profits.²³ Many companies without the tax capacity needed to take advantage of the first year allowances available to the lessor of finance leasing, as a buyer, who would transfer the benefits to the lessee by giving discount to the rentals.²⁴ Leasing became an attractive alternative to outright purchase.²⁵ As a result, big-ticket item finance leasing had a substantial boost during the period of high first year allowances.²⁶

At the same time, accounting procedures allowed lessees to avoid recording leasing transactions on their balance sheets because they were not legal owners of the assets.²⁷

¹⁸ Richard M Contino, *Complete Equipment-Leasing Handbook: A Deal Maker's Guide with Forms, Checklists and Worksheets* (AMACOM, New York 2002) 1.

¹⁹ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 3.

²⁰ JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007), p974.

²¹ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 4.

²² Department of Trade and Industry, *ibid*, 4.

²³ Department of Trade and Industry, *ibid*, 4.

²⁴ Department of Trade and Industry, *ibid*, 4.

²⁵ Department of Trade and Industry, *ibid*, 4.

²⁶ References are from HMRC, ‘Finance Leasing Manual - FLM1.38’

<http://www.hmrc.gov.uk/manuals/flmmanual/html/FLMCH01/02_0018_FLM1.38.htm> accessed 18 September 2007.

²⁷ Department of Trade and Industry, *ibid*, 3

Therefore the companies which leased equipment could protect their credit rating making further borrowings easier to obtain.²⁸

Being encouraged by the higher interest charges of finance leasing than bank loans, the financial institutes, e.g. banks and finance houses, developed their investing strength in capital equipment leasing business.²⁹ Around 1972, banks, such as Barclays Bank, Williams & Glyns and the Royal Bank of Scotland, set up their wholly owned leasing subsidiaries.³⁰

Therefore the UK leasing industry experienced real explosion in popularity in the 1970s. However, the favourite advantages to leasing over other means of finance did not last. In the 1980s, the first year allowances were removed between 1984 and 1986³¹, and from 1984 lessees have been required to record finance leasing transactions on their balance sheets under the Statement of Standard Accounting Practice No 21 (SSAP 21).³² Thus, the UK finance leasing industry stopped its high speed increase by 1984.³³ But finance leasing has established as a financing alternative to purchase and continues to facilitate sales of equipment both in the UK and worldwide.³⁴

²⁸ Department of Trade and Industry, *ibid*, 3

²⁹ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 4.

³⁰ Department of Trade and Industry, *ibid*, 4.

³¹ Although, at the same time, in compensation, corporation tax on profits was cut substantially from 52% to 35% and in 1991 was cut again to 33%. Department of Trade and Industry, *ibid*, 4.

³² SSAP 21, 'Accounting for Leases and Hire Purchase Contracts', is the current accounting standard introduced in the UK by the Accounting Standards Board (ASB) in 1984.

³³ HM Revenue & Customs, *History of Finance Leasing* (HMRC FLM1.38).

³⁴ Forward Trust, "Asset-based Finance", in Kogan Page Staff (CB), *Corporate Finance Handbook*, (3rd ed Kogan Page, Milford 2002) 50.

2.3 Advantages and disadvantages

2.3.1 Introduction

This section will highlight the benefits and shortfalls of finance leasing, in order to explain why it existed and what makes it continue to attract businesses.

2.3.2 The taxation benefits to the lessee

Finance leasing is very much tax driven. Its volume of usage started to rise rapidly in the 1970s because of the 100% first year allowances at the time. Since the benefit was removed in the 1980s, the development of finance leasing slowed down. By the time when the Finance Act 2006 came into force,³⁵ taxation benefits available to the lessee of a finance lease became rather limited.

2.3.3 An expanded financial resource to the lessee

Research shows that the choice of finance leasing is made for reasons other than low cost.³⁶ In fact, the lessee pays more than the interest he would pay under an ordinary bank loan by instalments in similar circumstances; the relatively higher interest rate attracts the finance companies to accept applications for finance leasing. But, it is common that the lessee is not required to pay down payment or deposit³⁷ and he could obtain 100% finance for the entire cost of the equipment, unlike a loan to purchase the

³⁵ July 19, 2006.

³⁶ S B Smart, W L Megginton and L J Gitman, *Corporate Finance*, (Thomson Learning, London 2003) 611, footnote 22.

³⁷ Even if down payment is required, it would be very little money, perhaps only the first few months' rentals.

equipment, where a down payment as high as 20 percent or more is generally required and the bank only offers as much as 80 percent financing.³⁸

In addition to the maximum financing, finance leasing provides good cash flow by spreading payments over months or years. The payments can be structured to match the lessee's credit quality, time-in-business and pattern of income. For example, the lessor may agree that the lessee can pay small amount of rentals at the beginning of the lease period but a 'balloon rental' at the end of it; or he can pay rentals according to the seasons of his business and skip payment in the months when his business is slow; or he can defer payment by which he makes money with the leased asset prior to making his first payment; or he can start with a small initial payments which grow as the cash flow from the leased asset grows.³⁹

However, once the payment plan is set, the lessor would rarely agree to change it. The lessee may be forced to pay hefty early termination fees for breaking the contract, if he fails to fulfil his duty of payment. The lessee's commitment to regular payments is the certainty expected by the lessor from the transaction. This is understandable because the lessee should have been able to compare the payments of rentals with the expected revenue and profits generated by the use of the asset. The payments of rentals at a usually fixed amount avoid inflation.⁴⁰

³⁸ Ryan Kernan, 'Business Equipment: Purchase Loan or Lease Agreement?' (Attard Communications Inc) <<http://www.businessknowhow.com/money/leaseequipment.htm>> accessed 20 November 09.

³⁹ References from the commercial sites, for example, <<http://www.chdleasing.com/index.asp/mm/3/sm/3/Content>> accessed 17 September 07.

⁴⁰ Great Britain, Small Business Service, Finance and Leasing Association, *Asset finance: hire purchase and leasing* (Department of Trade and Industry, London 2002) 6.

2.3.4 Profitable return and security to the lessor

In comparison to lending, the lessor of finance leasing receives more profitable rate of investment return. He has the security of his interest in the reservation of the ownership of the asset. During the leasing period, the lessor is the legal owner and is able to repossess the equipment uncomplicatedly when the lessee can not perform his obligation of rental payments. When a lessee goes insolvent, the lessor usually can repossess the asset and receive the proceeds of disposition of it to recover his loss of the rentals unpaid under the lease. There has been a proposal to regard the finance lessor's interest in the asset as a security interest and to require it to be registered.⁴¹ If the proposal is adopted, the lessor's priority over other secured creditors of the lessee would depend on whether he registers his security interest with the register before them.

2.3.5 Increase of the supplier's outright sale

Finance leasing enables the supplier to sell his equipment outright to the lessor and therefore enlarge their market portion in a certain area. There is no obvious disadvantage to the supplier. Finance leasing hugely improves sales of equipment; unsurprisingly the supplier often takes the initiative to introduce finance leasing to his potential customers who seem to need some kind of financing for the purchase of the asset.

⁴¹ The Law Commission published a set of consultation documents: Law Commission, *Registration of Security Interests: Company Charges and Property Other Than Land* (Law Com No 176, 2002), Law Commission, *Company Security Interests a Consultative Report* (Law Com No 176, 2004) and Law Commission, *Company Security Interests* (Law Com No 296, 2005). Law Commission, Consultation Paper No.296, 'Company Security Interests', 31 August 2005). The registration issue will be discussed further in subsection 2.4.4 below.

2.3.6 Summary

Finance leasing is an effective financing mechanism for equipment acquisition. It offers an alternative to borrowing money and provides benefits to all parties involved. It is designed to meet the needs of the three parties: the lessee (who needs the equipment to use), the lessor (who has money) and the supplier (who has the equipment for sale). For the lessee, as a result of finance leasing, his financial resources are expanded while he gets 100% financing for the asset. He also enjoys the flexibility in payments and is certain about the amount to pay. He may also avoid restrictions set by law to lending and have less restrictive covenant than loans. In some cases, he may also have benefits in the taxation regime.

However, there are disadvantages of finance leasing to the lessee. For example, he is committed to payment of all the rentals. He may be restricted with the use or disposal of the asset. There may be complication in the accounting and taxation of the transaction. For the lessor, he would benefit from the relatively profitable rate of investment return and considerably certain security, being the legal owner of the asset. For the supplier, finance leasing means outright sale of the asset and has no risk of failure of consideration at all.

The strength of finance leasing exists in its distinctive way of funding. It takes a different reward and risk structure from the traditional secured loan. The lessee obtains all the benefits of the ownership of the asset except for the title to the asset and also takes all the risks of the ownership except for obsolescence. The lessor gets rewards in the payments of rentals and spares the risk by preserving the ownership as a means of protection against default of the lessee.

2.4 Finance leasing in disciplines other than commercial law

2.4.1 Introduction

Finance leasing is a commercial innovation. It has been regulated in accounting and taxation and is gaining recognition in the proposed company security registration scheme. This section will discuss the concept of finance leasing used in these areas, in order to understand how finance leasing is employed by the businessmen before the next section explains why it takes the current form at law.

2.4.2 Accounting

The current accounting standard in the UK, SSAP 21, is the only regulation which clearly defines “finance lease”. It will be quoted below in length, for a convenient explanation of how a finance lease differs from another form of lease – an operating lease:

“Background Leases and hire-purchase contracts are means by which companies obtain the right to use or purchase assets. In the UK there is normally no provision in a lease contract for legal title to the leased asset to pass to the lessee. A hire-purchase contract has similar features to a lease except that under a hire-purchase contract the hirer may acquire legal title by exercising an option to purchase the asset upon fulfilment of certain conditions (normally the payment of an agreed number of instalments). Current tax legislation provides that in the normal situation capital allowances can be claimed by the lessor under a lease contract but by the hirer under a hire-purchase contract.

“Forms of lease Leases can appropriately be classified into finance leases and operating leases. The distinction between a finance lease and an operating lease will usually be evident from the terms of the contract between the lessor and the lessee. An operating lease involves the lessee paying a rental for the hire of an asset for a period of time which is normally substantially less than its useful economic life. The lessor retains most of the risks and rewards of ownership of an asset in the case of an operating lease. A finance lease usually involves payment by a lessee to a lessor of the full cost of the asset together with a return on the finance provided by the lessor. The lessee has

substantially all the risks and rewards associated with the ownership of the asset, other than the legal title. In practice all leases transfer some of the risks and rewards of ownership to the lessee, and the distinction between a finance lease and an operating lease is essentially one of degree”

A finance lease is defined as a transaction in which substantially all the risks and rewards of an asset except ownership are transferred from the lessor to the lessee. It is commonly understood in substance as equivalent to a secured loan in the sense that the lessor is insulated from the commercial risks and rewards of the ownership of the leased assets. The lessee is regarded as the economic owner of the asset and required to capitalise material finance leases in his accounts, *viz.* the lessee should record on his balance sheet the asset and the liability arisen from a finance lease. In contrast, an operating lease is regarded to be more closely akin to the hire of an asset and the lessee is not required to capitalise it.

The courts have quoted and accepted the classification between finance leases and operating leases under the SSAP 21 as a basic concept of leases. For example, in the case *On Demand Information plc and another v Michael Gerson (Finance) plc and another*,⁴² the passage quoted above from SSAP 21 was cited to provide a basic understanding of the nature of a finance lease.⁴³

However, SSAP 21 has been much criticised to be deficient in reflecting the substance of transactions,⁴⁴ because the direct effect of the accounting changes was that lessees chose operating leases rather than finance leases because many finance leases were disguised to be operating leases for the off-balance sheet benefit permitted to the

⁴² [2002] UKHL 13; [2003] 1 AC 368 (HL), reversing [2001] 1 WLR 155 (CA).

⁴³ [2001] 1 WLR 155 (CA), per Robert Walker LJ, at 158.

⁴⁴ V Beattie, A Goodacre and SJ Thomson, 'International Lease-Accounting Reform and Economic Consequences: The views of UK Users and Preparers' (2006) 41 (1) *The International Journal of Accounting* 75-103, p98.

operating lessees.⁴⁵ Also, evidence shows that the distinction between operating and finance leases is neither a clear-cut nor useful principle on which to base a good quality accounting standard itself.⁴⁶

2.4.3 Taxation

The classification of leases under the SSAP 21 had been used and followed in tax law until the enactment of the Finance Act 2006.

The implication of the 2006 Act on taxation is that it introduced rules to tax long funding leases in a similar way to a loan. Where plant or machinery is acquired for long funding leasing, the lessor is prevented from claiming capital allowances but the lessee is entitled to claim capital allowances. Thus, the lessor is taxed only on that proportion of the rental income that represents interest - a figure that is closely related to its accounting profit, period by period; the lessee is entitled to relief for only part of the lease rentals because the balance is relieved under the capital allowances rules.⁴⁷

Where a lease is not a long funding lease a lessor is taxed on the full amount of rentals receivable under the lease.⁴⁸

The effect of the 2006 Act on the law pertaining to finance leasing was to insert new category of leases into the Capital Allowances Act 2001.⁴⁹ On the base of the commonly used classification of “finance leases” and “operating leases” in the

⁴⁵ Department of Trade and Industry, *Equipment Leasing in the UK: A Report and Guide to the UK Equipment Leasing Industry* (HMSO, London 1995) 4-5.

⁴⁶ V Beattie, A Goodacre and SJ Thomson, 'International Lease-Accounting Reform and Economic Consequences: The views of UK Users and Preparers' (2006) 41 (1) *The International Journal of Accounting* 75-103, 99.

⁴⁷ Quoted from HM Revenue & Customs, *Taxation of long funding leases: basic principles: introduction* (HMRC BLM 40010).

⁴⁸ HM Revenue & Customs, *Taxation of leases that are not long funding leases: finance lessors: general taxation issues* (HMRC BLM 33005).

⁴⁹ S 70 of the Capital Allowances Act 2001 was added by the Finance Act 2006, Sch 8 (1) Para 6.

accounting standard, the Capital Allowances Act 2001 reclassified leases into “short leases”, “funding leases” and “long funding leases” for taxation purposes.

Under s 70I of the 2001 Act, a “short term lease” is a lease whose term is 5 years or less, or between 5 years to 7 years, if it meets specific conditions.⁵⁰

Under s 70J, a “funding lease” is a plant or machinery lease, in the definition under s 70K, which at its inception meets one or more of the following tests: (a) the finance lease test according to s 70N, i.e. the accounting classification; (b) the lease payments test, according to s 70O, *viz.* the net present minimum rentals exceed 80% of the market value of the asset; (c) the useful economic life test, according to s 70P, *viz.* the leasing period is longer than 65% of the remaining useful economic life of it.

Under s 70G, a “long funding lease” is a funding lease which meets the criteria: a) more than 5 years in length, b) it is not an excluded lease of background plant or machinery for a building according to s 70R, c) it is not excluded by s 70U with regard to plant or machinery leased with land: low percentage value.

The new change in the concepts of leases in taxation emphasises the substance of the transaction. The economic owner of plant and machinery, instead of the legal owner, is entitled to the capital allowances unless the lease is a “short term lease”.

⁵⁰ Condition A: the lease is one which, under generally accepted accounting practice, falls (or would fall) to be treated as a finance lease;
Condition B: the residual value of the plant or machinery which is implied in the terms of the lease, is not more than 5% of the market value of the plant or machinery at the commencement of the term of the lease, as estimated at the inception of the lease;
Condition C: the total rentals falling due in the first reference year, if less than the total rentals falling due in the second reference year, are no more than 10% less than those rentals, and the total rentals falling due in the final year or in any reference year after the second reference year, if greater than the total rentals falling due in the second reference year, are no more than 10% greater than those rentals.

2.4.4 Security registration

The first suggestion on reforming the company security registration was made in “Diamond Report” in 1989.⁵¹ Then the (England and Wales) Law Commission has published three Consultation Papers in 2002 (Law Comm 164), in 2004 (Law Comm 176), and in 2005 (Law Comm 296). In the proposal to reform the company security registration system, a unitary concept of “security interest” was suggested to regard the various interests which function as security.

The definition of a “security interest” takes the functional approach, which was initiated from Article 9 of the Uniform Commercial Code (UCC) in the US.⁵² In England, a ‘security interest’ was drafted to be ‘an interest in personal property which secures payment or performance of an obligation’.⁵³

Although very weak, the concept of “security interest” is useful to encompass the traditional securities, e.g. charges, mortgages and pledges, and the so-called “quasi-securities”, e.g. conditional sales, hire-purchase agreements and finance leases, under the proposed security registration scheme.⁵⁴ Although the Companies Bill, which became the Companies Act 2006, did not adopt this approach, the consultation as to whether the quasi-securities should be regarded as security is continuing.⁵⁵

⁵¹ A Diamond, *A Review of Security Interests in Property for the Department of Trade and Industry* (HMSO, London 1989), on behalf of the Department of Trade and Industry, para 9.7.16.

⁵² The UCC Revised Article 9 has been adopted by all States (and the District of Columbia) and also has been borrowed by many common law systems, e.g. most Canadian provinces and New Zealand. The Section 1-201(35), the former section 1-201(37), defines ‘security interest’ as including “an interest in personal property or fixtures which secures payment or performance of an obligation.” Note Article 9 was revised in 2001 and therefore renumbered.

⁵³ Drafted regulation section 3(1).

⁵⁴ See Law Commission, *Company Security Interests a Consultative Report* (Law Com No 176, 2004), para 2.81.

⁵⁵ When reforming the company law, the Government decided not to include the recommendations regarding registration of company security interests in the former the Companies Bill, which was then titled the Company Law Reform Bill and has become the Companies Act 2006 which received Royal

According to the proposed functional approach, whether a transaction falls within the scope of “security interest” is no longer a question of the intention of the parties or merely of interpretation. It will depend on one of characterisation of the transaction to which they have agreed, such as period of leasing, rental calculation, renew or purchase conditions, disposition of the asset, distribution of surplus, etc.

Consultative Report listed the following factors which would constitute a lease for a security purpose:⁵⁶

- whether the lessee is required to pay the bulk of the capital cost of the equipment;
- whether after that period the lessee has the right to continue to use the equipment for a reduced payment;
- whether if the equipment is not required by the lessee it is to be returned to the lessor or sold by the lessee as agent for the lessor;
- how the proceeds of any disposition are to be divided between the lessee and lessor; and
- who bears responsibility for maintenance of and repairs to the equipment during the currency of the lease.

The Law Commission proposed that any lease of goods for more than one year should be brought within the scheme for purposes of perfection and priority, whether or not it had a ‘security purpose’ in the conventional sense of securing a debt or performance of an obligation. Accordingly, an operating lease for more than one year would be treated in the same way as a finance lease; if it were not perfected by filing, the lessor would risk loss of priority to a buyer or a subsequent secured party and, if the lessee

Assent on 8 November 2006. The DTI has not yet reached a final decision on whether to accept the recommendations of the Law Commission and discussions will continue with interested parties about the merits of the proposals.

⁵⁶ They were not listed in the draft regulations, but it would be possible to do so if consultees think that would be desirable. See Law Commission, *Company Security Interests a Consultative Report* (Law Com No 176, 2004), para 3.32.

became insolvent, the lease would not be effective against the administrator or liquidator.⁵⁷ In other words, a lease whose term is more than one year would be treated as a lease registrable for the security interest which it contains so that the holder of the security interest would be protected with priority over other holders of security interests over the assets of the company.

If the proposals are accepted, the current classification of leases borrowed from the SSAP 21 would be disregarded. There would be leases required for registration, distinct from leases not for security purpose.

2.4.5 Summary

There are three sets of classifications of leases under English law, i.e. “finance leases” and “operating leases” in accounting, “short leases” and “funding leases” in taxation, and the leases for security purpose and not for security purpose under the proposed security registration scheme. With the exception of the accounting classification, they base their criteria on the finance/security substance of the transaction, especially the length of the transaction. Leases are divided by 5-year in taxation and 1-year in security registration. It was suggested to draw a 3-year distinction by the Diamond Report, which was the first security interest registration proposal in the UK.⁵⁸

It is admitted that, generally speaking, finance leases of an asset often are longer than operating leases of the same asset. For example, hiring a bouncing castle for the use of it for a day is an operating lease but hiring the same equipment for one or two years is likely to be regarded as a finance lease. However, other factors also affect the

⁵⁷ Law Commission, Consultation Paper No. 176, ‘Company Security Interests a Consultative Report’ (TSO 13 August 2004, London), para 2.96.

⁵⁸ It was suggested by professor Diamond to include leases over three years in the registration regime. See AL Diamond, *A Review of Security Interests in Property* (HMSO, London 1989) para 9.7.16.

length of the lease. Leasing a big-ticket item usually is longer than leasing a small-ticket item because it takes longer to pay off a bigger capital. For example, a finance lease of an aeroplane can be at a length of decades but a finance lease of a motor vehicle can be at a length of a couple of years. The length of the lease can also depend on the lessee's opportunity for finance. For example, a lessee who has good financial resources can make a term of finance lease less than the term of finance lease by someone who does not have. Therefore, the length of the lease cannot accurately, indicate whether the purpose of it is for security. To a degree, all leases have a financial element, being alternatives to sale.

Among the three classifications mentioned above, the classification in accounting is the most widely accepted. It is useful for the discussion of this thesis because it highlights one significant difference between a finance lease and an operating lease: the rewards and risks of ownership of the asset are transferred from the lessor to the lessee.

2.5 Finance leasing from the legal perspective

2.5.1 Introduction

Generally speaking, at law there is no universal labelling system to leasing but it is a common classification among the countries that there are two types of leasing: operating leasing and finance leasing.⁵⁹ This section will explain how the concept of finance leasing is defined under English law and compare it with the equipment leasing defined in the UCC of the US and the “international financial leasing” described by the Unidroit in the Unidroit Convention on International Financial Leasing 1988 (the “Convention”) and the Unidroit Model Law on Leasing 2008 (the “Model Law”).

2.5.2 The concept used by the English courts

There appears no legal definition of finance leasing under English law except the quotation of the definition of finance leases provided by the SSAP 21.⁶⁰

A finance lease is defined in SSAP 21 as one in which substantially all the risks and rewards of asset ownership are transferred to the lessee. Risks may include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions.⁶¹ Rewards may include the expectation of profitable operation over the asset’s economic life and the

⁵⁹ RM Goode, *Commercial law* (3rd edn, Penguin Books, London 2004) 721.

⁶⁰ Operating lease and finance lease are similarly defined in the International Accounting Solutions (IAS 17) (revised), ‘Leases’, which is a standard on accounting for leases published by the International Accounting Standards Committee (IASC) in 1982.

⁶¹ T Harding, ‘Operating or Finance Lease’ (2000) 126 (283) *Accountancy* 106.

expectation of gain from appreciation in value or realisation of a residual value.⁶² In contrast, the operating lease refers to any lease other than the finance lease.

The passage of the SSAP 21 was quoted by the deputy judge⁶³ and then affirmed by the Court of Appeal in the case of *On Demand Information plc (in administrative receivership) and another v. Michael Gerson (Finance) plc and another*,⁶⁴ which was concerned with four finance leases of equipment used for purposes such as making and editing videos.

Lord Hobhouse of Woodborough said:⁶⁵

“There is no problem about the financing agreements themselves ... They were elaborate agreements structured so as to keep the cost to the [lessee] as low as possible. They took the form of hire agreements.”

In that case, the House of Lords recognised the nature of finance leases to be financial.

The concept of “finance lease” appears to be a financial arrangement taking the form of hire.

First of all, finance leasing is a bailment, where one party is given possession of a chattel owned by somebody else.⁶⁶ Accordingly, finance leasing is given an essential feature of bailment that ownership is separated from possession. Secondly, finance leasing is a form of hire of goods in the group of bailment. The essence of a hire is to allow the user to acquire possession of the goods at a cost of paying rentals during a period of time. During the term, the title is retained by the owner as security to the payment obligation of the user and the user has neither option nor obligation to

⁶² T Harding, 'Operating or Finance Lease' (2000) 126 (283) *Accountancy* 106.

⁶³ [1999] 1 All ER (Comm) 512, p514-515.

⁶⁴ [2002] UKHL 13, [2003] 1 AC 368 (HL), rev'd [2001] 1 WLR 155 (CA). The quotation appeared in [2000] 4 All ER 734, per Robert Walker LJ, at 158.

⁶⁵ [2002] UKHL 13, [2003] 1 AC 368 (HL), per Lord Hobhouse of Woodborough, at 373.

⁶⁶ R Goode, *Commercial Law* (3rd edn, Penguin Books, London 2004) 721.

purchase the leased asset.⁶⁷ Under English law, a mere hire of goods means that the hirer never has the title to the goods nor the choice to obtain it and the title to the goods remains with the owner.

A contract for the hire of goods is subject to the Supply of Goods and Services Act 1982,⁶⁸ which excludes hire purchase, conditional sale, mortgage and pledge from the scope of its application.⁶⁹ The 1982 Act laid down implied terms as to title, quality and description for the contracts of hire, which are similar to those of the contracts of hire purchase⁷⁰ or sale but they are not identical.⁷¹

As Lord Hobhouse points out in *On Demand*,⁷²

“The title to the goods remained throughout with the [lessor] and was not at any time nor in any circumstances to pass to the [lessee] or any company associated with them. The [lessee] had the possession of the goods but no power to sell or otherwise deal with them either during the currency of the agreements nor afterwards. This structure reflected the fact that one of the important features of the agreements was the inclusion of provisions to enable the [lessor] to obtain the maximum tax advantages.”

Finance leasing may have variants. If the lessor purchases the equipment from a third party supplier, it is a direct lease. If the equipment is sold by the lessee and leased back from the lessor, it is a sale-and-leaseback. Finance leasing may involve another finance lease and consists of head lease and sublease, or involve a financier to finance the lease and become leveraged leases. When the lessor and the lessee agree to apply similar terms and conditions to a series of finance leasing transactions, they may enter

⁶⁷ The PricewaterhouseCoopers Leasing Teams, *International Leasing* (Tolley Publishing Company Ltd, London 2000) 202.

⁶⁸ S 6 of the Supply of Goods and Services Act 1982.

⁶⁹ S 1 of the Supply of Goods and Services Act 1982.

⁷⁰ R Goode, *Commercial Law* (3rd edn, Penguin Books, London 2004) 709 and 721.

⁷¹ Ss 6-10 of the Supply of Goods and Services Act 1982 apply to contracts of hire of goods. Ss 13-15 of the Sale of Goods Act 1979 apply to contracts of sale of goods. Ss 9-11 of the Supply of Goods (Implied Terms) Act 1973 apply to hire purchase agreements.

⁷² [2002] UKHL 13, [2003] 1 AC 368 (HL), per Lord Hobhouse of Woodborough, at 373.

into a master lease agreement, so that the subsequent lease arrangements between them could be easily commenced.

For the purpose of discussion in the thesis, the term “finance leasing” refers to the basic structure, which is a direct lease, signified by the involvement of the lessor, who acquires the asset from the supplier and leases it to the lessee. It is a tripartite transaction and includes a sale of the asset between the supplier and lessor under a “supply agreement” and a lease between the lessor and lessee under a “finance lease agreement”.

2.5.3 The concept under the UCC of the US

The US law is an important common law jurisdiction. With the American leasing companies’ expansion in the world, the US law has considerable influence on the law of finance leasing in the international sphere. The concept of finance leasing under the UCC may be useful to understand the concept of finance leasing in international trade.

Article 2A of the UCC of the US is a model leasing contract law adopted with few changes in most states in the US.⁷³ Before Article 2A was added into the UCC in 1987, finance leases were regarded as secured loan transactions under Article 9. The aim of Article 2A was to clarify that not all finance leases as financing transactions would be converted by law into secured loan transactions.⁷⁴ Thereafter, a transaction which takes the form of a lease and serves as a financial alternative to a sale of equipment may be subject to two or three laws, namely Articles 2 (Sales), 2A (Leasing) and 9 (Secured Transactions) of the UCC.

⁷³ By 2004, fifty states have adopted the UCC Article 2A, but Louisiana (Article 2 and 2A) and Connecticut remained outside. Source is from < <http://www.law.cornell.edu/uniform/ucc.html#a2a>>, accessed on 18 September 07.

⁷⁴ JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007) 977.

Leasing in general is subject to Article 2A UCC. A lease is defined to be a transfer of the right to possession and use of personal property for a period of time in return for consideration, such as money.⁷⁵

As opposed to a “true lease”, a lease under Article 2A may be a “finance lease”, if it meets the requirements under Section 2A-103 (1) (g).⁷⁶ In essence, the lessee, instead of the lessor, is required to have connection to the leased equipment, particularly regarding the selection, manufacture, supply and prior ownership, and he also should be notified of the content of the supply contract. Article 2A separates the lessor from a position of active involvement in supplying the equipment and therefore relieves him from many duties which he would otherwise bear under a ‘true lease’ and confers on the lessee those warranties provided by the supplier.

A lease would be regarded as a lease which creates a “security interest” and therefore be subject to Article 2 (Sales) and/or Article 9 (Secured Transactions), if it contains one of the factors under Section 1-203(b) UCC. For example, the lease term equals or exceeds the remaining useful life of the equipment, or the lessee is obligated to become the equipment owner at lease end, or the lessee has the right to purchase the equipment for a nominal amount, or can acquire the equipment without cost.⁷⁷

⁷⁵ Section 2A- 103(1)(j) UCC.

⁷⁶ The lessor must not select, manufacture, or supply the goods. The lessor must not lease the goods from inventory. The lessee must have access to the supply contract, or to information concerning warranties contained in the supply contract.

⁷⁷ Quoted from RM Contino, *Complete Equipment-Leasing Handbook: A Deal Maker's Guide with Forms, Checklists and Worksheets* (AMACOM, New York 2002) 209.

Hence, the dividing line between a secured sale and a lease under the UCC is as to whether the transferor retains a meaningful economic interest in the residual value of the equipment.⁷⁸ The option to purchase would not disqualify a purported lease.

The application of the different Articles of the UCC to a purported lease would make a difference to the interests of all the parties to the transaction and also those of third parties. For example, the lessee of a true lease is entitled to warranties from the lessor, but under a finance lease, the lessor is exempted from those warranties in non-consumer cases, because the lessee is involved in selecting the asset and is entitled to remedies from the supplier. If a lease creates a security interest, the lessor should register his security interest by filing documents in a central registry.

The UCC of the US contributed clear criteria to classify leases. The involvement of the lessee in the selection of the supplier and the provision of the specification of the asset is a key element of a finance lease. The distinction between a true lease and a finance lease is clearer than that between an operating lease and finance lease under English law.

2.5.4 The Unidroit Convention and Model Law

In the international sphere, the concept of finance leasing may vary from jurisdiction to jurisdiction. For example, hire purchase agreements are regarded as a form of finance leasing in some jurisdictions.⁷⁹

The International Institute for the Unification of Private Law (Unidroit)⁸⁰ recognised the need of unifying the laws applicable to finance leasing in the international sphere

⁷⁸ RM Contino, *ibid*, 210.

⁷⁹ For example, the US, France, Germany, Italy, Russia.

and aimed to remove the barriers so that this financing mechanism could be widely used to facilitate international sale of goods. Through a diplomatic conference hosted by the Canadian government in Ottawa, the Unidroit Convention on International Financial Leasing 1988 (the Unidroit Convention) was signed in May, 1988 and then came into force in 1995. To date (December 2009) the Convention has been ratified by twenty countries and came into effect in ten of them.⁸¹

In December 2008, the Unidroit Model Law on Leasing was made for countries to take as the basis of their domestic legislation. These two laws aim at unifying the legal rules pertaining to finance leasing in the international sphere so that international trade of equipment by the means of finance leasing would be facilitated.

This section will discuss the concept of finance leasing used in the two instruments in order to compare it with that under English law for the purpose of inspiration of reform, if needed, in English law.

The Model Law and the Convention refer to the form of lease arranged mainly for financial purpose as “financial lease”. It is called “international financial lease” in the Convention because the Convention applies to “financial leases” which have

⁸⁰ It was founded in 1926 by the League of Nations for the purpose of examining ways of harmonizing and co-ordinating the private law of States and groups of States, and to prepare gradually for the adoption by the various States of uniform legislation in the field of private law. It is an autonomous international organization whose offices are in Rome. See Article 1 of the Statute of the International Institute for the Unification of Private Law (Rome, March 15, 1994).

⁸¹ It has been signed or acceded by fourteen countries, which are Belgium, Czech, Finland, France, Ghana, Guinea, Italy, Morocco, Nigeria, Panama, Philippines, Slovak Republic, Tanzania and United States of America. It has been ratified by ten countries, which are Belarus, France, Hungary, Italy, Latvia, Nigeria, Panama, Russian Federation, Ukraine and Uzbekistan. France and Russian Federation reserved Article 8(3) and Article 20. The information refers to the Unidroit web <<http://www.unidroit.org/english/implement/i-88-1.pdf>> accessed 21 December 2009.

international factors, for example, the lessor and lessee have their places of business in different States.⁸²

The Model Law defines “financial lease” to be a lease, whether with or without an option to purchase all or part of the asset, that has three characteristics: a) the lessee specifies the asset and selects the supplier; b) the lessor acquires the asset in connection with the lease and the supplier has knowledge of that fact; and c) the rentals or other funds payable under the lease take into account or do not take into account the amortisation of the whole or a substantial part of the investment of the lessor. In the above four factors mentioned in the definition of financial lease, the option to purchase and the rentals at the amortised amount of the capital outlay and profit of the lessor are optional; thus, the other characteristics are requirements for a transaction to be regarded as a financial lease. Therefore, a financial lease under the Model Law must have the connection between the supply agreement and the lease agreement and the involvement of the lessee in selecting the supplier and specifying the asset.

The Convention did not attempt to provide a universally acceptable definition to the so-called ‘financial leasing’ transaction. Instead, in Article 1(1), it describes that a financial lease transaction involves two agreements entered by the lessor: a) on the specification of the lessee, the lessor enters into the supply agreement with the supplier under which the lessor acquires the asset on terms approved by the lessee so far as they concern his interests and b) he also enters into the lease agreement with the lessee to grant him the use of the asset. The Unidroit Convention also highlights three

⁸² Article 3 of the Convention.

non-exhaustive characteristics of it in Article 1(2).⁸³ Firstly, the lessee chooses the asset and supplier without relying primarily on the skill and judgment of the lessor. Secondly, the lessor acquires the asset in connection with a lease agreement which, to the knowledge of the supplier, has been or is to be made between the lessor and lessee. Thirdly, the rentals are calculated so as to take into account the amortisation of the whole or a substantial part of the cost of the asset. The Unidroit Convention applies to transactions, despite whether or not the lessee has, or subsequently acquires, an option to purchase the equipment, or hold it on lease for a further period (Article 1(3)). Thus the Convention applies to both civil law countries and common law countries, because in the former countries, finance leases usually contain an option of purchase at the end of the lease period but in the latter, for example, under English law, a purchase option is usually avoided.⁸⁴

The Convention and the Model Law are similar in the following ways as to the concept of “financial lease”: a) they neither require nor exclude an option to purchase the asset at the end of the lease; b) they highlight that financial leasing contains a triangular relationship among the lessee, lessor and supplier and it involves two interrelated agreements. Commonly, the financial lease transaction under the two laws comprise a supply agreement between the lessor and the supplier, under which the lessor acquires equipment according to the specifications of the asset required by the lessee on terms approved by him in his own interests, and a leasing agreement

⁸³ S Hall, ‘Legal Features of Cross-border Transactions’, in C Boobyer (ed) *Leasing and Asset Finance* (4th edn Euromoney Books, London 2003) 105.

⁸⁴ It is not very clear why English law excludes hire purchase agreements from finance leases. Apparently, from the historical perspective, the hire purchase agreements were firstly regarded as sales of goods and then regarded as a unique financial device in that the hirer has an option to buy but is not obliged to buy; but finance leases have always been regarded as a form of leases, free from arguments as to its nature, i.e. whether it is a lease or sale. From the regulatory perspective, the hire purchase agreements are regulated by statutes, e.g. the Hire Purchase Act 1965; but the finance leases are not specifically regulated, although, being a type of hire of goods, the Supply of Goods and Services Act 1982 applies to it in general.

between the lessor and the lessee, in which the lessor confers the right of possession and use of the equipment on the lessee in return for his payment of rentals.

However, they differ in their views as to the range of financial lease transactions.

Firstly, the Convention requires the rentals payable under an international financial lease transaction to reflect the repayment of the lessor's outlay and profit but the Model Law does not see it necessary to specify that the rentals of financial leases should be so calculated. In this sense, the Model Law has a broader scope of application. In addition, Article 3(1) of the Model Law excludes a lease that functions as a security right but the Convention is silent on this issue. The Convention may deliberately avoid tackling this issue, because at the time of its drafting, there had been personal property law reforms in the US and some provinces of Canada, such as Saskatchewan.

Although there is slight difference between the concepts used in the two laws of the Unidroit, they have contributed significantly to a common understanding of what a "financial lease" could be. It is clear that the lessor's interest in the asset is "purely financial in nature"⁸⁵ and that the financial lease transaction constitutes a triangular relationship between the parties.

These characteristics are useful criteria to define finance leasing. The Unidroit concept contributes to a common ground for the parties to understand the transaction in the international sphere. It would be useful to adopt it, because there has not been a clear legal definition or description of finance leasing under English law.

⁸⁵ The Unidroit Working Group Explanatory Report, *Preliminary Draft Uniform Rules on International Financing* (Unidroit Study LIX Doc 18, 1985) 23.

However, does English law acknowledge the same characteristics? If it does, the characteristics could and should be added for clarity of the legal concept of finance leasing under English law. If it does not, what are the characteristics of finance leasing under English law? Could they be underscored and spelled out? The next Chapters are aimed to answer these questions.

2.6 Concluding remarks

This Chapter has looked at the history of leasing, the advantages and disadvantages of finance leasing and discussed the concepts of finance leasing under English law.

The use of finance leasing in the international sphere has experienced rapid development by virtue of taxation benefits in the middle of 20th century in industrial countries such as the UK and the US. Since the reduction or loss of those taxation benefits, finance leasing has continued to be accepted as an alternative to sale for its other benefits, including good cash flow and maximum financing. It found favour particularly in developing countries and countries engaged in the transition to a market economy in the last few decades.

But the term “finance leasing” has slightly different meanings in accounting, taxation and law. The discussion has shown that the crucial characteristics of finance leasing are the lessor’s role as financier and the triangular relationship between the parties.

The next Chapters will consider whether English law has recognised them in the areas of contractual relationship and property right.

PART TWO – THE CONTRACTUAL RELATIONSHIP

Part Two aims to answer the question: “Does English law encourage the nature of finance leasing to be reflected in the parties’ relationship?” The parties’ rights and obligations to each other will be discussed, with a focus on how well the law recognises the lessor’s role as financier and the triangular relationship between the parties.

Part Two consists of three Chapters. Chapter 3 will look into the lessee’s obligations and Chapter 4 will examine the lessor’s obligations. Then Chapter 5 will consider the role of the supplier in the contractual relationship and seek to answer the question as to whether there is a triangular relationship between the parties, particularly whether in some cases a direct relationship between the lessee and supplier is recognised by law.

CHAPTER 3 THE LESSEE'S OBLIGATIONS

3.1 Introduction

This chapter and the next will discuss the relationship between the lessor and lessee under a finance lease agreement. It can be seen from the description of a finance lease in the SSAP 21 that, because the rewards and risks of ownership are largely transferred from the lessor to the lessee, the lessor acts as the financier and the lessee acts as the beneficial owner of the asset. As a result, the lessee enjoys the greatest rewards of ownership but also undertake significant risks of the asset. According to the finance lease agreement, he often has an obligation to pay the rentals, an obligation to use the asset in a good manner, an obligation to maintain it and an obligation to return it at the end of the lease or in its termination. These obligations are subject to common law and there is therefore little intervention by legislation. This thesis will focus on those specially reflecting the financial nature of a finance lease agreement. The discussion will focus on how well the law recognises the lessor's rights as a financier. It will examine the lessee's obligation to pay the rentals, because this is crucial to the return of the lessor's expectation. There will also be a short note on the lessee's obligation to maintain and to return the asset.

3.2 The lessee's obligation to pay the rentals

3.2.1 Introduction

In all contracts of hire for value, a vital obligation of the hirer is to pay for the use of the asset. The rentals in an operating lease are payable for the period of use and therefore are calculated to reflect the user value of the asset and the costs of its maintenance, insurance and taxation.⁸⁶ In contrast, the rentals stipulated in a finance lease agreement are payable not for the period of use but for the whole period of lease, regardless of how long it is actually used. If the finance lease is terminated before its maturity, the lessee will still be obliged, by contract, to pay the rentals for the full term of the lease, together with a right to share the majority of the proceeds arising from the disposal of the asset. The rentals are calculated to amortise the lessor's capital outlay and profit margin by the term of the finance lease.

In order to ensure his economic interests, the lessor commonly inserts certain clauses into the finance lease agreement, to the effect that, in the event of the lessee's default or insolvency, the lessee is obliged to pay the total rentals, including the rentals in arrears (referred to as "the current rentals") and the rentals to be paid for the rest of the lease (referred to as "the future rentals").

The lessee's obligation to pay the rentals regardless has been called a "hell or high water" clause, which originated in ship charter agreements and refers to an irrevocable and independent obligation to pay the total rentals.⁸⁷ Such an obligation to

⁸⁶ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 19.

⁸⁷ <<http://www.lesingsolutionsllc.com/why/history.shtml>> accessed 18 November 2009.

pay is a typical term of a finance lease in the US and is protected by the UCC.⁸⁸

Under English law, the parties' freedom of contract is recognised and the parties can provide specific clauses in their agreement suitable for their business purposes but the clauses may be subject to some rules which affect their enforceability, for example, the rule against a penalties, the rule against forfeiture and the provisions of the Unfair Contract terms Act 1977. When any of them applies, equitable relief would possibly be granted to the lessee and therefore free him from the liquidated damages obligation stipulated by the contract.

Aiming to answer the question of whether the lessee should pay the total rentals in his default, this section will firstly examine the rules and then discuss the attempts of the lessor to evade them and finally make suggestions on reforms which might be called for.

3.2.2 The rule against penalties

The rule against penalties means that, if a clause provides that a sum is *payable* by the defaulting party in circumstances of varying importance, it may be considered to aim to punish the defaulting party and therefore be "a penalty clause" and become unenforceable. If a clause of the finance lease agreement provides that, when the lessee fails to pay the current rental, he should pay damages to the lessor at a sum which is in equivalence to the total rentals, the lessee may claim for relief on the ground that that clause is a penalty clause and is subject to the rule against penalties.

⁸⁸ Section 2A-407 of the UCC and the Official Comment to the section.

The leading authority on the rule against penalties is the decision of the House of Lords in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,⁸⁹ which concerned a set of price maintenance clauses. The House of Lords laid down a few propositions, which were confirmed to be authoritative and are briefly summarised below.⁹⁰ Firstly, the intention of the parties is to punish the defaulting party.⁹¹ Secondly, the expression or label used by the parties to describe the clause has evidential value and *prima facie* indicates what they want to say, although the value is likely to vary in accordance with the equality of the bargaining power of the parties. Finally, the intention of the clause may be assessed by various tests, for example, whether the amount of damages is extravagant or unconscionable, whether it is greater than it ought to be, whether it applies to serious or trifling breaches, and whether or not the loss can be accurately pre-estimated.

The principles set up in *Dunlop* were applied to *Bridge v Campbell Discount Co Ltd*,⁹² which was a case concerning a hire purchase agreement. Clause 6 of the hire purchase agreement provided that: “The hirer may at any time terminate the hiring by giving notice of termination in writing to the owners, and thereupon the provisions of clause 9 shall apply.” Clause 9 provided that, if the agreement was for any reason terminated before the vehicle became the hirer’s property, the hirer “shall forthwith ... pay to the owners ... by way of agreed compensation for depreciation of the vehicle such further sums as may be necessary to make the rentals paid and payable equal to two-thirds of the hire-purchase price.” The hirer informed the owner that he could not keep up the payments and consequently he returned the car. According to clause 9, the

⁸⁹ [1915] AC 97 (HL).

⁹⁰ *Bridge v Campbell Discount Co Ltd* [1962] AC 602 (HL), per Lord Redcliffe, at 621.

⁹¹ [1915] AC 79 (HL), per Lord Dunedin, at 86.

⁹² [1962] AC 600 (HL).

owner claimed damages, consisting of the minimum sum, i.e. the two-thirds of the total price.

The House of Lords unanimously decided that, on the ground that the hirer did not exercise his option under clause 6 but was in breach of his obligations, the amount alleged due under clause 9 was not a genuine pre-estimate of damages but a penalty and that therefore the owner could not rely on clause 9. The case was remitted to the court of first instance to determine the amount of damages, if any, which the owner had suffered. The principle confirmed by the House in *Bridge* is that when a hirer fails to pay the rentals and the owner brings an action against him to claim for a minimum payment under the contract, such a clause is subject to the rule against penalties and becomes unenforceable.

However, it should be noted that the case of *Bridge* was decided on the ground that the hirer's letter and act of returning the car should be regarded as a breach of contract, departing from the point of law raised for consideration of the House, i.e. that of whether the hirer should be granted relief, if his letter was to be considered as exercising his right to terminate the contract.⁹³ Their Lordships, however, decided that the hirer's return of his car constituted a breach of contract and as a result the rule against penalties applied to a case where a sum was payable upon breach.

The legal question as to whether a stipulated sum payable upon an event, e.g. termination, should be subject to the rule against penalties was left open, with their Lordships expressing different views on the issue. Lord Morton of Henryton thought that the clause which stipulated a minimum sum payable on the occurrence of an

⁹³ [1962] AC 600 (HL), per Viscount Simonds, at 613.

event would have been enforceable, had the hirer terminated the contract pursuant to clause 6.⁹⁴ Viscount Simonds agreed and added that, in that case, the hirer would not be entitled to relief.⁹⁵ But Lord Denning and Lord Devlin disagreed on the ground that a liquidated clause could not be enforceable for one purpose but unenforceable for another. They also thought that relief would be granted against it, were the clause to be enforceable. Lord Radcliffe said that the question should remain open.

Lord Denning and Lord Devlin, however, had the view that, even in the case of termination, the hirer should be granted relief so that honesty in business could be encouraged. Lord Denning said: “the courts have power to grant relief against the penal sum contained in this ‘minimum-payment’ clause, no matter for what reason the hiring is terminated. The ‘minimum-payment’ clause is single and indivisible, and no just distinction can be drawn between the cases where the hirer is in breach and where he is not.”⁹⁶ Lord Denning illustrated his point that the law had granted relief against penalties in the area of non-performance of a condition, with examples of mortgage and penalty bond.⁹⁷ For example, when a mortgagor failed to repay the loan within a certain time the law had relieved him from being punished with deprivation of his right to redeem the mortgaged land.⁹⁸ When a person imposed a penalty bond on another person saying that the latter would be punished for not doing something, equity would relieve the latter from being punished for not doing it.⁹⁹ Therefore, Lord Denning held the view that the courts had power to grant relief against the penal sum

⁹⁴ *Ibid*, at 614-615.

⁹⁵ *Bridge v Campbell Discount Co Ltd* [1962] AC 600 (HL), at 614.

⁹⁶ [1962] AC 600 (HL), at 631.

⁹⁷ [1962] AC 600 (HL), at 630.

⁹⁸ *Ibid*, at 630, per Lord Denning, who referred to *Kreglinger v New Patagonia Meat and Cold Storage Co Ltd* [1914] AC 25 (HL), per Viscount Haldane LC, at 35.

⁹⁹ [1962] AC 600 (HL), at 630-631, per Lord Denning, who referred to *Tall v Ryland* (1670) 1 Ch Cas 183, at 184; 22 ER 753; *Collins v Collins* (1759) 2 Burr 820, at 826; 97 ER 579, and the very learned note by Mr Evans in his appendix to *Pothier on Obligations* (1806), Vol. II, p. 92.

contained in the ‘minimum-payment’ clause, no matter for what reason the hiring is terminated.¹⁰⁰

Lord Devlin agreed with Lord Denning that clause 9 should be treated as penal and relief be granted. He thought that no agreement could be “genuine for one purpose and a sham for another”.¹⁰¹ But he refrained from agreeing with Lord Denning’s view on the extension of the application of the rule against penalties to non-performance of a condition and emphasised on the interpretation of the actual wording of the clauses in each case.¹⁰² He was cautious about drawing a general principle that relief should be granted against penalties, regardless of whether or not there were breaches of contract.

Lord Denning’s view had merit on the point that the rule against penalties should not be limited to breaches of contract only.¹⁰³ But the House was not prepared to extend the application of the rule against penalties to the case where the hirer terminated the contract.¹⁰⁴

To sum up, the House of Lords confirmed in *Bridge* that the rule against penalties applied to the case where a minimum sum was payable at the hire purchaser’s default.

¹⁰⁰ *Ibid*, at 631.

¹⁰¹ *Ibid*, at 634.

¹⁰² *Ibid*, at 635.

¹⁰³ He also rightly expressed his concern that too narrow application of the rule against penalties might give rise to an unjust effect called ‘absurd paradox’: “it will grant relief to a man who breaks his contract but will penalise the man who keeps it.” He said, if the rule against penalties was confined to breaches of contract and did not extend further, it would mean: “if *Bridge*, after a few weeks, finds himself unable to keep up the instalments and, being a conscientious man, gives notice of termination and returns the car, without falling into arrear, he is liable to pay the penal sum of £206 3s. 4d. without relief of any kind. But if he is an unconscientious man who falls into arrear without saying a word, so that the company retake the car for his default, he will be relieved from payment of the penalty.” [1962] AC 600 (HL), at 629.

¹⁰⁴ The issue was settled in a later case of *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399 (HL). It was established that a case where a penal sum was payable on the occurrence of specific events was excluded from the application of the rule against penalties. The case will be discussed in section 3.2.5 below.

The rule against penalties was applied in *Lombard North Central Plc v Butterworth*,¹⁰⁵ which concerned a finance lease agreement. Clause 6(a) of the agreement provided that when the lessee fails to pay, the lessor was entitled to damages covering all arrears, damages for breach and all future rentals. This clause was decided by the Court of Appeal to be penalty, because it provided damages more than the rentals in arrear and the interest thereon in all circumstances of breaches varying in seriousness and triviality and also failed to give credit to the lessee in the proceeds of the asset resold.

Therefore, if a clause provides that the lessor is entitled to recover the future rentals at the lessee's default regardless, it is likely to be regarded as a penalty clause and therefore be unenforceable.

3.2.3 The rule against forfeiture

Sometimes, instead of a term in the contract which provides for penalty of a sum *payable* upon breach, there may be 'a forfeiture clause', which provides that, in the event of his failure to perform the contract, the defaulting party's money *paid* by him, or property transferred from him, will be forfeited by the innocent party. For example, if in the event of the lessee's default, the lessor retains the whole of the proceeds of the sale of the asset leading to forfeit of the lessee's share, the lessee might claim for equitable relief from forfeiture. Although the lessee would never become the owner of the asset and he is entitled to have certain proportion of the proceeds of the sale of the asset only after the primary lease period and he has paid the total rentals, the contingent right has been considered as a proprietary right and enables the lessee of a finance lease to equitable relief from forfeiture, in an action of the lessor for damages.

¹⁰⁵ [1987] QB 527 (CA).

The application of the rule against forfeiture to finance leases was established in *On Demand Information plc and another v Michael Gerson (Finance) plc and another*.¹⁰⁶

The defendant was a finance company, which had acquired video and editing equipment from a third party and leased them to the lessee under four finance leases agreements. Each lease was for a 'primary period' of 36 months and could continue for one or more periods of 12 months ('secondary periods'). Para 12 of Sch 2 of the lease agreements provided that the lessee could terminate a lease, by no less than 60 days' notice, before the primary period or any secondary period expired and then he could negotiate a sale of the equipment to a third party as an agent of the lessor and retain 95% of the proceeds.

When the primary rental had been paid on all but one of the agreements, the lessee went into administrative receivership, which constituted a repudiatory breach under the lease agreements. The lessor accordingly gave notice to the lessee to terminate all the lease agreements on the ground that receivers had been appointed. Believing that the only feasible means of keeping the lessee a going concern was to sell the company with the leased equipment to the proposed purchaser, the receiver of the lessee wished to achieve a speedy sale of the company including the equipment. Thus, instead of serving a 60-day notice pursuant to para 12 of Sch 2 of the lease agreements and exercising the contractual right to sell the equipment as an agent of the lessor, the lessee chose to seek leave of court for the sale of the company and the leased equipment with good title, on terms that the net proceeds of the equipment would be paid into an escrow account. The leave was granted and the sale took place. The lessee brought a motion for relief from forfeiture, requesting to have their share in the sale proceeds, as if the equipment had been sold in accordance with the lease terms.

¹⁰⁶ [2002] UKHL 13, [2003] 1 AC 368 (HL), reversing [2001] 1 WLR 155 (CA).

The judge held that, although the court had jurisdiction to grant relief from forfeiture in the case of a finance lease while the leased asset remained unsold, there was no jurisdiction to grant relief after it had been sold, because the contract was terminated and could not continue and also because the subject matter became money rather than property. Then both parties appealed to the Court of Appeal. The lessor contended that the court had no jurisdiction to grant relief from forfeiture in ordinary commercial cases unconnected with interests in land, and that, alternatively, if there was jurisdiction in relation to contracts other than those involving interests in land, it was confined to cases where there was a grant of a proprietary interest, not merely possessory. The lessee argued that relief should not be deprived of by the sale pursuant to an interim order and that he had proprietary right over the assets and subsequently the proceeds of them.

The Court of Appeal applied to the current case the requirement set in the speech of Lord Wilberforce in *Shiloh Spinners Ltd v Harding*,¹⁰⁷ i.e., the provision occasioning forfeiture could be regarded as a security for the payment of money or a security for attaining a specific and attainable result. It was held that the forfeiture right inserted into the four finance lease agreements was essentially aimed to provide the lessor with security for the lessee's payment of money and therefore fulfilled the requirement for the application of the rule against forfeiture. It was thus decided that a finance lease was in principle capable of attracting relief from forfeiture. As to the fact that those leases were commercial contracts with chattels as subject matter as opposed to land, it was held that it was a question of whether discretion should be exercised rather than of the court's jurisdiction. The Court held that, had the leased equipment not been sold, the lessee's possessory rights under the leases would have entitled him to relief

¹⁰⁷ [1973] AC 691 (HL).

from forfeiture. It was held (Sir Murray Stuart-Smith dissenting) that, after the sale, relief from forfeiture was not available to a case which did not involve a proprietary or possessory right and was not going to continue.¹⁰⁸ The lessee appealed and his appeal was upheld by the House of Lords.

The House directed judgment to grant an appropriate share of the money held in the escrow account.¹⁰⁹ Their Lordships agreed in principle with the courts below that relief from forfeiture became impossible due to the sale of the assets. However, they decided that the parties' contractual rights should not be affected by an interim order of the court, which was aimed to avoid the injustice that would result from property becoming worthless or being significantly reduced in value during the period between the application for sale and the determination of the relevant proceedings or issue. The House of Lords thought that relief from forfeiture was a means to the end of protecting the defaulting party's rights and pointed out that the court would grant other remedies when relief from forfeiture became impossible.

The following points are submitted to draw attention to the light shed by the decision of the case of *On Demand*¹¹⁰ on the rule against forfeiture and its application to finance leases. Firstly, the rule against forfeiture applies to finance leases. When a finance lease agreement contains a forfeiture clause, which provides that the rentals paid, or property transferred, or a certain proportion of the proceeds from the sale of the leased asset, would be forfeited at his default, the lessee has an equitable right to claim for relief from forfeiture. Lord Millett said in his *obiter*:

¹⁰⁸ [2001] 1 WLR 155 (CA), by Robert Walker LJ and Pill LJ (Sir Murray Stuart-Smith dissenting), at 174.

¹⁰⁹ [2002] UKHL 13; [2003] 1 AC 368 (HL).

¹¹⁰ [2002] UKHL 13, [2003] 1 AC 368 (HL), rev'd [2001] 1 WLR 155 (CA).

“Accordingly, it must be taken to be settled that the court would have had jurisdiction to grant relief from forfeiture in respect of all four leases on suitable terms at the date of the application for such relief and at all times until the actual sale of the equipment pursuant to Harman J’s order, which must be taken to have been properly made. No reason has been advanced before your Lordships why, if the jurisdiction existed, it should not have been exercised, and I would assume that, had the equipment not been sold, the lessee would have obtained relief from forfeiture and sold the equipment pursuant to clause 12 of the leases in due course.”¹¹¹

Secondly, the contention that the lessee’s right was a merely contractual right was at first rejected by the Court of Appeal¹¹² and then the House of Lords¹¹³ and this suggests that the lessee’s right over the leased asset is more than a contractual right. In fact, the Court of Appeal decided that either a proprietary or possessory right would have been sufficient to grant the lessee relief from forfeiture, had the leased equipment not been sold.¹¹⁴ By the time of the case of *On Demand*, the principle that “Relief is only available where what is in question is forfeiture of proprietary or possessory rights”¹¹⁵ had been established in case law.¹¹⁶ The requirement for a proprietary or possessory right highlights the reason to consider whether equitable

¹¹¹ [2002] UKHL 13, [2003] 1 A.C. 368 (HL), at 380. Lord Scott of Foscote also expressly said: “It was accepted both at first instance and in the Court of Appeal that immediately before the sale of the video and editing equipment pursuant to the order of Harman J on 5 March 1998, or perhaps immediately before the order was made, the court had jurisdiction to grant the appellants relief from the forfeiture of the finance leases that had been brought about by the entry of the appellants into administrative receivership.” [2003] 1 AC 368, at 382.

¹¹² *Ibid.*, per Robert Walker LJ, at 170.

¹¹³ [2003] 1 AC 368 (HL), per Lord Millet, at 379.

¹¹⁴ [2001] 1 WLR 155 (CA), per Sir Murray Stuart-Smith, at 176.

¹¹⁵ *BICC plc v Burndy Corporation and Another* [1985] Ch 232 (CA), per Dillon LJ, at 252.

¹¹⁶ The principle that relief against forfeiture can be granted in commercial contracts if the plaintiff has a proprietary or possessory right over the asset in question was gradually clarified by the time of the case of *On Demand*. It was explained by Lord Diplock in *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694 (HL) that, being mainly a historical statement, the speech of Lord Wilberforce in *Shiloh Spinners Ltd v Harding* [1973] AC 691 (HL), at 702, never meant to apply generally to contracts not involving any transfer of proprietary or possessory rights. In the subsequent case of *Sport International Bussum BV v Inter-Footwear Ltd* [1984] 1 WLR 776 (HL), the House of Lords decided that the rule against forfeiture did not apply to mere contractual licences and as a result the court’s jurisdiction to grant relief against forfeiture was confined to cases which involved the transfer or creation of proprietary or possessory rights. The principle was then applied to the case of *BICC plc v Burndy Corporation and Another* [1985] Ch. 232 (CA), where the Court of Appeal granted relief from forfeiture to the first defendants on the ground that they had proprietary rights over the patents under a commercial agreement. It was also decided in that case that, in the exercise of its discretion, the court would grant relief by extending the time in which payment was to be made under an assignment agreement.

relief could be granted to the defaulting party's request – only when the defaulting party's interest is so substantial as to stand against the innocent party's contractual right.

Thus, the decision of the Court of Appeal in *On Demand* seemed to indicate that the lessee's right over the leased asset was not only a contractual right but also a proprietary or possessory right. The exact nature of the lessee's right over the asset will be discussed later in this thesis.¹¹⁷

Thirdly, the case of *On Demand* also confirmed another principle regarding the rule against forfeiture that relief should be granted only when the contract could continue.¹¹⁸ The Court of Appeal quoted the speech of Dillon LJ in *Fuller v Judy Properties Ltd*¹¹⁹ that “the object of relief against forfeiture is the continuation of a lease, not its extinction”. It is obvious that, only if the innocent party's loss of interest of the contract arising from the default could be remedied by the performance of the defaulting party, will the latter's request for relief from forfeiture be granted. Often, an extended period of time is given by the court for the defaulting party to perform his payment obligation and, on this condition, the court grants relief from forfeiture to the defaulting party.

Fourthly, the case of *On Demand* also highlighted that relief from forfeiture was a means to an end, which may be achieved by other means. With the intention of protecting his commercial valuable rights in the lawsuit, the lessee in that case claimed for relief from forfeiture while the court issued the order for sale at his request. He (and the court) did not anticipate that, following the sale, the leases ceased

¹¹⁷ Chapter 7 below.

¹¹⁸ [2001] 1 WLR 155 (CA), per Robert Walker LJ, at 174.

¹¹⁹ (1991) 64 P & CR 176 (CA), at 184.

and the claim for relief from forfeiture lost its ground. But Lord Millet said: “The sale brought an end to the lessee’s claim to a particular remedy, viz. relief from forfeiture, but not to the rights to which such a remedy would have responded, and substituted a claim to payment out of the fund.”¹²⁰

This statement suggests that, where relief from forfeiture is impossible or inappropriate but the circumstances call for a solution, the court is prepared to grant another form of remedy to bring justice to the transaction. Lord Hobhouse of Woodborough also recognised: “The purpose of claiming relief was so that the appellants could take advantage of the provisions for the sale of the goods and enjoy the benefit of the rebate.”¹²¹ The lessor had received almost all of the rentals due for the full length of the leases; if no remedy were granted, the lessor would receive substantial windfalls from the remaining value of the leased asset and this would be unjust to the lessee, who should enjoy most of the proceeds under the contract.¹²² The decision of the House of Lords demonstrates that the grant of relief from forfeiture, together with other possible remedies, is a means to achieve justice.

Fifthly, the Court of Appeal said that the forfeiture clauses in question were a security for the payment of money, fulfilling the conditions given in the passage of Lord Wilberforce in *Shiloh Spinners Ltd v Harding*,¹²³ viz. “the object of the transaction and of the insertion of the right to forfeit is essentially to secure the payment of money”.¹²⁴ Further, the House of Lords commented that the forfeiture clauses in question were “default provisions of a familiar kind which gave the [lessor] the right

¹²⁰ [2003] 1 A.C. 368 (HL), at 382.

¹²¹ [2002] UKHL 13, [2003] 1 AC 368 (HL), per Lord Hobhouse of Woodborough, at 373.

¹²² [2001] 1 W.L.R. 155 (CA), per Sir Murray Stuart-Smith, at 179.

¹²³ [1973] AC 691 (HL).

¹²⁴ [1973] AC 691 (HL), at 722.

to bring the agreements to an end at any stage if the appellants failed to perform their obligations. These were the forfeiture rights which the [lessor] exercised and from which the [lessee] claimed relief in the action.”¹²⁵ Although being *obiter*, the recognition quoted above shows that the forfeiture clauses of the finance leases function as security for the payment of money.

Finally, the House of Lords also recognised the nature of finance leases to be financial.

Lord Hobhouse of Woodborough said:

“There is no problem about the financing agreements themselves ... They were elaborate agreements structured so as to keep the cost to the [lessee] as low as possible. They took the form of hire agreements. The title to the goods remained throughout with the [lessor] and was not at any time nor in any circumstances to pass to the [lessee] or any company associated with them. The [lessee] had the possession of the goods but no power to sell or otherwise deal with them either during the currency of the agreements nor afterwards. This structure reflected the fact that one of the important features of the agreements was the inclusion of provisions to enable the [lessor] to obtain the maximum tax advantages.”¹²⁶

In summary, the case of *On Demand*¹²⁷ decided that the rule of relief from forfeiture applied to the case of finance leases and it also clarified a few specific points in relation to the rule against forfeiture.

It should be noted that *On Demand* was decided in the context that the finance leases were terminated in the event of the lessee’s insolvency. In theory, the same principle should be applicable to finance leases where they are terminated on the lessee’s default. This assumption was confirmed by the case of *More OG Romsdal*

¹²⁵ [2002] UKHL 13, [2003] 1 A.C. 368 (HL), per Lord Hobhouse, at 373.

¹²⁶ [2002] UKHL 13, [2003] 1 AC 368 (HL), per Lord Hobhouse, at 373.

¹²⁷ [2002] UKHL 13, [2003] 1 AC 368 (HL), rev'd [2001] 1 WLR 155 (CA).

Fylkesbatar AS v The Demise Charterers of the Ship Jotunheim,¹²⁸ which concerned a demise charterparty of a vessel.

Clause 32 of the charter provided that, in the case of the hirer's failure to pay, the vessel would be returned to the owner free from expense and that the owner would not be obliged to pay back any money paid down during the bareboat period but be entitled to damages if the rentals received could not cover the losses and expenses. When the hirer failed to pay two rentals at the specific times of payments, the owner pressed to receive the third rental on time with the threat to withdraw the vessel in the event of failure to pay it again. The hirer failed to pay it on the specific day. The owner gave notice to the hirer to inform him of the termination of the charterparty and claimed for possession of the vessel on the ground that the charter had been terminated for non-payment. The hirer argued that specifications as to payment were not of the essence of the charter because the agreement was a conditional sale rather than a hire purchase and also that the court had jurisdiction to grant relief from forfeiture and it should grant it to him in the present case.

As to the question of the time of payment, Cooke J decided that, because Clause 32 set out the specific consequences of failure to make any payments due, it was of essence of the charterparty.¹²⁹ He then considered whether the rule against forfeiture should apply to the case. The classic passage of Lord Wilberforce in *Shiloh Spinners Ltd v Harding*¹³⁰ was cited to show that the court could grant relief from forfeiture of a contract such as this, provided that the object of the transaction and of the insertion of the right to forfeit for non-payment of money was essentially to secure the payment

¹²⁸ [2004] EWHC 671 (Comm), [2005] 1 Lloyd's Rep 181 (Com Ct).

¹²⁹ [2005] 1 Lloyd's Rep 181 (QB), at 186.

¹³⁰ [1973] AC 691 (HL), at 723-724.

of that money or was security for the attainment of a specific result which could be achieved through the courts.¹³¹ Cooke J found that the owner of the vessel could always sue for recovery of rentals and deposits due, so the insertion of the right to withdraw the vessel under Clause 32 was essentially to secure that the rentals and the deposits required would be paid at certain times.¹³² Further, Cooke J refused the owner's argument that, by analogy to the case *The Scaptrade*,¹³³ relief from forfeiture was not available in a charterparty case. It was explained that relief from forfeiture was not available in *The Scaptrade* partly because it was a case of a time charterparty, under which the hirer had no possessory right over the vessel. However, in *More OG*, Cooke J decided that the hirer had possessory rights over the vessel during the period of the charterparty and also had a right to obtain ownership at the end of the period. Thus the court had jurisdiction to grant relief from forfeiture in the present case.

When exercising discretion, Cooke J considered the gravity of the lessee's breach, particularly the hirer's wilful failure to pay the rentals at the specific times and the disparity between the value of the vessel and the damage caused by the breach. Relief was not granted on the ground of the facts of the case.¹³⁴

The decision of *More OG* shows that, when the hirer fails to pay, the owner of a vessel may exercise his right of withdrawal pursuant to the charter, together with a right for damages and forfeiture of the rentals and deposits, meantime, the lessee can claim for relief from forfeiture. Because the characteristics of a charterparty by demise are essentially similar to those of a finance lease, the case of *More OG* not

¹³¹ [2005] 1 Lloyd's Rep 181 (QB), at 188.

¹³² [2005] 1 Lloyd's Rep 181 (QB), at 189.

¹³³ *The Scaptrade* [1983] 2 Lloyd's Rep 25 (CA).

¹³⁴ [2005] 1 Lloyd's Rep 181 (QB), at 190-191.

only followed the line of authority in relation to forfeiture, but also added a new factor to the law pertaining to finance leasing.

It is submitted that, by analogy, the decision that the insertion of the owner's right to withdraw the vessel on the substantial breach of the hirer under a charterparty by demise was aimed to provide security to the owner could mean that in a finance lease the lessor's retention of the right of repossession of the asset is to secure his interest in the payment of the rentals. As a result, if the finance lease agreement provides that punctual payment of the rentals is of essence of the contract and, upon the lessee's failure to pay, the lessor can repossess the asset and forfeit the rentals, when the lessee fails to pay the rentals pursuant to the contract, the court may support the lessor's right to terminate the contract and to repossess the asset and refuse the lessee's request for relief from forfeiture by discretion.

Therefore, it can be seen that the rule against forfeiture applies to the cases of finance leases in both the event of the lessee's failure to pay and the event of his insolvency.

3.2.4 Penalty or forfeiture?

From the above discussion, it appears that both the rule against penalties and the rule against forfeiture are equitable principles aimed at protecting the defaulting parties. The application of both rules requires the clauses in question to be purposed to provide security to the innocent party. When the clauses are subject to the rules in equity, they could be unenforceable and thereby the lessee can escape from paying the sum agreed in a contract.

However, there are differences between the rules and their application. A "penalty" clause usually concerns the money *payable* by the party on his default but a

“forfeiture” clause usually concerns the money already *paid*, or a property already transferred or some of its property right enjoyed. If a clause is recognised as a penalty, relief will be granted automatically; but, after a clause is considered to be a forfeiture clause, the court will exercise discretion as to whether relief from forfeiture should be granted. Furthermore, granting relief against penalties leaves the defaulting party to pay damages in common law which would cover the innocent party’s actual loss; but granting relief from forfeiture usually take the form of extra time being given to the defaulting party for him to pay the rentals along with interest and costs. Moreover, the rule against penalties mainly applies to the cases when the payment is required at default. But the scope to grant equitable relief from forfeiture is broader. It has been granted to the cases when forfeiture happens at default and in insolvency.

In general, the defaulting party can choose the most beneficial approach to establish his case. In other words, he can claim for relief from forfeiture or penalty or both. It is usually obvious whether the innocent party’s claim would give rise to forfeiture or penalty, depending on whether the money claimed for is paid or payable. However, as it will be illustrated in the two cases below, sometimes a clause might have characteristics of both kinds and it could be difficult to decide which rule to apply.

The first case is the case of *Transag Haulage Ltd v Leyland DAF Finance plc & Anor*,¹³⁵ which concerned three hire purchase agreements under which the hirer hired three lorries by paying the outstanding sum by instalments. Clause 24 provided him with an option to purchase the lorries for £5 once he had paid all the sums due under the agreement. Clause 13 provided that, in the event that a receiver was appointed, the future instalments became due. Clause 14 provided that at default of the hirer, the

¹³⁵ [1994] BCC 356 (CD).

owner could terminate the agreements and repossess the vehicles. The hirer went into receivership.

There was no failure to pay instalments by the company before the administrative receivers were appointed. At the time when the hirer went into receivership, the lorries were together valued at between £65,000 and £72,500 but the sum of remaining future instalments was then just over £14,000. In the fear that the owner might recover possession of the vehicles, the receivers sought an order from the court to grant relief, whether from a forfeiture or a penalty, against the owner's request for repossession and claim for damages.

Knox, J. first of all, distinguished the application of the rule against penalties in that case, because Clause 13 was not a clause in respect of payment for a breach of contract but payment of a sum on an event, namely, the appointment of a receiver.

Then deciding on the fact that the owner did not claim for retaining the past payment of instalments, he identified the only possible forfeiture of the hirer's interest to be the loss of a contingent right to buy the vehicles for £5 pursuant to clause 24, if the owner were allowed to withdraw them from the possession of the hirer. Applying the case of *BICC Plc v Burndy Corp*,¹³⁶ the judge decided that the loss of the right to exercise the purchase option could be described as a forfeiture of a proprietary right and accordingly the court had jurisdiction to grant relief from forfeiture.¹³⁷ Next, exercising discretion, Knox J particularly considered the disparity between the value of the vehicles and the owner's loss, i.e. if the owner could not obtain what he contracted for, no relief would be granted; if the owner would obtain a substantial

¹³⁶ [1985] Ch 232 (CA).

¹³⁷ The issue as to the court's jurisdiction to grant relief from forfeiture of the asset will be discussed in Chapter 7 below.

benefit above and beyond what he contracted for, except for situations where the hirer's conduct was such as to disentitle him to relief, relief should be granted. He finally decided that relief could be granted to the hirer's receiver on the condition that the outstanding instalments could be paid within seven days.

The case of *Transag* applied the rule against forfeiture on the ground of the facts. Were the hire purchase agreements finance leases, the lack of option to purchase the asset would prevent the lessee from claiming for relief from forfeiture of his right to purchase; however, it is submitted, he should still be able to claim for relief from forfeiture of his substantial commercial interest in the remaining value of the asset entitled under the contract, following the case of *On Demand*.

In another case, *Jobson v Johnson*,¹³⁸ the defaulting party also claimed for relief from either penalty or forfeiture, and on this occasion the issue as to whether relief could be given to penalty or forfeiture was not as clear as in *Transag*. In that case, the plaintiff had some shares in a football club and the defendant agreed to buy all of them by instalments. Paragraph 6(b) of the side letter, which constituted part of their agreement of sale, provided that if the buyer defaulted in payment, the shares would be retransferred to the seller at a fixed price below the actual value. When the buyer failed to pay, the seller sought to enforce the provision for retransfer. The buyer contended that the clause was a penalty and counterclaimed for relief from 'forfeiture of the shares'. But this counterclaim was struck out on the ground of failure to comply with an undertaking regarding discovery of documents considered material on the issues and the defendant did not appeal.

¹³⁸ [1989] 1 WLR 1026 (CA).

The Court of Appeal agreed the clause was penal, on the ground that, as Kerr LJ put it, it “subject[ed] the defendant to the same liability irrespective of the gravity and consequences of the breach relied upon by the plaintiff in seeking to enforce the clause”.¹³⁹ Instead of representing a genuine pre-estimate of the seller’s loss, the clause aimed to punish the buyer in default by retransferring the shares back at a fixed price less than the defendant had paid. The defendant’s claim for relief against penalties was upheld.

The Court agreed that the innocent party, the seller, could sue on the penalty clause, “but it will not be enforced ... beyond the sum which represents [his] actual loss”.¹⁴⁰ They were concerned that the value of the shares would exceed the plaintiff’s loss. So they decided to direct an inquiry to ascertain the current value of the shares, the aggregate of the unpaid instalments and the outstanding amounts charged on the shares. Following that, they would either order a sale of the shares with payment to the seller of the amount of the unpaid instalments and interest, if the value of the shares were to exceed the sum presently due from the buyer, or make an order of specific performance in the terms of paragraph 6(b) if such value were to be less than the sum due.¹⁴¹

This was a “puzzling case”.¹⁴² Paragraph 6(b) provided that the buyer should retransfer the shares purchased by him on his failure to pay the whole price. The court’s decision had merit in that the clause could be a penalty clause in the sense that it failed to represent a genuine pre-estimate of the seller’s loss but it aimed to punish the buyer by forcing a retransfer of the shares at a fixed price less than he had paid.

¹³⁹ [1989] 1 WLR 1026 (CA), per Kerr LJ, at 1047.

¹⁴⁰ [1989] 1 WLR 1026 (CA), per Dillon LJ, at 1036.

¹⁴¹ [1989] 1 WLR 1026 (CA), per Dillon LJ, at 1037, 1046.

¹⁴² [1989] 1 WLR 1026 (CA), per Kerr LJ, at 1046.

However, once the shares had been transferred to the buyer, they belonged to the buyer; to retransfer them would represent another sale of the shares. This explains why the court felt bound to find out the value of the shares in the second sale. If they were worth more than the fixed price, the exceeding amount would be the amount which the original seller could forfeit. Paragraph 6(6) could simply be a forfeiture clause.

In fact, the Court considered that the clause was also “a forfeiture clause” and was “something of a hybrid”.¹⁴³ Kerr LJ said: “it is in my view much closer to what is commonly referred to as a ‘forfeiture’ than a ‘penalty’ clause.”¹⁴⁴ Indeed, it is submitted, the dispute was more an issue of forfeiture than of a penalty clause, because the enforcement of retransfer of the shares would deprive the buyer of his ownership of the shares (his money *paid*), rather than punish him with an extra payment (a sum *payable*). But because the counterclaim for relief from forfeiture was struck out in the first instance and was not appealed, the Court of Appeal had to decide on the issue of penalty. In principle, the case could be a case of penalty, if the difference between the actual loss of the seller and his gain in the retransfer would prove to be significant.

However, although the retransfer price was set to be less than the defendant had paid, it was merely an assumption that the same percentage of the shares would worth more than the retransfer price, though it seems to be the case, and therefore the Court did not have sufficient evidence to say that the retransfer price was unfair and aimed to punish the defendant.

¹⁴³ *Ibid*, per Nicholls LJ, at 1043; Kerr LJ, at 1047.

¹⁴⁴ *Ibid*, at 1047.

The case of *Jobson* is a good example of the problems caused by ambiguity as to whether the clause in question is a penalty clause or a forfeiture clause. The difficulty in deciding the nature of the clause gave rise to disagreement between the judges as to the remedies available to the plaintiff. Were there an issue as to a forfeiture clause, relief in the form of an extension of time for the defendant to pay the instalments due could have easily solved the dispute. However, because the court could not decide on the forfeiture issue, the judges had to seek alternative remedies under the rule against penalties. Thus, the actual loss of the plaintiff had to be assessed. Nevertheless the way by which the Court of Appeal measured the innocent party's remedy was problematic. Nicholls LJ said, with concurrence of the other judges,¹⁴⁵

“the strict legal position [of a penalty clause in a contract] is not [emphasis added] that such a clause is simply struck out of the contract, as though with a blue pencil, so that the contract takes effect as if it had never been included therein. Strictly, the legal position is that the clause remains in the contract and can be sued upon, but it will not be enforced by the court beyond the sum which represents, in the events which have happened, the actual loss of the party seeking payment.”¹⁴⁶

Although it is true that, in practice, the defaulting party would not pay more than the actual loss of the innocent party, this effect does not result from a principle that the penalty clause is enforceable up to the extent of the innocent party's actual loss, rather, a measure of the remedies to which both parties are entitled: the defaulting party is relieved from the obligation of payment under the penalty clause on the condition that the innocent party's actual loss can be recovered from him. In *Bridge v Campbell Discount Co Ltd*,¹⁴⁷ Lord Denning MR said that relief against penalties could only be granted on the condition that the defaulting party would pay the damage which the innocent party had really sustained. It is therefore submitted that it is more accurate to

¹⁴⁵ [1989] 1 WLR 1026 (CA), per Dillon LJ, at 1038; Kerr LJ, at 1049.

¹⁴⁶ *Ibid.*, at 1040.

¹⁴⁷ [1962] AC 600 (HL), at 632.

say that under the rule against penalties, if a clause is found to be penalty, it is *unenforceable* and the innocent party's remedy will be measured by his actual loss at common law.

A finance lease would not have a provision of resale. However, it is possible to have a provision of a hybrid of the penalty clause and the forfeiture clause. For example, a clause may provide that at the lessee's default, the lessor is entitled to repossess the asset and retain the proceeds of the sale and the lessee should pay the lessor the rest of the rentals. In this case, the lessee is obliged to pay the total rentals and is also deprived of the value of the asset in its disposal. The lessee's obligation is more than the lessor's expectation from the contract even if it is properly carried out. The lessee can claim for relief against penalties, because he is obliged to pay the total rentals regardless of the seriousness of his breach. He also can claim for relief from forfeiture on the ground that his substantive interest in the asset would be forfeited, if the lessor is allowed to claim the damages pursuant to the contract. In this circumstance, it is very useful to allow the lessee to choose under which rule, or both, he claims for relief. But this approach has caused an ambiguity in the extent to which the court should grant relief from forfeiture or penalty as it has been exposed in *Jobson v Johnson*.¹⁴⁸ However, it appears that this ambiguity is necessary in order to maintain the flexibility required by the law.

In short, the rule against forfeiture is more flexible than the rule against penalty. The rule against forfeiture is broader in its scope of application than the rule against penalties, because the former applies to insolvency and default but the latter merely applies to default. Moreover, relief from forfeiture is a milder remedy than relief from

¹⁴⁸ [1989] 1 WLR 1026 (CA).

penalty because the contract would continue in the former case but would be struck out in the latter case.

In order to obtain his commercial interest in the payment of the total rentals, the lessor has attempted to evade the application of the equitable rules. The law has allowed the innocent party to recover a minimum sum payable in the lessee's default or insolvency by the means of three types of clauses. A clause may stipulate payment on the occurrence of an event other than breaches of contract, or a clause may stipulate that the future rentals become due when the lessee fails to pay the current rentals, or a clause may make the payment obligation a condition of the contract. These clauses will be discussed one by one below for the purpose of finding out the scope allowed for freedom of contract, before a conclusion is drawn as to whether the law with regard to the lessee's payment obligation is satisfactory overall.

3.2.5 A clause providing payment on occurrence of an event

If a clause stipulates that a sum is payable on the occurrence of an event, it may provide for escape from the application of the rule against penalties.

In *Bridge v Campbell Discount Co Ltd*,¹⁴⁹ Clause 6 of the hire purchase agreement stipulated that if the hirer terminated the contract, he would be obliged to pay a minimum sum of the total rentals as damages to the owner under Clause 9. Clause 9 was decided to be penalty on the ground that the payment was required for breaches of varying importance. However, it was left undecided by the House of Lords as to

¹⁴⁹ [1962] AC 600 (HL).

whether a stipulated sum payable upon an event, which was termination under Clause 6 in that case, should be subject to the rule against penalties.¹⁵⁰

In a later case *Export Credits Guarantee Department v Universal Oil Products Co*,¹⁵¹ it was established that a case where a penal sum was payable on the occurrence of specific events was excluded from the application of the rule against penalties. In that case, it was decided that a clause requiring the guarantors, in the event of default of their obligations under other agreements, to reimburse the guarantors for any sums paid by them, was not a penalty clause and was enforceable.

Unfortunately, the House of Lords made no attempt to discuss those opinions expressed in *Bridge* as to whether or not the rule against penalties should be limited to the case of breaches of contract,¹⁵² probably because no such dispute arose in *Export Credits*. Their Lordships simply confirmed that there is a limitation to the scope of the law on penalties: it does not include a clause which provides for a sum payable on the happening of an event.

For the current purpose, it is sufficient to say that a clause which provides for payment on the occurrence of an event falls outside the rule against penalties.

As a result, the law strikes a balance between the two parties' interests. It allows the lessee to be released from a large amount of penalty via the rule against penalties and the rule against forfeiture, whilst, for the sake of the parties' freedom of contract, it

¹⁵⁰ Details were discussed in section 3.2.2 above.

¹⁵¹ [1983] 1 WLR 399 (HL).

¹⁵² AG Guest and EP Ellinger (eds) *Benjamin's sale of goods* (7th edn The Common law library Sweet & Maxwell, London 2006), Volume 1, §16-035.

excludes payment of a sum payable upon specified events other than breaches of contract. Lord Roskill explained in *Export Credits*:¹⁵³

“one purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain.”

It is obvious that the law aims to prevent oppression and injustice by the use of the rule against penalties but it does not prepare to rewrite the bargain for the parties.

Inevitably, there could be a paradox in the exclusion of the clause providing payment on the occurrence of an event, as was pointed out by Lord Denning the case of *Bridge*:¹⁵⁴ an honest man who has no ability to pay and therefore terminates the contract and returns the goods would be obliged to pay a sum agreed in his contract under the clause which provides that the sum is payable when the person terminates the contract, however an unconscientious person who has no ability to pay but lets the rentals fall in arrears will not pay a ‘penalty’ because the provision to this effect is subject to the rule against penalties and therefore unenforceable. If this happened, admittedly, it would be unfortunate.¹⁵⁵ Probably aiming to avoid its occurrence in *Bridge*, the House of Lords interpreted the facts in favour of the honest hirer. Hence, there are good reasons to hope that the courts would be sensitive with the application of the law, so that the law on penalties would protect the honest man who terminates the contract (under an express power to do so) when he finds that he is unable to fulfil

¹⁵³ [1983] 1 WLR 399 (HL), at 403.

¹⁵⁴ [1962] AC 600 (HL), at 629.

¹⁵⁵ AG Guest and EP Ellinger (eds) *Benjamin's sale of goods* (7th edn The Common law library Sweet & Maxwell, London 2006), Volume 1, 16-035.

his remaining obligations, but not the person who deliberately breaks his contractual obligations.

Thus, it is submitted that the rule against penalties does not apply to the occurrence of an event and that the lessor can evade the application of the rule against penalties by including in the finance lease agreement a clause which provides that the lessee should pay a sum on the happening of an event.

3.2.6 An acceleration clause

Another clause which may exclude the application of the rule against penalties is an acceleration clause and can be often found in a contract providing for payment by instalments. It provides that, on default of paying one instalment, all future instalments become immediately payable as one sum.¹⁵⁶ The theory behind an acceleration clause is: a sum of money is due at the beginning of the contract and payable by instalments pursuant to conditions; if one of the conditions is broken, for example, one instalment is unpaid, the future instalments will become immediately payable as one sum. The 'present debt' and an 'indulgence' are the two crucial ingredients.¹⁵⁷

Having the effect that the lessee is obliged to pay the total rentals when he fails to pay one, acceleration clauses are similar to minimum payment clauses. But by making the sum payable in the future a deferred present debt, it usually avoids the application of the rule against penalties because the default party's overall obligation is not

¹⁵⁶ Quotation is from Hugh G Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 26-140.

¹⁵⁷ E McKendrick, 'Liquidated Damages and Related Clauses' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 955-974, 964.

increased.¹⁵⁸ For example, in *Oresundsvarvet AB v Lemos (The Angelic Star)*,¹⁵⁹ the Court of Appeal upheld an acceleration clause in a contract of loan which provided that once one instalment was unpaid the rest of the instalments became due and payable, together with the interest up to the date of default.¹⁶⁰ It was decided that, on the borrower's failure to pay an instalment, the lender was entitled to repayment of the whole capital of the loan and also the interest due at the date of default. Because finance leases are essentially financing agreements and consist of elements of instalments, it is possible that, by analogy to the principle applicable to an acceleration clause in a loan contract, an acceleration clause in a finance lease agreement would be regarded as valid and therefore the total rentals are payable by the lessee in his failure of payment.

However, the clause should be drafted carefully to create a present debt and a condition under which the debt is payable by instalments, a breach of which would lead to immediate payment of the debt.¹⁶¹

Also, it is important that the acceleration clause should not conflict with other clauses, particularly a clause of repossession. This is because "[the] acceleration of payment presupposes the continuance of the agreement, but upon terms that the debtor's liability, instead of being capable of discharge by instalments as originally provided, now becomes immediate."¹⁶² If the lessor claims for the sum under an acceleration clause, he should regard the contract as continuing; an attempt to claim for the total rentals and also to repossess the goods will attract the application of the rule against

¹⁵⁸ Hugh G Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 26-140.

¹⁵⁹ [1988] 1 Lloyd's Rep 122 (CA).

¹⁶⁰ *The Angelic Star* [1988] 1 Lloyd's Rep 122.

¹⁶¹ E McKendrick, 'Liquidated Damages and Related Clauses' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 955-974, 964.

¹⁶² RM Goode, 'Acceleration Clauses' [1982] *JBL* 148.

penalties. It is sensible that, once the lessee is obliged to pay the total rentals, he should be entitled to retain the asset for the rest of the leasing period and the lessor has no justification for depriving him of the possession.¹⁶³ Goode points out, “The reason why claims to accelerated rentals have almost invariably failed is that lessors insist on combining them with repossession of equipment following termination of the agreement, when it is axiomatic that rent cannot be charged as such in respect of periods after such termination.”¹⁶⁴

So, in principle, the innocent party has to choose: either to accept the other party’s breach as repudiation of the contract and then on that ground claim for damages under common law, or to claim for payment of the total rentals under the acceleration clause but ignore the breach and accept that the contract remain in full effect.¹⁶⁵ This principle was well illustrated by an Australian case of *O’Dea v Allstates Leasing System (WA) Pty Ltd*.¹⁶⁶ Clause 1(a) of the agreement could have been interpreted to be an acceleration clause in isolation but this was in conflict with the interpretation of clauses 6(a) and 12 of the agreement, which entitled the lessor to repossess the vehicles immediately in the event of the lessee’s failure to pay punctually. The High Court of Australia held that clause 1(a) was subject to the rule against penalties and was a penal clause on the ground that, given due consideration to these clauses, it transpired that the lessee’s obligation to pay the total rentals could only arise in the events which were specified in clause 12, under which the lessor was also entitled to repossession of the vehicle; however the return of the asset imposed liability more than the acceleration of the present debt.

¹⁶³ E McKendrick, *ibid*, 965.

¹⁶⁴ RM Goode, 'Penalties in Finance Leases' (1988) 104 *LQR* 25, 29.

¹⁶⁵ *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 (HL), per Lord Reid, at 427.

¹⁶⁶ (1983) 57 ALJR 172 (High Court of Australia), cited by E McKendrick, 'Liquidated Damages and Related Clauses' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 955-974, 965.

An example under English common law is the case *County Leasing Ltd, County Leasing Asset Management Ltd v East*.¹⁶⁷ Clause 5 of the business loan agreement provided that, once the borrower failed to pay one instalment, the rest of the loan became due and payable and that the borrower was obliged to pay on termination not only the principal amount of the loan unpaid but also the interest for the whole period of the loan. The clause was held to be a penalty clause, because it regarded the contract as being terminated but required for the future interest of the loan, which was more than the present debt.

The above points regarding acceleration clauses highlight the importance of drafting in making a term of contract effective. It recalls the classic speech of Lord Dunedin made in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,¹⁶⁸ which was put in a contemporary way by Colman J in *Lordsvale Finance Plc v. Bank of Zambia*: “whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach.”¹⁶⁹

3.2.7 A clause under which an obligation to duly pay is a condition of the contract

The above two clauses are designed to evade the application of the rule against penalties. To ensure that, in the event of the lessee’s failure to duly perform payment of a single rental, the total rentals will be reasonably included in the sum of the lessor’s actual loss and thereby be recoverable as damages at common law, the lessor may choose to employ in the agreement a clause which stipulates that the time, the

¹⁶⁷ [2007] EWHC 2907 (QB).

¹⁶⁸ [1915] AC 97 (HL).

¹⁶⁹ [1996] QB 752 (QB), per Colman J, at 762.

amount or the means of payment of any singular rental is of the essence of the contract.

The theory is that if a clause makes the lessee's duly and punctual payment of the rentals be a condition of the contract, when the lessee fails to pay some rentals pursuant to that condition, the lessor could regard the breach as a repudiation and therefore is entitled to claim for damages to recover his loss of the bargain, which would include the loss of future rentals. Such a clause is based on the common law of damages and hence is not subject to the rule against penalties.

This method is beneficial to the lessor, because, by resorting to damages at common law, the lessor is free from the rule against penalties but can still recover a sum equivalent to that under a liquidated damages clause. The two clauses, i.e. a clause which provides that the time of payment is of the essence of the contract and a clause which provides for liquidated damages, can be combined for the purpose that if either of them succeeds it will provide the lessor the same recovery of the total rentals in the lessee's failure to pay¹⁷⁰

This practice was proved to be successful in a finance lease case of *Lombard North Central Plc v Butterworth*.¹⁷¹ In that case, a finance lease agreement was entered into by a finance company and an individual for the hire of a computer and a printer at quarterly rentals for five years. Clause 2(a) provided that the punctual payment of rentals was of the essence of the contract. Clause 5 provided that, on the default of the lessee's payment of any instalment, the lessor was entitled to regard the contract as being repudiated and accordingly to retake possession of the asset and claim damages

¹⁷⁰ E McKendrick, 'Liquidated Damages and Related Clauses' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 955-974, p968.

¹⁷¹ [1987] QB 527 (CA).

under Clause 6(a), which provided that the lessor was entitled to damages covering all arrears, damages for breach and all future rentals. The lessee failed to pay punctually. By due notice, the lessor terminated the agreement and retook the asset and resold it. Then the lessor brought an action for damages covering a sum of loss, which was calculated by the arrears and interests thereon, plus future rentals with some discount, less the proceeds from the sale.

The lessee argued that Clauses 5 and 6 were penalties because they failed to give credit to the proceeds of the asset from the sale in the pre-estimate of damages. He also argued that the future rentals were not recoverable in the absence of a repudiatory breach under the hire purchase law, although he acknowledged that there was no option to purchase in the present case. The lessor contended that Clause 6(a) was not penal because the sum was a genuine pre-estimate of the damage made at the time of agreement and the damages claimed for were damages at common law as the consequence of the lessee's breach of a condition of the contract.

The Court of Appeal decided that Clauses 5 and 6 were penalties, because they applied to all circumstances of breaches varying in seriousness and triviality and also provided damages more than the rentals in arrear and the interests thereon. However, the lessor's claim for damages was upheld on the basis of Clause 2(a). The Court of Appeal said that in the present case a breach of Clause 2(a), i.e. failure to pay timely, constituted a repudiatory breach and therefore the lessor's claim for damages under common law of damages, which had reasonably calculated to be the arrears and interests thereon, plus future rentals, less some discount accelerated, less the sale proceeds, should be upheld.

Thus, the lessee's failure to pay any one instalment gave the lessor a right to terminate the agreement and retake the possession of the asset whereupon the lessee became liable to make good to the lessor the loss of the whole transaction.

However, their Lordships were concerned about the result that the rule against penalties was evaded by the means of a term making the time of payment of the essence of the contract. Mustill LJ said: "This is not a result which I view with much satisfaction: partly because the plaintiffs have achieved by one means a result which the law of penalties might have prevented them from achieving by another, and partly because if the line of argument under clause 2 had been developed from the outset, the defendant might have found an answer based on waiver which the court is now precluded from assessing, for want of the necessary facts."¹⁷²

It is understandable that the court would not like to see abuse of the freedom of contract or misuse of legal principles. However, it is submitted that the rationale behind the lessor's practice in employing the clause in question is sound, because the parties can agree in their contract that a term is of essence of the contract and therefore damages for loss of the bargain will be given to the innocent party, when the party chooses to regard the breach of the term as a repudiatory breach of the contract. This common law principle in relation to damages is separate from the rules applicable to contractual obligations, including the rule against penalties. Clauses 5 and 6 were liquidated damages clauses and would be penal on their own, because unless there is a repudiatory breach, the damages are to be the rentals in arrear and the interest thereon; anything more than those would amount to penalty.¹⁷³ However, a breach of Clause 2(a) gave rise to claim for damages to loss of bargain, because the

¹⁷² [1987] QB 527 (CA), at 540.

¹⁷³ *Financings Ltd v Baldock* [1963] 2 QB 104 (CA).

legal consequence of such a clause is “not from the law on penalties but from the firmly established rule that the parties are free to agree that any term of the contract is a condition.”¹⁷⁴

Nicholls LJ, who also felt sorry for the lessee, however considered it justified to decide in favour of the lessor, on the consideration of the commercial reality of the transaction. It may be useful to quote his statement in length, as the features of a finance lease transaction were highlighted in his statement. Nicholls LJ said:¹⁷⁵

“I preface this issue with a reminder of the commercial realities of this lease transaction. In so doing I do not seek to ascribe to the transaction any legal characteristics other than those set forth in the lease agreement entered into by the parties. But in considering whether a hirer’s conduct amounts to repudiation the commercial setting and objective of the agreement must be of prime importance. The owners, the plaintiffs, are a well-known finance company. Their business is to provide finance for, amongst other matters, the acquisition by customers of goods, whether by hire purchase or lease or otherwise. They do not themselves supply the goods. They adopt the normal practice of finance companies: they purchase the goods chosen by the customer from the supplier and pay for them, and then let them to the customer on hire purchase or hire or as the case may be. It is in these circumstances that the plaintiffs became the owners of a Lomactina computer. When entering into the present lease agreement the objective of the plaintiffs was the unexceptional one of obtaining over the agreed period of hire a rate of return, which would yield for them a commercial profit, on the money paid out by them on the acquisition of the computer being hired.”

He went on to say:¹⁷⁶

“In these circumstances, it was a matter of importance to the plaintiffs that the agreed instalments should be paid, and should be paid promptly. I can see no reason to doubt that the interest charges were calculated by reference to the

¹⁷⁴ Hugh G Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 26-141. It should be noted that the earlier edition (29th ed, § 26-123) however criticised the decision: “It is submitted that such a clause should be interpreted so as to give the innocent party the power to terminate, but not an entitlement to damages for loss of the contract as a whole (unless the clause satisfies the criteria for liquidated damages). If the *Lombard* decision is upheld, the whole law on penalties can be avoided by a simple, small change in the terminology of the contract which makes every term a “condition” in the sense of a term any breach of which entitles the promisee to terminate. If, in the light of such a clause, any sum specified as damages for breach must be tested on the ground that it is a pre-estimate of “the loss to the promisee resulting from the loss of his bargain” as a whole, the law as to penalties can be avoided.”

¹⁷⁵ [1987] QB 527 (CA), at 543.

¹⁷⁶ *Ibid*, at 544.

agreed hire instalment dates, on the footing that the instalments would be paid regularly and with reasonable promptness. To the plaintiffs, a hirer who is repeatedly and significantly late with his payments, and who has to be chased with reminders and warnings, time after time, is an unattractive hirer whose transaction may eventually become an unprofitable one, in which event the plaintiffs will lose substantially the whole benefit intended to be acquired by them under the agreement.”

Therefore, Nicholls LJ, with concurrence of other members of the Court of Appeal, agreed that it was important for the lessor to receive damages equivalent to the total rentals when the lessee failed to pay the rentals pursuant to the condition of the contract. The facts, such as the lessor being a mere financier and the lessee selecting the asset and the supplier, are special characteristics of finance leases. A clause which makes the time of payment a condition of the contract reflects these characteristics. Although the difference between a clause of an express power to terminate and a clause making time of essence may be “one of drafting form and wholly without substance”, their legal effects are significant.¹⁷⁷

3.2.8 Proposals drafting the liquidated damages clause

The case of *Lombard North Central Plc v Butterworth*¹⁷⁸ shows that a simple and small change in the drafting of the contract could change an otherwise unenforceable clause to give effect to recovery of the total rentals.¹⁷⁹ If the parties, particularly the lessor, could improve the drafting of the liquidated damages clause of a finance lease agreement, the clause itself might be enforced and therefore enable the lessor to recover the total rentals.

¹⁷⁷ [1987] QB 527 (CA), per Nicholls LJ, at 546.

¹⁷⁸ [1987] QB 527 (CA).

¹⁷⁹ H G Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 26-141.

Therefore, it is submitted that, in addition to insertion of provisions to the effect of evading the application of the rule against penalties, it would be helpful if the parties could pre-estimate the damage as close as possible to the actual loss. It was pointed out that the existence of a wide gulf between the level of damages likely to be suffered and the level of damages stipulated in the contract had led to the recognition to the penalty nature of the clause in case law.¹⁸⁰

The lessor's possible loss in the lessee's breach of contract is predictable. Thus a clear calculation of the lessor's loss in the lessee's breach will improve the chance of the liquidated clauses to be upheld by the court. The common law damages assessed and granted to compensate the lessor for his actual loss in *Lombard North Central Plc v Butterworth*¹⁸¹ provided a useful reference for the parties to decide on a reasonable formula for their own agreements. In that case, the lessor's damages were calculated by the rentals in arrear and their interest plus the future rentals less discount plus costs for recovery of the asset less the net proceeds of the asset resold.

However, if a clause provides that a default interest will apply, the interest rates and the dates of calculation must be carefully stipulated. According to the decision made in a case of loan in the Queen's Bench Division in *Lordsvale Finance Plc v Bank of Zambia*,¹⁸² a default interest could be at risk of being a penalty, if it is not merely applicable on the date of default and thereafter but to the period before that date (retrospectively). In a later case of *County Leasing Ltd, County Leasing Asset*

¹⁸⁰ In *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281 (TCC); (2005) 21 Const LJ 539, at 549, per Jackson J.

¹⁸¹ [1987] QB 527 (CA).

¹⁸² [1996] QB 752 (QB). Although the case was decided by a court of low authority, the obiter dictum of Colman J has been approved and applied by the Court of Appeal in *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (CA) and in *CMC Group Plc v Zhang* [2006] EWCA Civ 408.

Management Ltd v East,¹⁸³ the claim for the interest covering the whole period of loan was refused but the interest up to the date of repudiation was awarded as damages to the lender's actual loss. In addition, the interest rates of business loans have been restricted to a certain margin – one or two percent over the Bank of England's base rate may be enforceable, with the maximum of eight percent.¹⁸⁴ For example, one percent over the rate was held to be enforceable in *Lordsvale Finance*, but five percent per week, equivalent to 260 per cent per annum, was held to be a penalty in *Jeancharm Ltd (t/a Beaver International) v Barnet Football Club Ltd* [2003] All ER (D) 69 (Jan). Finance leases and business loans are similar in that both aim to be paid the amount of original outlay and an element of interest, although the statutory restriction on the default interest rate in business loan agreements does not apply to finance lease agreements. However it would be wise to follow these restrictions in any case if the lessor intends to insert a clause providing for the interest of the defaulted payment.

3.2.9 An irrevocable and independent obligation to pay the total rentals at law?

From the discussion above, it seems that the finance lease agreement commonly contains some provisions which are aimed to ensure that the lessee should pay a sum equivalent to the total rentals in any case. Under English law, the provisions are subject to the rule against penalties and the rule against forfeiture. The lessee might be granted equitable relief, if any of the rules applies. If the rule against penalties applies, the provision is unenforceable and the lessor's actual loss would be assessed by the court. If the rule against forfeiture applies, the lessee would often be given more time

¹⁸³ [2007] EWHC 2907 (QB).

¹⁸⁴ Isaacs and Davies said: "The statutory regime is found in the Late Payment of Commercial Debts (Interest) Act 1998 and the Late Payment of Commercial Debts Regulations 2002 (SI 2002/1674), which enable default interest to be charged at the statutory rate, currently 8 per cent above the Bank of England's base rate". M Isaacs and N Davies, "The fine line between liquidated damages and penalties", (2008) 3 *JIBFL* 152.

to perform his obligation to pay and the contract would continue. In both cases, the lessor would not obtain more than what he contracts for and the lessee would not escape paying for the lessor's damage. The law is satisfactory to protect the interests of both parties in this area. But the law, although it has merit as a comprehensive law, has led to high costs at courts, particularly in the case where the actual loss of the lessor has to be assessed.

In the international sphere, the 1988 Unidroit Convention and the 2008 Unidroit Model Law on Leasing provide a different model: the lessee's obligation to pay the total rentals to the lessor is an irrevocable and independent obligation. By making this obligation independent of the underlying contract, the Unidroit approach ensures that there would not be disputes as to the lessor's right to recover the total rentals and therefore provides good protection to the lessor's interests as a financier. This section will examine the provisions in order to see the advantages and disadvantages of the Unidroit approach and to answer whether it is suitable for English law to adopt.

Article 12(1) of the Convention provides that, where the asset is not delivered or is delivered late or fails to conform to the supply agreement, the lessee has the right as against the lessor to reject the equipment or to terminate the leasing agreement.

According to Article 12(3) of the Convention, the lessee has a right to withhold rentals payable under the lease agreement until the lessor has remedied his failure to tender the asset in conformity with the supply agreement or the lessee has lost the right to reject the asset.

Article 13 of the Convention clarifies the remedies with regard to payment of the rentals. Article 13(1) generally provides the lessor with a right to a remedy against the

lessee in the latter's default. The lessor may recover accrued unpaid rentals, together with interest and damages. Where the lessee's default is substantial, Article 13(2) enables the lessor to choose one of the following options: either to recover the future rentals, where the lease agreement requires so, or to terminate the lease agreement and to repossess the asset with a right for damages; in either case, the damages would not be more than those which could place the lessor in a position in which he would have been had the lessee performed the lease agreement according to the terms. In short, besides interest and damages, the lessor's recovery of the rentals should not be more than the total rentals if the contract were performed. This provision is certain and overt, in contrast to the position of the English law.

Article 13(3) allows the parties to agree on the calculation of the damages in their lease agreement and the clause to that effect is enforceable unless it would result in damages substantially in excess of those provided for under the previous paragraph. This provision may not be derogated or varied by contract and therefore is a regulation similar to the rule against penalties under English law.

Article 13(4) does not allow the lessor to claim for the accelerated future rentals when he has terminated the contract but the value of such rentals could be taken into account in computing damages. Again, this provision may not be derogated or varied by contract and has an effect similar to English common law.

The Convention is significant in ensuring that the rights of the parties are equally stipulated and reasonably restricted. For example, in the provisions mentioned above, Article 13 grants the lessor a right to damages, but restricts the amount every time. The Convention is also good at providing the parties with all the possibilities to

remedy their defaults. For example, in addition to the restrictions to the lessor's rights to damages mentioned above, Article 13(5) further requires the lessor to give a period of notice to the lessee, before he takes action of terminating the contract or accelerating the payment of the value of the future rentals, so that the lessee may take this reasonable opportunity to remedy his default. Article 13(6) asks the lessor to take all reasonable steps to mitigate his loss; otherwise his damages would not be supported to the extent that he has failed.

However, the Convention does not clearly state that the obligation of the lessee's payment is irrevocable and independent, although it is implicit in Article 12(3), which requires that, once the lessee has lost the right to reject the asset, he cannot withhold rentals payable under the lease agreement.

In relation to this issue, the Unidroit Model Law on Leasing has openly pronounced the "irrevocability and independence" duties of the parties to a finance lease agreement. Article 10 provides that the duties of the lessor and lessee under a finance lease become irrevocable and independent, when the asset has been delivered to and accepted by the lessee; a duty that is irrevocable and independent must be performed, regardless of the performance or non-performance of any other party, unless the party to whom the duty is owed terminates the lease. Thus, in line with that the Convention, the deciding point from which the lessee becomes responsible to pay the rentals nevertheless is when he accepts the asset under the Model Law.

Article 22(1) of the Model Law allows the parties to a finance lease agreement to specify in their agreement a fixed sum or a sum computed in a specified manner for a default committed by the defaulting party. Article 22(2) requires that the sum

specified to cover the loss should be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the default. This rule is similar to the rule against penalties under English law.

Article 13 further specifies the acceptance of the asset. Acceptance of an asset occurs when the lessee's acts fall within one of the following scenarios: either he signifies to the lessor or supplier that the asset conforms to the agreement, or he fails to reject the asset after a reasonable opportunity to inspect it, or he has used the asset.

Apparently, in view of the next paragraph Article 13(2)(a), "the agreement" in the first scenario refers to the supply agreement, because after the asset is accepted, the lessee is entitled to damages from the supplier for non-conformity of the asset to the supply agreement. Thus, there seems to be only one agreement – the supply agreement, to which the asset should conform. In this stand, the Model Law is again in line with Article 12(3) of the Convention.

However, it is unfortunate that the Model Law fails to expressly require the lessee to undertake an obligation to pay the rentals, albeit undoubtedly payment is an element of the finance lease transaction and its importance to the lessor is evident. It is submitted that it is a blemish of the Model Law that the lessee's obligation to pay the rentals is not required as overtly as his other obligations, e.g. to maintain and to return the asset.

Interestingly, the Model Law imposes the requirement of the irrevocability and independence of the parties' duties under a finance lease not only on the lessee but also on the lessor. Article 10 provides that the duties of the lessor and lessee under a finance lease become irrevocable and independent, when the asset has been delivered

to and accepted by the lessee. This is significantly different from the Convention. The Convention fails to expressly stipulate that the lessee's payment obligation is independent but all that it implies merely refers to the lessee's payment obligation. It does not demand the lessee's other obligations or the lessor's obligations to be performed to the same degree.

In contrast, the Model Law applies the autonomy principle to both the lessor and the lessee's obligations. Accordingly, the lessee's obligation to maintain and to return the asset is also irrevocable and independent. In addition, the lessor's obligation to ensure the lessee's quiet possession of the asset under Article 16 is also an irrevocable obligation and is independent of the lessee's performance. In other words, the lessor should ensure that the lessee can enjoy the possession of the asset free from disturbance of the person with a paramount title to the asset, despite whether the lessee has performed his obligation to pay or not. However the lessor's quiet enjoyment obligation is allowed to be excluded by the parties under Article 5 of the Model Law.¹⁸⁵ The certainty of the lessor's obligation to ensure quiet enjoyment is therefore undermined by the possible exclusion.

It is a significant flaw of the Model Law that, although other less important and even unnecessary obligations have been required to be irrevocable and independent obligations, it fails to expressly require that the lessee has an obligation to pay the rentals. Undoubtedly, payment of the rentals is a key obligation of the lessee and is extraordinarily important to the lessor. It is submitted that this should be an obligation explicitly required by the Law.

¹⁸⁵ With reference to the provision of "freedom of contract" under Article 5 of the Model Law.

It is also noticed that the Model Law merely requires the lessor and lessee's obligations to be irrevocable and independent, but not the supplier's obligations. The omission seems to indicate that the supplier could raise a defence against the lessee. For example, he could refuse to deliver the asset in conformity to the supply agreement, on the ground of the lessor's failure to perform the supply agreement. Hence, the lessee would not be able to exercise his right under Article 14, i.e. to demand a conforming asset from the supplier, when the asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease agreement.

One reason for the omission could be that, although a finance leasing transaction concerns both the finance lease and the sale of the asset, the rules purely applicable to the sale of goods are not supposed to be duplicated in the Model Law on Leasing. For example, the Model Law does not speak about the supplier and lessor's duties to each other, presumably because their relationship is a sale of goods and therefore should be subject to other substantive law than leasing. But the Model Law recognises the speciality of the acquisition of the asset. Article 7 stipulates that the lessee of a finance lease acts as the beneficiary of the supply agreement and therefore the duties of the supplier under the supply agreement are 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. In this case, the lessee is entitled to act as if he were in the position of the lessor under the supply agreement.

The Model Law apparently focuses more on essential provisions with regard to the equal obligations of the three parties of finance leasing than the provisions purely with regard to sale. For example, Article 16 requires the lessor to warrant the lessee's quiet possession, Article 17 requires the supplier to warrant acceptability and fitness

for purpose of the asset and then Article 18 requires the lessee to maintain and return the asset to the lessor.

Another reason that the Model Law does not require the supplier's obligations to the lessee to be independent of the supply agreement could be that it is impossible to grant independence to all the parties' duties. The autonomy principle is a requirement on a very high level and therefore its application is rather restricted. In international trade, only certain instruments are considered to be independent of their underlying transactions, for example, letters of credit and bills of exchange. Being a financing device, finance leasing has similar financial features. Therefore the lessee's payment obligation could be classified as an obligation owed to the lessor once he has accepted the asset, independent of the finance lease agreement, i.e. despite whether or not the lessor has performed his other obligations.

Thus, the Model Law's provision for independence of the lessor's obligation to the lessee is unrealistic and that of the supplier's obligation to the lessee is unnecessary. It is submitted that the Model law should be modified and merely require that the lessee's obligation to pay the rentals to the lessor be independent.

Despite these blemishes, the Unidroit approach promotes the importance of requiring that the lessee is obliged to pay the total rentals. It is a direct result of the Unidroit emphasis on the financial nature of financial leasing. On its own, the requirement is not in conflict with the current English law but acts to compliment to it and add clarity. It is hoped that a similar obligation might be recognised and adopted so that the lessor might find more assurance under English law.

3.2.10 Summary

The above subsection examined the lessee's obligation to pay the rentals. It is clear that the lessee under a finance lease has an obligation to pay the rentals to the lessor both at common law and under the contract. In general, the innocent party can sue the defaulting party for damages; in the case of finance leases, the lessor often seeks to recover the total rentals payable under the contract. However, common law does not allow the innocent party to punish the lessee and it has developed the rule against penalties and the rule against forfeiture to eliminate the occurrence of penalties. In principle, the lessor's damages exceeding his actual loss would be at risk of being regarded as penalty and as a result would not be enforced.

However, due to the financial feature of finance leasing, the lessor seeks to recover his capital outlay and a certain margin of profit from the transaction, therefore it is essential for him to be paid damages covering not only the current unpaid rentals but also the future rentals. In practice, there are different clauses which the lessor can employ to evade the application of the rule against penalties, for example, a clause to provide payment on the occurrence of an event, or an acceleration clause. In addition, the lessor can stipulate that the lessee's obligation to pay duly is a condition of the contract. This clause is different from the other two in that it seeks to recover the future rentals as loss of transaction so the effect of enforcing the clause is that the contract is terminated. In any case, it was proposed that the calculation of the lessor's damages should be drafted carefully to reflect the possible loss of the lessor.

To conclude, the law pertaining to the lessee's obligation to pay and the lessor's right to recover the total rentals is satisfactory overall, although it is rather complicated and some ambiguity exists as to whether relief should be granted against penalty or

forfeiture. The clarity might improve if English law were to adopt the provision suggested by the Unidroit Convention and the Model Law that the lessee has an irrevocable and independent obligation to pay the total rentals.

3.3 *The lessee's obligation to maintain and to return the asset*

It is commonly agreed in a finance lease agreement that the lessee should use the asset for the agreed purpose with care and return it at his cost by the end of the lease or at the termination of it. Being a beneficial owner of the asset, the lessee rarely disputes with the lessor about his obligation to take proper care of the asset at his cost and often he obtains services of maintenance and repair from the supplier directly and separately. It is also indisputable that the lessee should return the asset to the lessor at the end of the lease period or at his default. The lessor usually excludes obligations as to maintenance and repair.

The Convention in Article 9 requires the lessee to take proper care of the asset, use it in a reasonable manner and keep it in the condition in which it was delivered, subject to fair wear and tear and to any modification of the asset agreed by the parties, and to return the asset to the lessor at the end of the lease unless otherwise agreed.

The Model Law in Article 18(1) requires the lessee to use the asset with care and in accordance to the agreement and to maintain it in good condition. Article 18(2) requires the lessee to return the asset to the lessor, unless otherwise agreed. Because Article 10 requires that both the duties of the lessor and lessee under a finance lease become irrevocable and independent after the acceptance of the asset, the lessee's obligations to maintain and to return the asset are irrevocable and independent. As was argued earlier in section 3.2.9, this requirement is high and unnecessary.

The above laws commonly permit the lessor to be excluded from maintenance and repair of the asset. It meets the need of the lessor to be a financier only in a finance leasing transaction.

3.4 Concluding remarks

This Chapter has examined the obligations of the lessee under the finance lease agreement. It has assessed the law with regard to payment, among three obligations of the lessee: to pay the rentals, to maintain the asset and to return it at the end of the lease or in insolvency.

The discussion shows that English law is good as to recognising the lessee's obligation to pay. However, it is somewhat complicated. It recognises that the lessor's interest in the transaction rests on the lessee's payment of the total rentals and allows the lessor to recover them. Where the recovery of the total rentals would exceed what the lessor contracts for, the law intervenes and grants equitable relief to the lessee, either against penalty or against forfeiture.

In contrast, the Unidroit Convention and the Model Law require that the lessee's obligation to pay the rentals is irrevocable and independent. They have made a significant contribution to the law pertaining to finance leasing in the international sphere. However the two international instruments contain inconsistency and blemishes. Nevertheless, the approach to clearly recognise the lessee's obligation to pay the total rentals should be welcomed by English law.

CHAPTER 4 THE LESSOR'S OBLIGATIONS

4.1 *Introduction*

This chapter will consider the obligations of the lessor to the lessee under a finance lease. The obligations to be discussed include an obligation to transfer possession of the asset, an obligation to ensure the quiet enjoyment of the lessee and an obligation to ensure the condition of the asset.¹⁸⁶ The first obligation is required by the nature of bailment at common law but the other two are required by the Supply of Goods and Services Act 1982. The discussion will focus on whether these obligations should, and if so to what extent, be imposed on the lessor.

4.2 *The lessor's obligation to transfer possession*

4.2.1 *Introduction*

Because the lessor transfers the asset for the lessee to possess and use for the most useful life of it, it is an obvious obligation of the lessor to transfer possession of the asset to the lessee. However, usually it is up to the supplier to deliver the asset to the lessee. With regard to delivery of the asset, the lessor's obligation under the lease agreement and the supplier's obligation under the supply agreement are mingled together.

The following sections will examine the law with regard to delivery of the asset firstly under English law and then under the Unidroit Convention and the Model Law. The

¹⁸⁶ Under the finance lease agreement, the lessor often has other obligations, for example, an obligation to ensure that the asset is delivered pursuant to the term of the contract and an obligation to act diligently in seeking remedy from the supplier for the defects in the asset etc. Due to the limit of space, these obligations are not particularly examined, although general discussion in relation to them can be found in Chapter 5.

discussion will focus on whether the lessor's role as financier and the triangular relationship are protected.

4.2.2 English law

The Supply of Goods and Services Act 1982¹⁸⁷ governs all kinds of hiring including finance leases but it neither imposes on the lessor an implied obligation to transfer possession of the asset nor imposes on the lessee an implied obligation to accept the asset for lease. Because the essential characteristic of bailment is to transfer possession of the asset from the bailor to the bailee, the finance lease agreement usually requires that the lessor should deliver the asset to the lessee, probably through the supplier, and the lessee should accept it within a reasonable time.

Clear statutory obligations to deliver and to accept the asset can be found in the law of sale. Section 27 of the Sale of Goods Act 1979 requires the seller to deliver the goods and the buyer to accept and to pay for them, in accordance with the terms of the sale agreement. Due to the close relationship between the supply agreement and the finance lease agreement, the supplier and lessor's obligations with regard to the delivery and acceptance of the asset directly affect the lessee's rights and obligations under the finance lease agreement.

On the one hand, the supplier commonly delivers the asset to the lessee and his performance of delivery under the supply agreement is regarded as the lessor's delivery under the finance lease agreement. In the case of the supplier's failure to deliver the asset, the Contracts (Rights of Third Parties) Act 1999 enables the lessee to enforce the supplier on his own right, if either the agreement specifies that the

¹⁸⁷ The Supply of Goods and Services Act 1982 came into force on 1st February 1991.

lessee can enforce the obligation or it can be interpreted from the agreement that he is the beneficiary of it.¹⁸⁸ However the lessee must be expressly identified in the supply agreement, either by name, as a member of a class, or as answering a particular description but need not be in existence when the agreement is entered into.¹⁸⁹ Accordingly, in the case of the supplier's failure to deliver, not only the lessor but also the lessee may bring an action to enforce the supplier's obligation of delivery pursuant to the supply agreement. S 1(5) of the 1999 Act specifies the lessee's right for damages and other remedies against the supplier, including injunction, specific performance and other relief, as if he were a party to the supply agreement. As a result, when the asset is not delivered, or delivered late, or the delivered asset does not conform to the supply agreement, in addition to his remedies against the lessor, the lessee can bring an action against the supplier claiming for damages and other relevant remedies.

The statutory right of the lessee to sue the supplier for specific performance and damages etc. has significantly improved the chance of the lessee to satisfy his need in the transaction. As a result, it considerably releases the lessor from pressure to remedy the delivery default, although he is not excluded from the obligation of delivery pursuant to the lease agreement.

On the other hand, the Sale of Goods Act 1979 requires the buyer to accept the asset. In a finance lease transaction, the lessee's acceptance of the asset will be regarded as the lessor's acceptance of the asset under the supply agreement. To decide whether the lessee has accepted the asset, in the absence of relevant provisions at law in relation to finance leases, it is reasonable to refer to the law of sale. Thus the asset

¹⁸⁸ S 1(1) of the 1999 Act.

¹⁸⁹ S 1(3) of the 1999 Act.

would be deemed to have been accepted under s 35 of the 1979 Act, when the lessee intimates to the lessor that he has accepted the asset, or when the asset has been delivered to him, he carries out any act which is inconsistent with the ownership of the lessor in relation to the asset, or he retains the asset without intimating to the lessor that he has rejected it after the lapse of a reasonable time, or when the asset has been delivered to him and he has had a reasonable opportunity to examine its condition.

Thus, the law is relatively clear in relation to the transfer of possession of the asset, which concerns the supplier's delivery of the asset and the lessee's acceptance of it. The law is satisfactory in that the lessor's obligation to transfer the possession of the asset can be performed by the supplier's delivery of the asset under the supply agreement and in case of his default of delivery the lessee can seek remedies directly from him under the supply agreement.

4.2.3 The Unidroit Convention and Model Law

The Unidroit Convention provides in Article 10 that the duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee. This provision imposes a contractual duty on the supplier toward the lessee. It creates a cause of action by law, where applicable, in order to solve the legal problem with the principle of privity which hinders a third party's right under the contract in most common law jurisdictions.¹⁹⁰ By providing that the supplier's obligation to deliver the asset is owed to the lessee as if the lessee were a party to the supply agreement, the

¹⁹⁰ Under the similar theory, the US has solved the obstacle of privity by requiring that the lessee is regarded as the beneficiary of the supply agreement on whom is conferred all the benefits of it. See also Breslauer, Peter, "Finance Lease, Hell or High Water Clause, and Third Party Beneficiary Theory in Article 2A of the Uniform Commercial Code", (1992) 77 *Cornell Law Review* 318.

Convention offers a similar principle to English law which provides that the lessee has a right of enforcement against the supplier if the supply agreement provides so or confers a beneficiary interest on him. But the Convention's provisions offer better certainty than English law, because they recognise and define that the parties involved in an international financial leasing transaction have a triangular relationship with each other.

Article 12(1) of the Convention stipulates the lessor's responsibility for the supplier's delivery defaults. The lessee has a right against the lessor, either to reject the asset or to terminate the lease agreement, and the lessor has a right to remedy the default.

Article 12(2) of the Convention specifies that such rights are to be exercised in the same manner and lost in the same circumstances as if the lessee were the buyer and the lessor were the seller under the supply agreement. This provision imports the law of sale into the lease agreement in respect of delivery and therefore contributes certainty to the law applicable to finance leasing in this area. In contrast, there is no comparable rule in English law. Article 12(5) limits the lessor's obligation to the lessee to non-delivery, delay in delivery or delivery of non-conforming asset, unless others are results of the lessor's acts or omission. Article 12(6) ensures that the lessee's right against the lessor would not affect his right against the supplier directly. Thus, the Convention provides certainty to the obligations of both the lessor and supplier to the lessee in respect of delivery defaults.

Similar to the Convention, Article 7 of the Model Law clearly provides that the supplier's obligations under the supply agreement are 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. Noticeably, Article 14 specifies one of the lessee's rights against the

supplier, namely, a right to demand a conforming asset, which is absent in both English law and the Convention.

Interestingly, however, the Model Law does not contain a provision similar to Article 12 of the Convention with regard to the lessor's responsibility to the lessee for the supplier's delivery defaults. As a result, under the Model Law, it is not as clear as under the Convention that the lessee has a right against the lessor to reject the asset or to terminate the lease agreement, although it is hardly disputable. However, when Article 14 of the Model Law provides for the lessee's right to demand a conforming asset from the supplier, it also says that "[he may] seek such other remedies provided by law". Does the "other remedies provided by law" include the rights of the lessee against the lessor, like those specified by the Convention? If so, would it be clearer for the Model Law to spell them out, especially for the purpose of being a model law?

The lessee's acceptance of the asset is the dividing point of the obligations between the parties. Article 11 of the Model Law provides, subject to his proper care of the asset during his possession, that the lessee may regard the risk of the asset as having remained with the supplier from the beginning, when the asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, although in general the risk of loss passes to the lessee when the lease agreement is entered into.

Article 10 sets up a rule of independence to the lessor and lessee's obligations to each other upon the lessee's acceptance of delivery of the asset. This provision is unique and cannot be found either in English law or the Convention. According to this provision, once the asset is delivered and accepted, the lessee's obligations to the lessor, for example, those with regard to payment of rentals, maintenance and return

of the asset, become uncancellable and therefore must be performed, whether or not any other party performed.

Due to the significant consequence of the acceptance of the asset, the Model Law provides specific rules. According to Article 13, the asset will be regarded as being accepted by the lessee, when he informs the lessor or the supplier of the conformance of the asset to the agreement, or he fails to reject the asset within a reasonable time, or he uses the asset. This provision is similar to the rule in the case of sale of goods under English law, although not as comprehensive as the latter. However, it contributes to the clarity of the law pertaining to finance leasing in respect of delivery in the international sphere and also supports the author's proposal that a rule of finance leasing in respect of acceptance under English law should borrow from that of the law of sale of goods.

The Model Law also provides the consequences of acceptance. According to Article 23(1)(b), once the asset is delivered and accepted by the lessee, he may not terminate the lease upon the fundamental default by the lessor or the supplier, unless it is a breach of the lessor's obligation to warrant quiet possession. Once the lessee accepts the asset, he would lose the right to terminate the lease and, as Article 10 of the Model Law requires, he would have to perform his obligations to the lessor, regardless of how well or badly the lessor performs. It seems to imply that the lessee would not have a right to hold onto the payable rentals against the lessor, which is conferred by Article 12(3) of the Convention. This is a conflict between the provisions of the Model Law and the Convention.

If before the asset is delivered to the lessee it has been damaged without his fault, according to Article 12, the lessee can choose to inspect the damaged asset and accept it with due compensation from the supplier, or seek such other remedies as are provided by law. The Model Law allows the lessee to claim damages from the supplier under Article 13 or demand a conforming asset from the supplier under Article 14, if the lessee chooses to accept the asset which does not conform to the supply agreement.

However, if the lessee chooses to accept the asset, according to Article 10, he would not be able to claim that the asset does not conform to the lease agreement and to refuse to perform his obligations, for example, to pay the rentals. In other words, once the asset is accepted, the lessee cannot exercise his rights against the lessor as set-off of his obligation to the lessor but he can seek remedies from the supplier.

Article 12(1)(a) of the Convention provides that when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee has the right as against the lessor to reject the asset or to terminate the leasing agreement. This provision is significant when considered with Article 8(1)(a), which generally excludes the lessor from any liability to the lessee in respect of the asset save to the extent that the lessee's loss was a result of his reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the asset.

In contrast, the Model Law lacks clarity as to the lessor's liability to the lessee in respect of defaults of delivery and defects in the asset. When Article 9 excludes the lessor from liability for reasons of death, personal injury or damage to property, either

to lessee or third parties, in his capacity of lessor and as owner of the asset, unless the supply agreement and the lease agreement provide otherwise, it does not extend it to the cases of defaults of delivery and defects in the asset. But no other provision provides that the lessor should be liable to the lessee for defaults of delivery and defects in the asset and gives specification of the circumstances under which the liability may occur. On the one hand, there is little clue in the Model Law as to which party is liable for the defects in delivery and the condition of the asset before the asset is accepted by the lessee. On the other hand, Article 13(2)(a) of the Model Law provides that, after the asset is delivered and accepted by the lessee, the lessee is entitled to damages from the supplier if the asset does not conform to the supply agreement. It does not expressly exclude the lessor from such a liability to the lessee. But the next paragraph Article 13(2)(b), which applies to a lease other than a financial lease, provides that the lessor is liable to pay damages to the lessee. Thus, it would make sense if Article 13(2)(a) is interpreted to mean that in a financial lease, in the case of defects in the asset appearing after it has been accepted by the lessee, the lessor would be excluded from liability, but the lessee could claim damages from the supplier. Therefore, in order to improve the clarity of the Model Law, modification of Article 13(2)(a) is called for.

Therefore, it is submitted that the omission as to the lessor's responsibility for defaults of delivery and defects in the asset before the asset is accepted by the lessee detrimentally affects the clarity of the Model Law and also its function as a model to domestic laws.

In short, the Unidroit Convention and the Unidroit Model law are similar in the sense of improving clarity of the law in respect of delivery and acceptance and both provide

certainty to the relevant area of law; but they contain blemishes and even conflicts, which should be carefully avoided in their application. However, in general, the Unidroit has improved clarity and certainty of law pertaining to finance leasing in the international sphere with regard to delivery.

4.2.4 Summary

This section has examined the law with regard to delivery in a finance lease transaction both under English law and international conventions. English law has not overtly recognised that there is a direct relationship between the lessee and supplier and also that some specific rules in respect of acceptance in the law of sale of goods apply to finance leases. But the Unidroit Convention and the Unidroit Model law have prepared clear provisions to these effects. They recognise the close connection between the finance lease agreement and the supply agreement and provide fair balance between the parties in relation to delivery, although with blemishes.

4.3 The lessor's obligation to ensure quiet enjoyment

4.3.1 Introduction

In a finance lease, the asset is possessed and used by the lessee for the most useful life of it. If the interruption to possession and use is committed by wrongful acts of a third party, for example, by theft or fraud, the lessee can sue the third party for conversion under the law of tort.¹⁹¹ However, if the disturbance is related to the lessor, particularly if it results from disputes to the title to the asset, it is a question as to whether the lessor is responsible. This issue has found different answers under English law and under the two Unidroit instruments.

4.3.2 English law

In the eyes of English law, the lease of goods is a type of hire¹⁹² and the Supply of Goods and Services Act 1982¹⁹³ governs all forms of hire,¹⁹⁴ therefore the obligations of an owner of hire apply to the lessor of a finance lease. S 7(1) of the 1982 Act provides that it is an implied condition of the contract of hire of goods that the owner has a right to transfer possession of the asset for the period of the hire. S 7(2) of the

¹⁹¹ Of course it may differ if the lessor conspires at the disturbance or negligently permits it to occur. NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991)1215.

¹⁹² RM Goode, *Commercial law* (3rd edn, Penguin Books, London 2004)721.

¹⁹³ The Supply of Goods and Services Act 1982 came into force in January 1983.

¹⁹⁴ S 6 says:

“The contracts concerned.

(1) In this Act in its application to England and Wales and Northern Ireland a "contract for the hire of goods" means a contract under which one person bails or agrees to bail goods to another by way of hire, other than an excepted contract.

(2) For the purposes of this section an excepted contract means any of the following:--

(a) a hire-purchase agreement;

(b) a contract under which goods are (or are to be) bailed in exchange for trading stamps on their redemption.

(3) For the purposes of this Act [in its application to England and Wales and Northern Ireland] [FN1]a contract is a contract for the hire of goods whether or not services are also provided or to be provided under the contract, and (subject to subsection (2) above) whatever is the nature of the consideration for the bailment or agreement to bail by way of hire.

[FN1] Words inserted by the Sale and Supply of Goods Act (1994 c.35), Sch 2 Para 6 (6).”

Act provides that it is an implied warranty in the contract of hire of goods that the owner ensures that the hirer will enjoy quiet possession of the asset for the period of the hire, except in the situation where the disturbance is caused by the people whose rights were known to the hirer before the contract was made.

Therefore, the lessor is obliged to have the right to transfer the possession of the asset to the lessee at the time of transfer and for the period of the lease. Unless previously made known to the lessee, any rights of the lessor or other people should not be exercised in a way which may disturb the lessee's exclusive possession and normal use of the asset for the whole term of the lease.

Obviously, the lessor's acts pursuant to his statutory obligations or rights do not constitute breaches of the warranty, for example, if he needs to inspect the condition or status of the equipment for the purpose of complying with health and safety legislation. S 7(3) of the 1982 Act excludes acts of the lessor resulting from exercise of his contractual rights pursuant to the agreement. For example, during the lease of the asset, the lessor may inspect the asset to ensure his contractual right would not be infringed by the lessee's improper manner of use. He may also take action to repossess the asset pursuant to the agreement at the default of the lessee.

Except for the reasons mentioned above, under the 1982 Act, the lessor is liable for interrupting the lessee's normal use of the asset. Similar provision can be found in the law of sale of goods and the law of real property. In a sale of goods, the seller is liable for disturbance caused by his own act and anyone claiming through or under him, for example, his employees or agents.¹⁹⁵ A landlord is similarly liable for those acting

¹⁹⁵ S 12(5) of the Sale of Goods Act 1979.

under his title, for example, his employees or agents, whether lawful or not. For example, in a Canadian case of *Maclennan v Royal Insurance Co*,¹⁹⁶ a caretaker locked the building after office hours and this conduct limited the tenants' freedom of use of the building. It was held that the landlord, who employed the caretaker, was responsible for the behaviour which constituted a denial of the lessee's right of quiet enjoyment under the lease. In the English case of *McCall v Abelesz*,¹⁹⁷ Lord Denning MR decided that the covenant for quiet enjoyment was not confined to direct physical interference by the landlord but extended to any conduct of the landlord or his agents that interfered with the tenant's freedom of action in exercising his rights as a tenant.

However, in contrast to s 2(5) of the 1982 Act, which requires that, in a case of transfer of goods, the transferee's quiet possession should not be disturbed by the transferor or anyone claiming through or under the transferor, s 7(2), which applies to hire of goods, omits this requirement. The omission could be explained as follows, either the owner of an asset is not liable for interruption by those claiming under his title, or on the other hand, he is liable not only for those claiming under his title but also for those with better title.

The first explanation is in conflict with the general rule of agency, under which the lessor should be responsible for those acting under his authority. Thus the only explanation is that of when the lessee's possession of the asset is interrupted by a third party who claims title paramount, the lessee can claim for damages against the lessor for breach of the statutory warranty.

¹⁹⁶ (1876) 39 UCQB 515, Upper Canada Court of Queen's Bench, per Morrison, J. (Harrison, C.J. and Wilson, J. concurred).

¹⁹⁷ [1976] QB 585 (CA), p594.

However, it is arguable whether the lessor should be liable for the disturbance caused by a title paramount in a case of a finance lease. This is because the lessee selects the supplier and the asset; what the lessor does is simply to acquire the asset according to the lessee's instructions after he agrees to enter a finance lease agreement with the lessee. It seems unfair to require the lessor to be responsible for losses arising from the lessee's own bad choice, because the lessee apparently has more knowledge of the asset and the supplier than the lessor does. The lessor is obliged to pay for the asset but disputes concerning the title to the asset seem to be beyond his control.

But the lessee may argue that quiet enjoyment is crucial to him because he receives the benefit yielding from the use of the equipment and that the lessor's responsibility is not unfairly placed. Being the owner, the lessor must ensure that the supplier has transferred the title to the asset to him.

To weigh the rights of the two parties, it seems that, although the lessee has more knowledge of the supplier and the asset through initial investigation and first-hand contact with the supplier, he is not the legal owner of the asset. At law, the lessor purchases the asset for the lease to the lessee; he is the one who should ensure that the asset is free from disputes as to its title. In comparison to the importance of the possession and use of the asset to the lessee, the lessor is not heavily burdened by the obligation to ensure that there is no title paramount to his title and that he has the right to lease. Although he cannot choose the asset or the supplier, if he suspects the ownership of the asset, he can decide to reject the prospective lessee's application and refuse to finance the acquisition of the asset. Therefore, it is submitted that the lessor should be responsible for breaches of the obligation to ensure the lessee's quiet possession. However, the law is not completely clear in this area.

4.3.3 The Unidroit Convention and Model Law

In contrast, the Unidroit makes a very clear statement. Both the Convention and the Model Law take the view that the lessor should ensure that the lessee's quiet possession is free from disturbance by a third party with paramount title.

Article 8(2) of the Convention expressly provides that "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", unless the disturbance arises from the lessee's act or omission. The Convention allows the parties to derogate from or vary the effect of the obligation, perhaps having considered the possibility that the lessee might insist on his choice of the supplier and/or the asset despite the lessor's suspicion of the title to the asset. According to Article 8(3), if the parties want to, they can agree that the lessor is excluded from this obligation, as long as the title paramount is not derived from an intentional or grossly negligent act or omission of the lessor. Article 8(4) does not permit exclusion of any broader mandatory obligation of the lessor in relation to quiet possession under the law applicable by virtue of the rules of private international law.

Similarly to the provisions of the Convention, Article 16 of the Model Law stipulates that the lessor should warrant that the lessee's quiet possession is free from disturbance by a person who has a superior title or right or claim, as a result of the lessor's act or omission, either negligently or intentionally. Article 23(1)(c) provides that the lessor's fault as such constitutes a fundamental default and in this case the lessee can terminate the agreement. Apparently the lessor's obligation to ensure the quiet enjoyment of the lessee is excludable under Article 5. In addition, under Article 16(1)(b), where the lessee provides specifications to the lessor or the supplier, he

should not hold them responsible for claims of infringement arising out of compliance with the specifications.

Thus, in an ordinary finance lease, where the lessee usually supplies the specifications of the asset, on which the lessor relies for the purchase of the asset from the supplier, the lessor would not be liable for claims of infringement to the lessee's quiet enjoyment unless they result from the lessor's own fault.

4.3.4 Summary

In respect of the lessor's obligation to ensure quiet enjoyment, English law is stricter than the Unidroit Convention and the Model Law. In a hypothetical case, if, with the knowledge of the lessor, a third party has a title better than his and retakes the asset from the lessee, the lessor is liable under English law but might not be liable under the Unidroit Convention and the Model Law if there is exclusion. Therefore, in this area, the Unidroit instruments are more appealing to the lessor than the English law.

The difference of the obligation as to quiet enjoyment under the two laws may be explained by their different views on the finance leasing transaction. English law sees finance leases as a form of hire between the lessor and lessee for a financial purpose but the lessor is always the legal owner of the asset. The Unidroit Convention and the Model Law see the transaction as a tri-partite transaction and, on the ground that the lessee has appropriate remedies from the supplier, the lessor is free from any liabilities as to the asset, except for the damage resulting from his fault.

It is submitted that the approach taken by the Unidroit should prevail, in consideration of the lessor's role as financier and the appropriate remedies available for the three parties under the two Unidroit instruments. However, it is open to the criticism that

how the lessee might find it difficult to ensure that the title to the asset is free from disputes, particularly with the greater obscurity of the transaction when it is cross border rather than confined to one country. While the Unidroit provision is more beneficial to the lessor, it can be worrying that the requirement that the lessee must take more responsibility for the choice of the supplier and the asset might hinder the potential user from choosing finance leasing as his financial method. But, it is hoped, the international registry of mobile equipment which was established under the Convention on International Interests in Mobile Equipment 2001 could provide some level of security to the lessees.

4.4 *The lessor's obligation to ensure sound condition of the asset*

4.4.1 Introduction

Being a contract of hire, a finance lease agreement is subject to the Supply of Goods and Services Act 1982 and accordingly the lessor should ensure that he fulfils four statutory obligations in respect of the condition of the asset. The lessor has an obligation to ensure that the asset transferred to the lessee will correspond with the description. He also has an obligation to ensure that the bulk transferred to the lessee will correspond with the sample in quality. He also has an obligation to ensure that the asset is of a satisfactory quality and an obligation to ensure that the asset is reasonably fit for the purpose specifically made known. But it appears that these obligations are excludable. This section will firstly examine each obligation and then discuss the approach of exclusion under English law and finally consider the approach taken by the Unidroit Convention and the Model Law.

4.4.2 Fitness for purpose

According to s 9(5), where the lessor leases out assets in the course of his business, he has an implied obligation to ensure that the asset is reasonably fit for the purpose specifically made known to himself or a credit-broker during negotiation. A credit-broker could be a dealer who introduces financing leasing to customers for the purpose of facilitating the sale of his assets. Such an introduction of business by the dealer is a very common commercial practice in relation to vehicles. In the case of finance leasing, it is the supplier, who often introduces finance leasing as a financial method to the potential user/lessee. If the lessee's purpose is made known to a dealer/

supplier, the lessor should be regarded as being liable for the outcome of the asset with regard to the purpose.

Section 9(6) of the Act allows the lessor to be excluded from the obligation as to the fitness for purpose where the lessee does not rely, or it is unreasonable for him to rely, on the skill or judgment of the lessor or creditor-broker.

In the case of finance leasing, the lessee's selection of the asset does not usually rely on the lessor's knowledge, therefore, in theory, the lessor would be generally excluded from the obligation as to the fitness for purpose.

Thus, the 1982 Act requires the lessor to be responsible for the asset's fitness for the purpose made known to him if he acts in the course of a business, except when the lessee does not rely on his skill or judgment. Before the enactment of the 1982 Act, the Law Commission perceived that, in a standard case of finance leasing, the lessor would not be liable for defects in the asset which make it unfit for its purpose because the lessee normally does not rely on the lessor.¹⁹⁸

4.4.3 Satisfactory quality

According to s 9(2)-(3), where the lessor leases out assets in the course of his business, it is a condition of the contract that he has an implied obligation to ensure that the asset is of a satisfactory quality in the eye of a reasonable person taking into consideration the description and price, unless the lessee's attention has been drawn to a particular condition of it, or, if before the contract is made the lessee has examined

¹⁹⁸ Law Commission, *Implied Terms in Contracts for the Supply of Goods* (LAW COM No 95, 1979) para 95.

the asset, or if he has examined a sample of it in the case of leasing by sample and the condition could have been revealed by such an examination.

Thus, in a finance lease, the lessor would have the obligation to ensure that the asset for lease is of satisfactory quality, unless he was aware of any defects and has drawn them to the lessee's attention.

However, the lessor is rarely involved in the selection, examination and delivery of the asset and actually rarely sees it prior to its installation at the lessee's premises, if at all. Even if he delivers the asset, it is questionable whether he is able to discover the defects and subsequently draw them to the lessee's attention, unless he has special expertise of the asset. Therefore, it would not be surprising that the finance lease agreement would usually exclude the lessor from the obligation to ensure that the asset is of satisfactory quality.

4.4.4 Correspondence with description

Section 8 of the 1982 Act requires that, where hire is by description, it is a condition of the contract that the lessor has an implied obligation to ensure that the asset transferred to the lessee will correspond with the description.

However, in the case of a finance lease, the description of the asset is normally given by the lessee to the lessor for the latter to purchase the asset required, although originally the description of the asset may be provided by the supplier during his negotiation with the lessee. Thus, the description in this case is given by the lessee for the lessor to identify the asset required, rather than given by the lessor for the lessee to denote the asset. For this reason, it is unlikely that a finance lease agreement would be regarded as "where hire is by description". Further, the lessor cannot control whether

or not the asset corresponds with the description. The description given by the lessee is only an instruction for the lessor to acquire and lease the asset specified. He may be negligent if he fails to fulfil his duty to purchase the desired asset but, more likely, there would be other reasons for the non-correspondence with the description, for example, the description of the asset might be inaccurate or insufficient, or the supplier might fail to provide the asset described. Under these circumstances, it would be unreasonable to hold the lessor responsible.

Thus, it is reasonable that, in a standard case of finance leasing, where the lessor's role is solely that of a financier, the lessor should be excluded from the obligation to ensure that the asset corresponds with the description. However, in exceptional cases, it is possible that, during the negotiation, the supplier acts as an agent of the lessor or the lessor consents to be bound by the description; in that case, the lessor should be held liable for non-correspondence with description.

4.4.5 Correspondence with sample

According to s 10, where the asset is leased by reference to a sample, it is a condition of the contract that the lessor has an implied obligation to ensure that the bulk transferred to the lessee will correspond with the sample in quality and the lessee has a reasonable opportunity to compare the bulk with the sample and the bulk is free from any defect making the bulk unsatisfactory, which would not be apparent on reasonable examination of the sample. By reasons similar to those regarding description, it is rare that a finance lease would be regarded as a lease by sample.¹⁹⁹ It

¹⁹⁹ 'A lease by sample' might be defined to be a lease whereby the lessor expressly or impliedly promises that the asset leased should answer the description of a small parcel exhibited at the time of the lease, by analogy with the definition of 'a sale by sample' given in *Parker v Palmer* (1821) 4 B.&A. 387, at p391. See also *Parkinson v Lee* (1802) 2 East 314, at p323.

would be reasonable to exclude the lessor, acting as a mere financier, from liability for non-correspondence with sample.

4.4.6 Why were not finance leases excluded from the scope of the 1982 Act?

The above discussion as to the lessor's four obligations under the Supply of Goods and Services Act 1982 showed that, being solely a financier, the lessor could be excluded from all those obligations imposed on an owner of hire for defects in the asset. In fact, it was an argument before the Law Commission in the consultation that finance leases, as a special form of leasing, should be excluded from the scope of the 1982 Act, on the ground that finance leasing is basically a finance tool and the lessor is solely a financier.²⁰⁰

For two reasons the Law Commission rejected the argument. One was that the burden of responsibility of the lessor would in any case be much lighter than that falling on an ordinary lessor.²⁰¹ The lessor is normally excluded from the obligation of fitness for purpose because no liability would be imposed on him where the circumstances show that the lessee did not rely, or that it was unreasonable for him to rely, on the lessor's skill or judgment. The obligation of merchantable quality²⁰² was considered by the Law Commission not to be imposed on the lessor, where the defect was one of which the lessee was aware or, if the lessee examined the asset before the contract was made, of which he ought to have been aware.

²⁰⁰ Law Commission, *Implied Terms in Contracts for the Supply of Goods* (LAW COM No 95, 1979) para 93-94.

²⁰¹ Law Commission, *Implied Terms in Contracts for the Supply of Goods* (LAW COM No 95, 1979) para 95.

²⁰² The term "merchantable quality" was substituted by "satisfactory quality" by the Sale and Supply of Goods Act 1994, Sch 2 Para 6(2).

The other reason that the Law Commission refused to exclude finance leases from the scope of the 1982 Act was that it was believed that the lessor had to accept a certain degree of responsibility for the quality of the goods supplied, subject to effective exclusion clauses.²⁰³ It was said that the lessor, being the buyer in the sale of goods, was entitled to indemnity from the supplier for any loss caused by defects in the asset, whereas the lessee did not have a direct relationship upon which he could sue the supplier.

This ground was undermined by the enactment of the Contracts (Rights of Third Parties) Act 1999, which allows a third party beneficiary to bring an action against the promisor. Being the beneficiary of the supply agreement between the lessor and supplier, the lessee may be able to claim for specific performance or damages from the supplier under the 1999 Act, if the supply agreement confers on the lessee such a right or it is clear from the supply agreement that the lessee is the beneficiary of it.²⁰⁴ Although, so far, few cases have been decided on this basis, Davies suggests that the 1999 Act should directly apply to finance leasing cases.²⁰⁵ If, the lessee can claim for damages from the supplier, the lessor should be released from the implied obligations. However, the application of the 1999 Act to the case of finance leasing has not been confirmed. Even if it were confirmed that the lessee can enforce the supply agreement, in some cases, the lessor could subsequently sue the supplier for indemnity and therefore not suffer any loss. In any case, based on a contractual relationship, the lessee can bring an action against his counterparty for damages resulting from defects in the asset, subject to exclusion clauses.

²⁰³ Law Commission, *Implied Terms in Contracts for the Supply of Goods* (LAW COM No 95, 1979) para 96.

²⁰⁴ S 1 of the Contracts (Rights of Third Parties) Act 1999.

²⁰⁵ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 58. He also points out that the problem of remoteness and the lessee's consequential losses as a result of the supplier's breach will still remain.

There appeared to be another reason underlying the rejection by the Law Commission of the proposal to exempt finance leasing from the provisions of the 1982 Act, namely, a desire to unify the common law rules on the supply of goods by analogy to the law of sale. This attempt was evident in the resemblance of the obligations imposed on the bailor by the Supply of Goods and Services Act 1982 and those on the buyer by the Sale of Goods Act 1979.

Therefore, it is submitted that the right of the lessee has better protection under the current law than merely being able to sue one party.

4.4.7 Can the lessor be excluded from the implied obligations by contract under English law?

It is shown from the previous discussion that finance leases are not excluded from the scope of application of the 1982 Act but in theory the lessor can insert exclusion clauses into the lease agreement so that he would be free from the implied obligations. Wood says, “while common practice in leases is to reduce the responsibilities of the lessor to the minimum, there may be statutory restrictions, inspired by consumerism and spilling over into business transactions, which limit the exclusion of these implied terms.”²⁰⁶ This section will discuss whether the lessor can be excluded from the implied obligations by contract and to what extent the exclusion is effective in practice.

Section 7 of the Unfair Contract Terms Act 1977 governs the exclusion clauses in the case of supply of goods, distinct from s 6, which governs exclusion in the case of sale and hire-purchase. S 7(2) prohibits exclusion of one party’s obligation as to the asset imposed by law when the other party to the contract acts as consumer. According to

²⁰⁶ PR Wood, *Law and Practice of International Finance* (Maxwell, London 1980) 350.

7(3), in a business case, the liability can be excluded or restricted as long as the term satisfies the “requirement of reasonableness” under s 11 of the Act. S 11(2) of the Act refers to five guidelines given by Schedule 2 of the Act for the court to exercise discretion as to what is reasonable.

*Chitty on Contracts*²⁰⁷ discerns that the customary existence of the exclusion clause in the case of finance leases with non-consumers would satisfy the reasonableness requirement in s 7(3) of the 1977 Act.

The case of *Abbey National Business Equipment Leasing Ltd v Dora Ife (t/a/ Hair Expressions)*,²⁰⁸ confirmed the possibility that the lessor’s obligations as to the condition of the asset could be excluded. In that case, a finance company brought an action for arrears under a hire agreement for the finance of a set of CCTV equipment against the defendant lessee. The lessee contended that the equipment failed to transmit pictures from the camera to the remote TV screens and therefore the lessor was in breach of the implied terms as to fitness for purpose and satisfactory quality and that the clauses in the hire agreement which specifically excluded the implied obligations of satisfactory quality and fitness for purpose were not reasonable. District Judge Wallace gave judgment in favour of the lessor. He held that, on the facts, the exclusion clauses satisfied the test of “reasonableness” required by s 7 of the Unfair Contract Terms Act 1977 and therefore excluded the lessor from the obligations. With reference to the guidelines under the Schedule 2, the judge considered the following factors: (1) the parties had traded as businesses at arm’s length, (2) the lessor had never seen the equipment when the hiring agreement was entered into, (3) the lessee

²⁰⁷ HG Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 2, § 33-081, footnote 434.

²⁰⁸ [2003] 12 CL 70 (CC), 11 July 2003, unreported.

had selected the equipment, (4) only the lessee knew the needs of his business and decided to meet the needs, and (5) the lessee should have known the existence of the exclusion clauses in the agreement when he signed and forwarded the agreement to the lessor.

The case of *Abbey* illustrated that the exclusion clauses were considered reasonable because the lessor acted solely as a financier. He did not have relevant technical expertise nor was involved in negotiations concerning the condition of the asset. This case is a good example that the lessor could be excluded from the statutory implied obligations in respect of the condition of the asset by inserting exclusion clauses into the contract.

However, there are two obstacles in practice which might cripple the lessor's attempt for liability exclusion: the diverse interpretations of the test of "reasonableness" and the broad definition of 'dealing as a consumer'.

The first obstacle concerns the test of "reasonableness". The judgment in *Lease Management Services v Purnell Secretarial Services*²⁰⁹ indicates that there is uncertainty with regard to how to interpret the test of "reasonableness". In that case, the lessee sought to finance lease a photocopier as a replacement for an existing one and made clear to the salesman that it should make paper plates but the replacement machine supplied did not have the feature required. In the lessor's action for rentals, the lessee contended that the lessor had not provided a photocopier fit for that particular purpose. The first instance judge held in favour of the lessor, on the ground

²⁰⁹ [1994] CCLR 127 (CA), 24 March 1994, per Sir Donald Nicholls VC, Hirst, Waite LJ.

that the lessor could rely on the exclusion clauses due to his role as financier. The Court of Appeal reversed the judgment.

In delivering the judgment of the Court of Appeal, Sir Donald Nicholls, VC ²¹⁰ said that the lessee's case did not rely on s 11(2) of the Unfair Contract Terms Act 1977 and the relevant Schedule 2 guidelines applicable to ss 6 and 7. Instead, he said that the lessee could rely on s 3 of the 1977 Act, which requires the exclusion of a contract using a standard form to fulfil the test of reasonableness under s 11(3) of the Act, which is in relation to a notice (not being a notice having contractual effect). Therefore, he decided, the disputed exclusion clause embraced virtually all liability for any shortcomings in the equipment regardless of seriousness and therefore could not pass the test of reasonableness as required according to s 11(3), in the absence of reference to the Schedule 2 guidelines.

Unfortunately the court did not make it very clear why the exclusion clause of a contract of hire which uses a standard written form should only fall within s 3 of the 1977 Act, rather than within both s 3 and s 7 under the same Act. S 3(1) says: "This section applies as between contracting parties where one of them deals as consumer or on the other's written standard terms of business". S 7 applies to miscellaneous contracts under which the possession or ownership of goods passes under or in pursuance of a contract not governed by the law of sale of goods or hire-purchase and therefore applies to finance leases. S 7(3) specifies that exclusion clauses as against a person dealing otherwise than as consumer are subject to the requirement of reasonableness. In *Purnell*, both parties made the contract of hire in the course of a business and it was not a case regarding a consumer. It seems that the court refused to

²¹⁰ Hirst LJ and Waite LJ agreed.

apply s 7, mainly because they felt reluctant to apply the guidelines under Schedule 2, which were expressly applicable to ss 6 and 7 and would give rise to a result supporting the lessor's argument.

The reluctance was understandable as to provide protection to the misled lessee based on the following facts. One is that making paper plates was required by the lessee as an essential quality of the photocopier and the salesman was informed. Furthermore, the lessor used a trading style which led the lessee to regard the supplier, rather than the lessor himself, as the counterparty to the leasing contract. The third significant fact is that the exclusion clause was part of a small-print standard leasing agreement which was considered to be insufficient to call it to the attention of the lessee.

However, the decision of *Purnell* is problematic because it excluded the application of the guidelines under Schedule 2 of the 1977 Act to standard terms of a finance lease agreement. The later cases concerning standard forms of contract have shown a better authority on the point that the guidelines are applicable in general to contracts made in a standard form.²¹¹ For example, in *Overseas Medical Supplies Ltd v Orient Transport Services Ltd*,²¹² the Court of Appeal said: "Although not specifically applicable to cases falling within s 3 of the 1977 Act, the five guidelines as to reasonableness set out in Schedule 2 are nonetheless relevant to the question of reasonableness, while bearing in mind that the Court is dealing with a commercial and not a consumer transaction."²¹³ In another case *Granville Oil and Chemicals Ltd v*

²¹¹ In *Chitty on Contracts*, it is stated that, although the guidelines are made expressly applicable for the purpose of ss 6 and 7, they are frequently regarded as being of general application. Hugh G Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 14-085.

²¹² [1999] 2 Lloyd's Rep 273 (CA). The case concerned whether the transport contract between the parties was subject to the British International Freight Association Standard Conditions 1989 and whether the transporter could enjoy limited liability provided for in the conditions.

²¹³ *Ibid*, per Potter LJ, at 277.

Davis Turner & Co Ltd,²¹⁴ the Court of Appeal said: “Schedule 2 which contains guidelines for application of the reasonableness test, only directly applies to contracts for the sale or hire purchase of goods. Nevertheless it is common ground that its provisions ought to be taken into account in a case such as this.”²¹⁵

It is hoped that the cases mentioned above might provide a good ground to suspect whether the decision made in *Purnell* is still good law and also that the court might clarify it in due course. It is submitted that, when the court considers whether an exclusion term of the finance lease agreement satisfies the test of reasonable under the Unfair Contract Terms Act 1977, the guidelines set up by Schedule 2 should be taken into account.

The other obstacle to the certainty of the lessor’s liability exclusion lies in the broad interpretation of the term “dealing as a consumer” decided in the case of sale and hire purchase.

The case of *R & B Customs Brokers Co Ltd v United Dominions Trust Ltd*²¹⁶ concerned the conditional sale of a car. The plaintiffs purchased from the defendant finance company a car supplied by the third party motor dealer. Clause 2(a) of the conditional sale agreement under which the car was purchased purported to exclude any implied conditions as to the condition or quality of the car or its fitness for any particular purpose in relation to business transactions. The plaintiffs rejected the car due to a serious defect and brought an action against the defendants to recover the

²¹⁴ [2003] EWCA Civ 570, [2003] 2 Lloyd’s Rep 356 (CA). The case concerned whether Clause 30 of the British International Freight Association (BIFA) Standard Trading Conditions (1989 edition) should be considered to incorporate into the contract and satisfied the requirement of reasonableness prescribed by the Unfair Contract Terms Act 1977.

²¹⁵ [2003] EWCA Civ 570, [2003] 2 Lloyd’s Rep. 356 (CA), per Tuckey LJ, at 358.

²¹⁶ [1988] 1 WLR 321 (CA).

amount paid under the sale agreement and the defendants in turn claimed an indemnity from the motor dealer.

Giving judgment for the plaintiffs, the Court of Appeal decided that Clause 2(a) of the contract did not apply because it only excluded liability in relation to business transactions, but in this case, in entering into the sale agreement, the plaintiffs were “dealing as a consumer”, by virtue of s 6(2) of the Unfair Contract Terms Act 1977. As to the contention that the plaintiffs were a one man private company, the Court explained that, where a transaction was only incidental to a business activity, a degree of regularity was required before the transaction could be said to be an integral part of the business carried on and so entered into in the course of that business. Since the car was only the second or third vehicle acquired by the plaintiffs on credit terms, there was not a sufficient degree of regularity capable of establishing that the contract was anything more than part of a consumer transaction.

The above rationale was followed by a later case of *Feldaroll Foundry Plc v. Hermes Leasing (London) Ltd & Ors*.²¹⁷ A finance company and a public company entered into a hire purchase agreement with regard to a car. The car was to be used by the hire-purchaser’s managing director as a reward. The hire purchaser rejected the car on the ground of breach of the obligation for fitness. The court, being bound by *R & B*, held that the hire purchaser had acted as a consumer and therefore the finance company could not rely on exclusion clauses in the agreement.²¹⁸

The two cases mentioned above concerned s 6(2) of the 1977Act, which stipulates that, as against a person dealing as a consumer, liability for breach of the obligations

²¹⁷ [2004] EWCA Civ 747 (CA); (2004) 101(24) LSG 32, 11 May 2004.

²¹⁸ [2004] EWCA Civ 747 (CA), (2004) 101(24) LSG 32, per Tuckey LJ (Kay and Kennedy LJJ agreed), §18.

implied by law could not be excluded or restricted by reference to any contract term. S 6(2) is essentially the same as s 7(2), except that the former applies to sale and hire purchase of goods but the latter applies to other contracts of supply of goods. When identical phrases occur in associated sections of a statute, the expectation is that they will be construed with similar effect. Therefore, it is highly possible that, by analogy to the law of sale represented by *R & B* and the law of hire purchase represented by *Feldaroll*, if the lessee of a finance lease is regarded as dealing as a consumer, the lessor would not be allowed to exclude the obligations as to the condition of the asset implied by the 1982 Act if such an issue is raised in court.

Therefore, whether the lessor can exclude or restrict his obligation as to the condition of the asset would hugely depend on whether the lessee is dealing as a consumer. Accordingly, in order to decide the nature of the lessee's act as a consumer or a business, the lessor has to discern whether the lessee has displayed a degree of regularity sufficient to form an integral part of the business carried on by him.

Although the requirement mainly applies to transactions concerning equipment suitable for both business and consumer use, and theoretically the assets in finance leasing are normally commercial capital assets and therefore they are likely to be leased in the course of a business, the existence of the broad interpretation of the term "dealing as a consumer" seems to be an unfortunate obstacle for finance companies to feel encouraged to provide finance by way of either finance leasing, or hire purchase, or conditional sale.

In the case of finance leasing, the lessor would need to pay attention to the business history of the lessee, in order to be excluded from the implied obligations. However,

sometimes, it is difficult to tell whether the company acquires an asset for a business or consumer purpose. For example, the car which was purchased for the use of the company's director in *R & B* had been booked as an asset of the company. There have been concerns as to the difficulty of distinguishing between the commercial or consumer purpose of a motor vehicle.²¹⁹

To give an example, suppose two companies enter into a finance lease agreement under which a helicopter is leased for the lessee's managers' transportation. Both the lessee and lessor are business persons and have agreed to insert an exclusion clause into their contract which excludes the lessor from any defect in the helicopter. When the helicopter turns out to be defective and the lessee claims for damages against the lessor, his case likely would be supported by the court. The court would be bound by the case of *R & B* and decide that the lessor could not invoke the exclusion clause, because the lessee is regarded as a consumer, in so far as the transaction is not of a type carried on with a degree of regularity which establishes it as an integral part of the business. In this case, the transaction would be of considerable risk to the lessor because the lessee, being a business person in the belief of the lessor, turns out to be a consumer by the court. To protect himself against this eventuality, the lessor would have to investigate the regularity of such transactions in the lessee's business which would result in increased expense. Or, balancing risk and cost, he may decide to withdraw from the transaction.

Unfortunately, it is highly likely that the broad interpretation of "dealing as a consumer" decided in the case of sale and hire purchase would apply to the case of finance leasing. This problem reveals a flaw of the approach taken by English law to

²¹⁹ I Davies, 'Ostensible Ownership and Motor Vehicle Financing in England: antipodean insights', (1994) 9(11) *Journal of International Banking Law* 474, 477.

impose obligations on the lessor of a finance lease. Unless finance leases are explicitly excluded from the scope of application of the Supply of Goods and Services Act 1982, there is always a risk that the lessor would be liable for defects in the asset under the Act, despite the fact that he merely acts as a financier.

The discussion in this section has endeavoured to assess the practicality of the lessor's exclusion from the obligations implied by law. It has shown that in principle the lessor can be excluded from the implied obligations by contract but in practice the exclusion is doubtful due to the divided views of the courts as to the test of "reasonableness" and the broad interpretation of the term "dealing as a consumer".

4.4.8 How can the English law be changed?

This section will consider how the current law can be changed, in the light of the developments in the international sphere, for example, the Unidroit Convention.

Article 8(1) of the Unidroit Convention exempts the lessor from any obligations in respect of the equipment, save to the extent that the lessee has suffered loss as a result of either his reliance on the lessor's skill and judgment, or the lessor's intervention in the selection of the supplier or the specifications of the equipment. In other words, unless the lessor is involved in the selection of the supplier or the equipment, he is not liable for defects in the asset. Then Article 10 confers on the lessee a right of the lessor under the supply agreement to claim remedies against the supplier. It specifies that the supplier undertakes the duty under the supply agreement to the lessee as if the lessee were a party to that agreement and as if the equipment were to be supplied directly to the lessee, but only if the supplier is not liable to either of them. In this way,

the lessee is entitled to a direct remedy through litigation against the supplier for all the warranties under the supply agreement as if he stands in the place of the lessor.

Article 12(1) provides that, where the asset fails to conform to the supply agreement, the lessee has a right to reject it or to terminate the lease agreement but the lessor has a right to remedy this failure. Article 12(2) added that such rights should be exercised in the same manner and be lost in the same circumstances as if the lessee had agreed to buy the asset from the lessor under the same terms as those of the supply agreement.

To enforce the lessee's rights stated above under Article 10(1), Article 11 requires in addition that, without the lessee's consent, any variation of any term of the supply agreement previously approved by the lessee should not affect his right derived from the supply agreement. The reason seems to be that since the lessor is a financier he should act solely as a financier. If without the lessee's consent, the lessor varies the terms of the supply agreement previously decided by the lessee so as to conflict with the lessee's best interests, the lessor ought to be liable for the intervention. This echoes the principle which exists in Article 8(1)(a) under which the lessor is liable for his intervention in the selection of the supplier or the specifications of the equipment.

Through these provisions, the Unidroit Convention removes the warranty in respect of the equipment from the lessor and places it upon the supplier who has expertise relating to the asset and should in all fairness be responsible for defects in the asset. Therefore the lessee benefits directly from the supplier's warranty and avoids the complications in litigation which may arise, for example, in English law. The lessor is released from the responsibility for defects and is solely a financier. The supplier's

responsibility for the condition of the asset remains unchanged by the reallocation of the obligations between the lessor and lessee.

The Model Law has almost the same provision in Article 7(1) as Article 10 of the Convention. It confers on the lessee a right of the lessor against the supplier under the supply agreement and accordingly the lessee can sue the supplier directly for remedies in respect of defects in the asset. Article 7(2) specifically added that such a right of the lessor against the supplier should be assigned by the lessor to the lessee; otherwise, the lessor would be deemed to have assumed the duties of the supplier.

Like Article 11 of the Convention, Article 7(3) of the Model Law provides that the lessee's right to sue the supplier under the supply agreement shall not be affected by a variation of any term of the supply agreement made by the lessor without the lessee's consent. Both the Convention and the Model Law have an underlying condition to the connection between the supply agreement and the lease agreement that the lessee should have approved the terms of the supply agreement. This condition has been expressly stipulated by the Convention in Article 1(1)(a) when it describes the supply agreement but it is not stipulated by the Model Law. It is submitted that, for consistency and clarity, the condition should be spelt out, preferably in Article 2 of the Model Law where the supply agreement is defined.

Article 17 of the Model Law provides that the supplier undertakes a warranty for the quality of the asset. It specifies that the asset should be at least such as is accepted to conform to the description in the lease and is fit for the ordinary purposes for which an asset of that description is used. It also clarifies that such a warranty is only enforceable against the supplier, as long as the lessor assigns to the lessee his right

under the supply agreement. In contrast, the Convention hardly specifies the supplier's warranty as to the condition of the asset but rather merely enables the lessee to enjoy the lessor's right under the supply agreement, including warranties of the supplier as to the asset. However it might be acceptable for the Convention to omit the specific contents of the supplier's warranty, considering that Article 1(1)(a) of the Convention clearly states that the terms of the supply agreement are to be approved by the lessee and therefore the lessee should be able to reinforce his relevant requests to the supply agreement.

Both the Unidroit Convention and the Model Law create certain uniform rules to define the lessor's role as a pure financier, recognise the triangular nature of a finance leasing transaction and distribute the rights and obligations between the three parties more evenly and overtly. This appears to suit the nature and function of finance leasing and is better than the English law. Thus, it would seem advantageous for the UK to sign the Unidroit Convention, or adopts the Model Law; as a result, the lessor will be clearly excluded from the obligations as to the asset.

4.4.9 Summary

This section discussed the lessor's obligations implied by the Supply of Goods and Services Act 1982 and examined the reasons for giving a general exemption to the finance lessor from the implied obligations under the 1982 Act. It had been argued that the approach had given rise to the unfortunate result that the lessor of a finance lease could not be excluded from the implied obligations, particularly because of the broad interpretation of the term "dealing as a consumer". Although this might be understandable in view of the fact that there has not been recognition by court as to the lessee's direct cause of action against the supplier for damages resulting from

defects in the asset, uncertainty remains in English law as to the lessor's obligation as to the condition of the asset. In addition, the law is flawed in the decision made in the finance lease case of *Purnell* in contradiction to other cases with regard to the guidelines to the test of "reasonableness". It was submitted that the approach not to provide general exemption to the lessor gave rise to these blemishes and that the approach taken by the Unidroit Convention and the Model Law should be preferred.

4.5 Concluding remarks

This Chapter has examined the obligations of the lessor to the lessee under the finance lease agreement. Because of his role as financier, the lessor commonly excludes himself from the obligations as to the condition of the asset, repair and maintenance etc. The exclusion is subject to the law.

Under English law, the Supply of Goods and Services Act 1982 applies to finance leases and therefore requires the lessor to be liable for his failure to have a right to lease, for disturbance to the lessee's quiet enjoyment and for defects in the asset, including that they are of satisfactory quality, fit for the purpose of use, and correspondent with the description or sample. In general, the lessor can be excluded from all the obligations. However, there are uncertainties.

As to the lessor's obligation to transfer possession, the current law is generally clear and satisfactory. Blemishes include that there has not been an overt recognition of the direct relationship between the lessee and supplier and to the application of the rules in respect of acceptance in the law of sale of goods to finance leases. In contrast, the Unidroit Convention and the Model Law are relatively clear and provide good reference for the English law to adopt.

As to the lessor's obligation to ensure the quiet enjoyment of the lessee, the law is satisfactory in that it requires the lessor to be responsible for disturbance caused by a third party unless the lessee was aware of the encumbrance on the lessor's title. But the law is not completely clear in this area. It is submitted that, although the law allows exclusion of this obligation, in the balance of the interests of the parties, the

lessor should be responsible for disturbance to the lessee's quiet possession resulting from a third party with title paramount. In contrast, under the Unidroit Convention and the Model Law, the lessor is not liable for claims of infringement to the lessee's quiet enjoyment unless they result from the lessor's own fault. The approach taken by the Unidroit Convention is preferred in view of the triangular relationship and the lessor's role as financier.

As to the lessor's obligation to ensure the condition of the asset, English law imposes on the lessor all the liabilities but allows exclusion. However, it was argued that there are practical obstacles to the exclusion. It is submitted that the approach taken by the Unidroit Convention and the Model Law to generally exempting the lessor from the obligations as to the condition of the asset is preferred.

Therefore, although English law is good itself, it seems that the Unidroit Convention and the Model Law are better laws with regard to the rights and obligations of the lessor and lessee. They have made good efforts to ensure that their provisions would reflect the characteristics of finance leasing, in particular, the triangular relationship and the lessor's role as financier.

CHAPTER 5 A TRIANGULAR RELATIONSHIP?

5.1 Introduction

This Chapter looks into the relationship between the three parties to a finance leasing transaction. It asks whether there is a triangular relationship between the lessor, lessee and supplier.

The law in this area is bound to be complex. One reason is that there are three parties and two agreements in the transaction. The supplier, lessor and lessee are involved in the transaction of finance leasing and they enter into two agreements: the finance lease agreement between the lessor and lessee and the supply agreement between the lessor and supplier. Another reason for complexity may be that the supplier often introduces a finance lease as a financial tool to a potential user and handles the latter's application form and payment between the prospective lessor and lessee; in some cases, the supplier even allows the prospective lessee to possess the asset before the prospective lessor accepts the application for the finance lease agreement. It is doubtful, therefore, as to whether the supplier acts as the agent of the lessor in some cases. One more reason for the law's complication could be that, although the lessee usually does not have a contract with the supplier, in some cases, their connection might give rise to some kind of a direct relationship between them. These three issues will be discussed in this chapter.

Before the discussion, it is felt useful to recall an overall description of the common practice of finance leasing given by the Court of Appeal in *Lombard North Central Plc v Butterworth*.²²⁰ In that case, a finance lease agreement was entered into by a

²²⁰ [1987] QB 527 (CA).

finance company and an individual for the hire of a Lomactina computer and a printer at quarterly rentals for five years.

Nicholls LJ said.²²¹

“I preface this issue with a reminder of the commercial realities of this lease transaction. In so doing I do not seek to ascribe to the transaction any legal characteristics other than those set forth in the lease agreement entered into by the parties. But in considering whether a hirer’s conduct amounts to repudiation the commercial setting and objective of the agreement must be of prime importance. The owners, the plaintiffs, are a well-known finance company. Their business is to provide finance for, amongst other matters, the acquisition by customers of goods, whether by hire purchase or lease or otherwise. They do not themselves supply the goods. They adopt the normal practice of finance companies: they purchase the goods chosen by the customer from the supplier and pay for them, and then let them to the customer on hire purchase or hire or as the case may be. It is in these circumstances that the plaintiffs became the owners of a Lomactina computer. When entering into the present lease agreement the objective of the plaintiffs was the unexceptional one of obtaining over the agreed period of hire a rate of return, which would yield for them a commercial profit, on the money paid out by them on the acquisition of the computer being hired.”

As has been introduced above in *Lombard North Central Plc v Butterworth*, it is common in a case of finance leasing that the supplier and lessee contact each other and negotiate details in relation to the asset before the lessor is involved in the transaction. The lessor’s involvement is for the purpose of financing. The lessor does not supply the asset himself. Instead, at the request of the lessee, the lessor acquires the asset from the supplier and becomes the buyer of the asset in order to let it to the lessee. The lessor is a financier in the tripartite finance leasing transaction.

This Chapter will firstly examine the rights and obligations of the supplier and lessor to each other based on their supply agreement, secondly discuss whether the supplier acts as the agent of the lessor, thirdly consider the situations where there might be some kind of relationship between the lessee and supplier and finally discuss the

²²¹ [1987] QB 527 (CA), at 543.

Unidroit Convention and the Model Law.

5.2 The lessor and supplier relationship

The lessor and supplier enter into a supply agreement concerning the acquisition of the asset. The supply agreement, being a sale of goods, provides the parties' details, the specifications of the subject matter of the transaction, the price and payment, delivery and responsibilities, remedies etc. A supply agreement is, in nature, a sale of the asset from the supplier to the lessor, although specifically arranged for the asset to be used by the lessee. In fact, the lessee is involved in the arrangement of the sale, for example, he selects the supplier, specifies the asset and applies to the lessor for the latter to purchase it for his use. For this reason, the relationship between the supplier and lessor is not a plain sale of goods where there is no third party's interests concerned. The obligations and rights of the lessor and supplier to each other particularly concerning the lessee's interests will be discussed below.

The Sale of Goods Act 1979 applies to the supply agreement between the supplier and the lessor and imposes a few liabilities on them as sellers and buyers. Under s 27, the supplier should deliver the asset and the lessor should accept and pay for it. Under s 12(1), the supplier should ensure that he has a right to sell the asset. Under s 12(2)(b), he should ensure that the lessor will enjoy quiet possession of the asset. The supplier is also obliged to ensure that the asset is of satisfactory quality (s 14(2)), is fit for the purpose specified (s 14(3)) and corresponds with the description given (s 13) or sample used (s 15(2)).

Because the acquisition of the asset is aimed for the lessee's use of the asset under a finance lease, the supply agreement should contain special provisions with regard to

the lessee's interests. It often stipulates that the supplier should perform his obligations directly to the lessee as if he were in the position of the lessor. For example, it is usually agreed in the supply agreement that the supplier should deliver the asset to the lessee, as performance of his obligation to deliver the asset to the lessor, because the lessor often does not see or handle the asset at all. If the supplier fails to perform his obligations under the supply agreement, the lessor can seek a remedy against him. But the lessor is unable to remedy the performance apart from urging the supplier to do it, because he is a financier rather than a supplier of equipment. The performance of the supplier affects the lessee more than the lessor, because the lessee is the end user of the asset.

Therefore, it is reasonable to require the lessor to undertake the responsibility under the finance lease agreement that, in order to ensure that the supplier would satisfy the requirement of the lessee as to the asset, he should insert relevant clauses into the supply agreement. English law is silent with regard to this duty of care but in principle the parties could insert specific clauses into the finance lease agreement to such an effect.

5.3 Is the supplier the agent of the lessor?

The lessor is often a finance company and sometimes leaves finance lease application forms with the supplier, with whom he may have an association. The supplier is often either a manufacturer or the “dealer” of a few manufacturers. He has premises to display the equipment. When a prospective user shows interest in acquiring an asset but needs finance for it, the supplier often introduces some financing options to him, including finance leases. The supplier often fixes the specifications with the user and the latter signs the form. Then the supplier hands over the application form for the finance company to approve. The finance company does not usually change anything but accepts and signs the finance lease agreement. The supplier also often receives a deposit and/or pre-payment, delivers the asset and accepts returned assets on the behalf of the finance company.

In a finance lease case *Lease Management Services Limited v Purnell Secretarial Services Limited*,²²² a salesman from the supplier Canon (South West) persuaded the user to try a demonstration model of his equipment. Being satisfied with the demonstration model, the user agreed to lease a copier for five years at a monthly rental and traded in its old machine in exchange. The salesman of the supplier went through the figures with the user and completed the details and the user signed an application form for finance leasing. The user thought that the lease was made with the supplier but in fact he signed an agreement to lease the copier from a finance company, who was not part of the Canon group. Disputes occurred later because the machine delivered did not have the feature of making paper plates, which was the key

²²² [1994] CCLR 127 (CA).

feature requested by the lessee. The finance company's attempt to be excluded from the obligation as to the condition of the asset failed on the ground that it was not reasonable for him to be excluded from liabilities under a contract in a standard form. It was held that, as the lease gave the impression that the user was contracting with the supplier, the finance company was prevented from asserting that it was a different body and that the supplier's representative had no authority to speak for it. The finance company was bound by the supplier's representation, because it deliberately used a confusing trading style in its application form.

The case of *Purnell* did not consider the question as to whether the supplier is in general the agent of the lessor in introducing business and handling documents. But this issue was raised and decided in a hire purchase agreement case.

The question as to whether there should be an assumption of agency relationship between the finance company and the dealer was argued for some time in the case of hire purchase agreements before it was effectively settled by the *obiter dicta* of the House of Lords in *Branwhite v Worcester Works Finance Ltd.*²²³ The majority of the House of Lords in the case refused to infer a general agency relationship to the hire purchase agreement.

In the case *Branwhite v Worcester Works Finance Ltd.*,²²⁴ a person who wanted a new car under a hire purchase agreement sold his own car to the dealer and the money stood as the initial payment under the hire purchase agreement for the finance company to sign. But the user signed the agreement in blank and the dealer fraudulently filled in the agreement with wrong figures. The finance company

²²³ [1969] 1 AC 552 (HL).

²²⁴ [1969] 1 AC 552 (HL).

purported to accept it, but the user refused to pay, as the document was forged, and claimed for the return of the value of his car. The House of Lords held that the consideration had wholly failed and the finance company was liable to repay the money, which the dealer had received and then the finance company had credited towards the hire purchase price.

As to the issue whether the dealer acted as the agent of the finance company, their lordship's opinions were divided. Lords Reid and Wilberforce preferred the approach taken by Lord Denning MR and Donovan L.J. in *Financings Ltd v Stimson*,²²⁵ that, based on the established mercantile background of hire purchase transactions known to and accepted by all three parties, an agency relationship should be established in general but any individual features of the particular case should be considered against that background to see whether they confirm or weaken the agency inference.²²⁶

However the majority of the House, i.e. Lords Morris of Borth-y-Gest, Guest and Upjohn, confirmed the view of Pearson LJ expressed in *Mercantile Credit Co Ltd v Hamblin*,²²⁷ that “there is no rule of law that in a hire purchase transaction the dealer never is, or always is, acting as agent for the finance company or as agent for the customer.”

The speech of Pearson L.J. was quoted and approved of as a correct statement of the law.²²⁸ He said:²²⁹

“In a typical hire-purchase transaction the dealer is a party in his own right, selling his car to the finance company, and he is acting primarily on his own behalf and not as general agent for either of the other two parties. There is no need to attribute to him an agency in order to account for his participation in

²²⁵ [1962] 1 WLR 1184 (CA).

²²⁶ [1969] 1 AC 552 (HL), per Lord Wilberforce, at 586.

²²⁷ [1965] 2 QB 242 (CA), at 269.

²²⁸ [1969] 1 AC 552 (HL), per Lord Morris of Borth-y-Gest, at 573 and per Lord Upjohn, at 576.

²²⁹ *Mercantile Credit Co Ltd v Hamblin* [1965] 2 QB 242 (CA), at 269.

the transaction. Nevertheless, the dealer is to some extent an intermediary between the customer and the finance company, and he may well have in a particular case some ad hoc agencies to do particular things on behalf of one or the other or it may be both of those two parties. For instance, if the car is delivered by the dealer to the customer after the hire-purchase agreement has been concluded, the dealer must be making delivery as agent of the finance company.”

By majority, the House of Lords set up a rule in the case of hire purchase agreement that one should not assume an agency relationship by the dealer on behalf of the finance company, except in certain specific circumstances. One of the cases where the dealer may be the agent of the finance company is with regard to his delivery of the asset to the hirer after the hire purchase agreement is made, as clarified above.²³⁰ In some cases, the dealer can even be the agent of the lessee. For example, Lord Upjohn pointed out that the sum received from the prospective hirer was held by the dealer for the prospective hirer.²³¹ However, in many cases, the dealer acts on his own account, rather than as an agent of the lessor or the lessee. For example, for the purpose of improving his business, he introduces finance options to the customer, including giving the hirer the documents of finance companies and handing them over to the companies. It is also likely that he is acting on his own initiative when he allows the hirer to take possession of the asset before the finance company accepts the lessee’s application.

Due to the similarity between finance lease and hire purchase, particularly at the negotiation stage, it is to be expected that the rule established in the case of hire purchase agreements would apply to finance leasing by analogy.

²³⁰ With reference to the speech of Pearson L.J. quoted in footnote 229 above.

²³¹ [1969] 1 AC 552 (HL), per Lord Upjohn, at 579.

Although the rule decided by the House of Lords in *Branwhite* is a three-to-two *obiter* opinion, it has not been questioned but has been followed in the case of consumer transactions. For example, in *Black Horse Ltd v Langford*,²³² where a consumer hirer was involved in a hire purchase agreement handled by the dealer and suffered loss from failure of the dealer to fulfil his statement, it was decided that the finance company was not responsible for the fault of the dealer, either under s 56(1)(b) of the Consumer Credit Act 1974 Act, or at common law, applying the authority of *Branwhite v Worcester Works Finance Ltd*.²³³ It was unfortunate that the hirer was helpless, as he was not protected by either the 1974 Act,²³⁴ or common law, because no specific facts suggested that there was an agency relationship between the hirer and the finance company. However, the hirer himself was to blame in *Black Horse*. He could have avoided his misfortune by insisting on receiving the balance of the value of his old car minus the deposit required for the new hire purchase agreement, instead of blindly believing that the dealer would pay off his obligation under the old hire purchase agreement for him. The hirer in fact trusted that the dealer would act for himself, rather than on behalf of the finance company, to settle the old hire purchase agreement. The coincidence that the same finance company entered into the new hire purchase agreement with the hirer did not (and should not) provide the hirer with any right as against the finance company.

It is admitted that, like the hirer in *Black Horse*, the lessee of a finance lease, a consumer in particular, might find financing transactions difficult to comprehend, due to lack of relevant knowledge of finance and the complication of the transaction.

²³² [2007] RTR 38 (QB).

²³³ [1969] 1 AC 552 (HL).

²³⁴ The hirer could not be protected against the chicanery of the dealer, because the dealer did not sell the car to the finance company directly and could not be regarded as the “credit-broker”, for whom the finance company should be responsible, according to the interpretation of “credit-brokers” under the requirements under the 1974 Act.

Because agency is not contractual but consensual, the dealer's acts in dealing with the goods and documents, contacting, handling money and goods etc. might have given the impression to the user that the dealer was acting on behalf of the finance company, although the documents might suggest the opposite.

However, the lessor is also vulnerable to risks in that he does not have knowledge of the asset and he relies on the lessee's selection of the supplier and specifications of the asset to form his supply agreement with the supplier. The lessee's inexperience in finance transactions does not seem to weigh out the lessor's innocence due to his absence in the negotiation of the details of the transaction taking place between the lessee and supplier.

In summary, in view of the persuasive authority in the case of hire purchase agreements and in the balance of the interests of the lessee and lessor, it is submitted that, by analogy to hire purchase law, there is no agency relationship in general between the lessor and lessee under a finance lease but in certain circumstances the supplier may be the agent of the lessor or the lessee, or act on his own account, depending on the specific facts of the case.

5.4 Any relationship between the lessee and supplier?

5.4.1 Introduction

Under English law, because of the rule of privity, there is generally no contractual relationship between the supplier and lessee. In this case it is a question at law what relationship might constitute between them when they negotiate the details of the asset and hand over documents and money.

This section will at first briefly introduce the rule of privity and then discuss the circumstance under which a claim against the supplier may be available to the lessee, e.g. under the 1999 Act, by assignment, under restitution and under a contract.

5.4.2 The rule of privity

The rule of privity means that a contract cannot confer rights or impose obligations arising under it on anyone except the parties to it. Thus for the lessee to take action against the supplier, he must have privity of contract with the supplier or have rights under statutes.

In the absence of privity and statutory rights, the lessee could only seek remedies through the lessor although these remedies were limited.²³⁵ In the lessor's action against the supplier for damages, the lessor might only obtain recovery of his own loss, not including the lessee's loss, either because he had been excluded from

²³⁵ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 153.

liability for the lessee's loss²³⁶ or the issue of remoteness of damages for loss was pertinent to the lessee's interests. As a result, the lessee might not be able to obtain any damages to cover the damage arising from the defects in the asset, from the lessor or from the supplier.

5.4.3 The Contracts (Rights of Third Parties) Act 1999

The Contracts (Rights of Third Parties) Act 1999 (henceforth "the 1999 Act") came into force on 11 November 1999. The 1999 Act preserves the right of the third party to enforce the term of a contract under common law or equity before the 1999 Act, if any, and confers on a third party a possible statutory right of action against the person who has an obligation to perform the contract if conditions for the application of the Act are met.

The 1999 Act allows a third party to enforce a contract term in one of the three situations: the contract provides that he may (s 1(1)(a)); the term purports to confer a benefit on him (s 1(1)(b)); or he would have been permitted to do so without the assistance of the Act (s 7(1)).²³⁷ Accordingly the lessee in a finance leasing transaction may be able to apply for enforcement of the supplier's obligations under the supply agreement, if that agreement expressly allows him to do so, or it expressly stipulates that the asset is supplied for the lessee's use.

Although the lessee may have a statutory cause of action against the supplier, there appears no case so far to confirm that the Act is applicable to finance leasing.

²³⁶ The lessor might have excluded liability for quality and fitness for purpose by satisfying the reasonableness test under the Unfair Contract Terms Act 1977 or the fairness test under the Unfair Terms in Consumer Contracts Regulations 1999 in a consumer case.

²³⁷ RM Merkin, *Privity of contract : the impact of the Contracts (Rights of Third Parties) Act 1999* (Lloyd's commercial law library, LLP, London 2000) 95.

Nevertheless there does not seem to be any obstacle to its application.²³⁸ Thus, presumably, if the asset is not delivered or delivered with defects, the lessee may be entitled to enforce the supplier's remedy pursuant to the supply agreement or/and to claim for damages recovering his loss resulting from the supplier's failure of performance.

Following the possible success of the lessee in bringing an action against the supplier, it is more likely that the lessor's argument that he should be excluded from any defects in the asset or any fault in its delivery of it would satisfy the requirement of reasonableness in s 11 of the Unfair Contract Terms Act 1977, because the lessee has been given an adequate direct remedy against the supplier, who is the real culprit. As a result, the rights and obligations between the lessor, lessee and supplier could be better balanced.

In order to enable the lessee to enjoy the statutory right under the 1999 Act, the lessor should ensure that particular terms will be inserted to the supply agreement. It is important that the lessee should, as required by s 1(3) of the Act, expressly be identified in the supply agreement by name, as a member of a class or as answering a particular description. In *Avraamides v Colwill*,²³⁹ the claimant's claim to enforce a contract under the 1999 Act failed because the term of the contract did not identify any third party or class of third parties, even although the contract evidenced an agreement between the third party and the promisee of the contract.²⁴⁰

²³⁸ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 58.

²³⁹ [2006] EWCA Civ 1533, [2007] BLR 76 (CA).

²⁴⁰ [2006] EWCA Civ 1533, [2007] BLR 76 (CA), per Waller LJ, at 79.

If, based on a proper construction of the term of the contract, a third party is entitled to enforce the contract, there are two implications. On the one hand, s 1(5) of the Act provides that he is entitled to the remedies in an action as if he had been a party to the contract. On the other hand, s 3 of the Act allows the promisor to raise defences, including the rules relating to damages, injunctions, specific performance and other relief available under the contract against the assignee of the promise. Thus, unless the contract provides to the contrary, the third party cannot purport to seek any self-help remedies, such as termination, or restitutionary remedies, including recovery of sums paid to the promisor by way of total failure of consideration, because the promisor cannot be regarded as having been unjustly enriched at the expense of the third party but only at the expense of the promisee.²⁴¹

The provisions of the 1999 Act presumably would apply to finance leasing with the result that, under the Act, the lessee can be treated as if he were the lessor under the supply agreement. Therefore, the lessee should be able to bring an action against the supplier in order to enforce the latter's obligations under the supply agreement, e.g. as to the delivery of the asset and its condition, as if he were a party to that agreement.

5.4.4 A contractual Relationship

It is not uncommon that, in the case of finance leasing, the supplier makes certain promises with regard to the quality of the asset or responsibility for maintenance to the lessee during their negotiation. If the supplier gives a warranty to the lessee and intends to be bound by it, the lessee, on reliance of the warranty, entered into a finance lease agreement with the lessor, there may be a contractual relationship between the lessee and supplier. The supplier's promise and the lessee's reliance

²⁴¹ Law Commission, Privity of Contract: Contracts for the Benefit of Third Parties (Law Com No 242, 1996) para 3.33.

could constitute a contract between them. As a result, if the supplier fails to fulfil his promise, the lessee can sue the supplier directly on his own account and claim damages for his loss arising from the supplier's breach of contract.

Such a contractual relationship has been well established in hire purchase cases. For example, in *Webster v Higgin*,²⁴² when negotiating with the prospective customer regarding a car, the seller gave a guarantee that the car was in good condition. The customer then entered into a hire purchase agreement with the seller. In the hire purchase agreement, the seller excluded liability for any previous agreement and representation. The Court of Appeal held that the guarantee of the seller and the consequent signing of the hire purchase agreement by the hire purchaser formed a contract and that the seller was bound by his warranty.

This principle would apply to finance leasing because the arrangement in the case of finance leasing is similar to that of hire purchase. Often a customer comes to the supplier, the supplier gives a warranty as to the condition of an asset to a customer and then the customer consequently enters a finance lease agreement with a finance company, which acquires the asset for the customer's use but excludes all liabilities as to the condition of the asset, as well as previous warranties or representations made by himself or anyone else. In the event of a default with regard to the asset, the court might, by analogy to the decision of *Webster v Higgin*, accept the lessee's argument that the guarantee of the supplier and the consequent signing of the finance lease agreement by the lessee formed a contract and therefore hold that the supplier is bound by his warranty.

²⁴² [1948] 2 All ER 127 (CA).

This contractual relationship provides the lessee with a cause of action against the supplier, while the lessor may have been validly excluded from liability as to the condition of the car. It is submitted that when there is an express promise made by the supplier and in return the lessee enters into a finance lease contract with the lessor, a contractual relationship is formed and therefore the lessee could sue the supplier in the event of any defects in the asset and seek remedies from him directly.

5.4.5 Assignment

Assignment is a popular means developed to overcome the hurdle of the rule of privity in contract law.²⁴³ If a party to a contract assigns his right under it to a third party, the third party could bring an action as against the other party to the contract. The approach of assignment is commonly used in the case of hire purchase agreements. The owner in a hire purchase agreement often assigns to the hirer his right under a sale contract with the dealer so that the hirer could sue the supplier for enforcement of obligations or claim for damages to cover the loss arising from the supplier's default. However the effect of the rule of assignment is usually limited in that the damages for which the assignee can claim usually only cover the assignor's loss rather than the assignee's own loss. It means that in transactions such as hire purchase or finance leasing, the actual user could not obtain substantial damages from the supplier. But recently, the common law has developed so as to enable a third party assignee to obtain a remedy under a contract to which he is not a party and make the defaulting party to the contract liable for his loss.

²⁴³ S 136 of the Law of Property Act 1925.

The decision made by the Court of Appeal in *Technotrade Ltd v Larkstore Ltd*²⁴⁴ shows that a third party could claim substantial damages against the defaulting party, even though the assignor himself had suffered no loss and could have recovered only nominal damages, had he sued. In that case, the original owner of a site obtained planning permission for the site, subject to a soil inspection report. Then a company which provided site investigation and engineering services produced a favourable report. The site was then sold, with the benefit of full planning and building control consents including all soil investigations. The new owner and its contractors undertook excavation works, which caused a landslip and damaged the properties uphill. The original owner then assigned his rights under the soil inspection report to the new owner, after nearly five years of sale. In the action against the new owner brought by the owners of the damaged properties, the investigation company was brought into the action for liability to the damage.

The Court of Appeal decided that the new owner as the assignee to the inspection contract was entitled to substantial damages from the investigation company, even if the assignor had only suffered nominal loss at the date of assignment. Mummery LJ, who delivered the judgment, said that what was assigned was a cause of action for breach of contract against the wrongful party and the legal remedies for it.²⁴⁵

Although the facts of this case concerned an assignment of the benefit of a contract for the performance of services relating to real property, there is no reason for its outcome to be limited to that situation.²⁴⁶ It is believed that it should be relevant to an assignment of the benefit of many types of contract, whether for the supply of

²⁴⁴ [2006] EWCA Civ 1079, [2006] 1 WLR 2926 (CA).

²⁴⁵ [2006] EWCA Civ 1079, [2006] 1 WLR 2926 (CA), per Mummery LJ, at 2936.

²⁴⁶ A McKnight, 'A review of developments in English law during 2006: Part 1' (2007) 127 *Journal of International Banking Law and Regulation* 140.

services or for work to be done and whatever the related subject-matter of the contract, be it goods, an intangible right or something else.²⁴⁷

Following this decision, it is likely that, by analogy, the lessee of a finance lease may claim for substantial damages from the supplier for the latter's breach of the supply agreement, if the lessor assigns his cause of action against the supplier for breach of their contract to the lessee, even if the lessor might merely suffer nominal loss.

5.4.6 Restitution

The rule of unjust enrichment means that, if one party is unjustly enriched at the expense of another, an obligation to make restitution arises, regardless of liability for wrongdoing.

The case of *Branwhite v Worcester Works Finance Ltd*²⁴⁸ decided by the House of Lords provided a persuasive authority in favour of the application of the rule of unjust enrichment to finance leasing. In that case, the prospective hirer traded in his car as part of exchange and his payment to the dealer included a deposit and the initial payments. It was clear that the finance company had received this sum from the hirer because they were deducted from the price payable by the finance company. Because the transaction between the hirer and the finance company was void, the finance company was obliged to repay what it had received upon a consideration which had wholly failed.

It was therefore established in that case that, where the consideration for a hire purchase contract wholly fails, the hire purchase company is obliged to restore to the

²⁴⁷ A McKnight, 'A review of developments in English law during 2006: Part 1' (2007) 127 *Journal of International Banking Law and Regulation* 140.

²⁴⁸ [1969] 1 AC 552 (HL).

prospective hirer any sums received from him by the supplier and treated as part of the hire-purchase price. This remedy is under the law of restitution, distinct from that in contract law, where only a genuine advance instalment is recoverable but a deposit intended to operate as security for the due performance of the payor's obligations is forfeitable.²⁴⁹

It is submitted that the rule of unjust enrichment should apply to finance leasing by analogy due to the crucial similarity between hire purchase agreements and finance leases. According, if the lessee has paid deposits and/or a pre-payment, but the lessor had not accepted his application for a finance lease, under the rule of unjust enrichment, the lessee could recover his payments, whether goods or money, from the supplier, on the ground of total failure of consideration.

5.4.7 Summary

From the discussion, there seem to be at least four ways by which the lessee could obtain certain remedies from the supplier. The lessee might sue the supplier on a contractual ground if the latter made a promise on the reliance of which the former enters into the lease agreement with the lessor. The lessee might by the means of assignment claim for damages from the supplier to cover his loss resulting from the supplier's default. He might also bring an action against the supplier in order to enforce the latter to perform the supply agreement so that he could enjoy the benefits of the performance. In the case of total failure of consideration, the lessee can recover the payment or goods for exchange from the supplier. English law has generally overcome the insufficiency of remedies to a third party arising from the rule of privity.

²⁴⁹ HG Beale (ed), *Chitty on Contracts* (30th edn Sweet & Maxwell, London 2008), Volume 1, § 26-146. G Jones, *Goff and Jones: the Law of Restitution* (7th edn, Sweet & Maxwell, London 2007) paras 20-041-20-046.

The variety of possible remedies available to the lessee against the supplier under English law offer additional protection to the lessee in an international financial lease transaction and therefore might be seen as a strength of English law. Nevertheless they might be felt too complicated to comprehend by the parties from other jurisdictions.

5.5 The Unidroit Convention and Model Law

The Unidroit Convention and the Model Law do not see the finance leasing transaction as two separate agreements. Instead, they clearly define that the supply agreement is arranged for the benefits of the lessee under the lease agreement.

Firstly, they recognise the connection between the supplier and lessee, particularly with regard to the lessee's independent decision on the selection of the asset and supplier. The Model Law stipulates in the definition of financial lease in Article 2 that the lessee specifies the asset and selects the supplier. Article 1(2)(a) of the Convention provides that one characteristic of the financial leasing transaction is that the lessee selects the supplier and specifies the asset without relying primarily on the skill and judgment of the lessor.

Secondly, Article 1(1)(a) of the Convention further requires that the terms of the supply agreement are to be approved by the lessee. The Model Law does not expressly require but implies in Article 7(3) that the terms of the supply agreement should be approved by the lessee. Under both laws, on the one hand, a variation of the terms of the supply agreement should not affect the lessee's rights derived from the supply agreement except for with his consent to that variation.²⁵⁰ On the other hand, the lessee cannot modify, terminate or rescind the supply agreement without the consent of the lessor.²⁵¹

²⁵⁰ Article 11 of the Convention and Article 7(3) of the Model Law.

²⁵¹ Article 10(2) of the Convention and Article 7(5) of the Model Law.

Thirdly, the connection between the lease agreement and the supply agreement is recognised. Article 2 of the Model Law requires that the supplier has knowledge of the fact that “the lessor acquires the asset in connection with a lease”. It also defines the supply agreement as “an agreement under which a lessor acquires the asset for lease under a financial lease”. Article 1(2)(b) of the Convention stipulates that “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.”

Fourthly, both the Convention and the Model Law recognise the lessee’s beneficiary role in the supply agreement. According to Article 10(1) of the Convention and Article 7(1) of the Model Law, the supplier’s duties under the supply agreement are owed to the lessee as if the latter were a party to that agreement and as if the asset were to be supplied directly to the lessee.

Fifthly, as to the lessor’s obligation to assist the lessee in claiming against the supplier, the Convention and the Model Law diverge. Article 7(2) of the Model Law requires the lessor to assist the lessee in a claim against the supplier, by the means of assigning his rights under the supply agreement to the lessee at the latter’s request; in other words, the lessor is deemed to have assumed the duties of the supplier. This requirement for the lessor’s duty of care owed to the lessee is desirable under English law. But there is no such provision under the Convention.

Finally, although both the Convention and the Model Law entitle the lessee to the rights of the lessor under the supply agreement, neither of them expressly spell out that the supplier is liable to the lessee for defaults of delivery and defects in the asset.

Rather, Article 12(1)(a) of the Convention provides that when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee has the right as against the lessor to reject the asset or to terminate the leasing agreement.

In contrast, the Model Law does not contain a provision to stipulate the lessee's right as against the lessor in the case of the supplier's defaults of delivery and defects in the asset. Instead, Article 14(1) of the Model Law provides that, when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee can demand a conforming asset from the supplier, in addition to other remedies provided by law. Also, Article 11(1)(b) of the Model Law provides that the lessee may in this case treat the risk of loss as having remained with the supplier, provided that he takes proper care of the asset. In the absence of specification of the circumstances under which the supplier is liable for defaults of delivery and defects in the asset, these two provisions appear to imply that the supplier is liable to the lessee, whether or not the lessee has accepted the asset. Thus, the two provisions can be interpreted to confer on the lessee a right to demand a conforming asset from the supplier and a right to treat the risk of loss as remaining with the supplier. It is submitted that the Model Law contributes clarity to the relationship between the lessee and supplier by these provisions. This is strength of the Model Law; it is clearer than the Convention in respect of the relationship between the lessee and supplier regarding defaults of delivery and defects in the asset.

To conclude, the specific provisions of both the Convention and the Model Law contribute to the recognition of the lessee's right against the supplier to the law pertaining to international finance leasing transactions.

5.6 Concluding remarks

This Chapter discussed the question as to whether there was a triangular relationship between the three parties. It was found that, in the relationship between the lessor and supplier, the lessor was obliged to pay for the acquisition of the asset for the purpose of a lease to the lessee and the supplier was obliged to deliver the asset for the use of it by the lessee. There is a clear connection between the lease agreement and the supply agreement. However, in general, English law does not see the supplier as an agent of the lessor in introducing business and handling documents and money. In the lack of a direct contractual relationship between the supplier and lessee, the rule of privity prevents the lessee from claiming a right or a benefit against the supplier. Nevertheless English law offers various ways by which the lessee can claim for damages for loss resulting from defects in the asset, claim for specific performance by the supplier to deliver a conforming asset, or claim for recovery of pre-payment or goods for exchange from the supplier. The law is satisfactory. The Unidroit Convention and the Model Law contribute clarity to the relationship between the lessee and supplier by providing that, being a beneficiary, the lessee is entitled to the rights of the lessor under the supply agreement against the supplier. The triangular relationship is explained by the Unidroit but has not been recognised by English law, although in theory it is believed to be in no doubt.

One might wonder why the UK has not adopted the Unidroit Convention and the Model Law.

Being a useful financing mechanism, finance leasing has been encouraged by the Unidroit in its 1988 Convention and 2008 Model Law for wide use in international trade. These two instruments contribute to the international law of finance leasing by providing a clear framework for international financial leasing. In their description of financial leasing, the following two key features are highlighted. There is a triangular relationship between the lessor, lessee and supplier. There is a clear linkage between the supply agreement and the financial lease agreement. The lessor acts as a financier and the lessee does not need to rely on the lessor in terms of the selection of the supplier and the asset, but is free to exercise his own judgment. The supplier is liable to the lessee for the delivery and condition of the asset as if the lessee were the party who is entitled to it under the financial lease agreement. The lessee is responsible to pay the rentals to the lessor and such an obligation is uncancellable and independent once he accepts the asset. But the lessor should not recover damages greater than he would be if the contract were performed.

The UK has neither accepted the 1988 Convention nor adopted the Model Law. The main reason may be that, as this thesis has shown, English law is satisfactory overall in meeting the needs of the parties in the transaction.

The Convention has not been adopted widely and appears unlikely to receive general application due to its limitations. Firstly, taking the form of unified rules, rather than a convention producing uniform law, the Convention merely applies to contracting States: however only a small number of States have ratified it.

Secondly, the Convention is restricted by its limited regime of application. It only applies to transactions in which the parties are based in different States and either the

States are Contracting States or both the supply agreement and the leasing agreement are governed by the law of a Contracting State. In addition, on each occasion the parties must choose to contractually incorporate the Convention into their transaction.

Finally, the Convention has not provided solutions to all disputes in relation to international financial leasing, thus uncertainties and complexities remain in many areas. For example, it does not deal with collateral and proprietary aspects. Domestic, consumer, bipartite transactions and transactions regarding real estate are also excluded from the scope of its application. Issues as to formation, misrepresentation, capacity and formal validity may need to resort to national laws.

The blemish of the Convention is that it fails to state expressly that the obligation of the lessee's payment is irrevocable and independent, although Article 12(3) implies the fact by providing that, once the lessee has lost the right to reject the asset, he cannot withhold rentals payable under the lease agreement.

The Unidroit Model Law was drafted to speed up the modernisation of national laws of leasing. Unfortunately, the blemishes contained in the Model Law undermine the certainty of the commercial rules recommended by it and would negatively affect their integration into national laws and the consequent unification of the laws of financial leasing in the international sphere. The blemishes uncovered by the thesis are summarised as follows.

Article 2 fails to describe one element of a finance leasing transaction; i.e. that the lessee should have approved the terms of the supply agreement

Article 3(1) wrongfully excludes from the regime of its application a finance leasing transaction in which the right of the lessor over the asset could be regarded as a security interest.

It fails expressly to require the lessee to pay the rentals.

Article 10(1)(a) wrongfully requires the lessor's obligations to be irrevocable and independent.

Article 13(1) fails to specify that the "agreement" to which the asset should conform is "the supply agreement".

There is ambiguity as to whether the lessee's right for damages against the supplier under Article 13(2)(a), when the asset does not conform to the supply agreement but the lessee has accepted it, means that he would lose his right against the lessor.

When Article 14 stipulates that, "when an asset is not delivered, is partially delivered, is delivered late or fails to conform to the lease, the lessee may demand a conforming asset from the supplier and seek such other remedies as are provided by law", it fails to specify what the other remedies could be, for example, it should include "a right as against the lessor, for example, to reject the asset or to terminate the lease agreement".

It does not include the certainty of the right of the lessee provided by the Convention and therefore fails to keep in line with the Convention. Under Article 12(3) of the Convention, the lessee has a right against the lessor to withhold the rentals payable under the lease agreement until the lessor has remedied his failure to tender an asset in conformity with the agreement or the lessee has lost the right to reject the asset.

However, the Unidroit Convention and the Model Law have successfully provided certain uniformed rules for international financial leasing transactions. In such a transaction, by adopting the Unidroit rules, the lessor, lessee and supplier would have relatively clear expectations of each other and their commercial disputes would be easy to solve without the need to consider their respective national laws. The Convention on International Interests in Mobile Equipment 2001 adds support to deal with the registration issue. The International Registry is in place to provide priority over creditors worldwide. The UK has ratified the 2001 Convention.

Although it does not seem to be necessary, if the UK also signs up the 1988 Convention, it will contribute to the unification of law in the international sphere and it will also improve the chances of English law being chosen as the governing law of an international finance leasing transaction, in which case English law would remain as an important and popular law in the commercial world.

It is submitted that, despite the inadequacies of the Unidroit Convention and the Model Law, they are useful to deal with the contractual relationship between the parties and therefore the UK could benefit from adopting them.

PART THREE – THE PROPRIETARY RIGHTS

Part III will discuss the proprietary rights of the lessor and lessee under a finance lease under English law. This area of law has been left unconsidered by the Unidroit Convention and the Model Law, due to the diversity of national laws and the complication of the issues concerning property. The nature of the lessor's proprietary right will be examined in Chapter 6 and the nature of the lessee's proprietary right will be examined in Chapter 7.

The terminology used in the law of personal property is largely borrowed from the land law. For the purpose of discussion in this thesis, a proprietary right is defined to be, as opposed to a contractual right, a person's right which places a burden on the asset and therefore binds other parties to respect it in the transfer of the asset. A proprietary right may be generated by law (and therefore be called "a legal right" or "a real right") or in equity (and therefore be called "an equitable right").

CHAPTER 6 THE LESSOR'S PROPRIETARY RIGHT

6.1 Introduction

It may seem obvious that the lessor's property right is the ownership of the asset, i.e. it is absolute as against the world. However, the lessor's ownership is subject to his promise to allow the lessee to possess and use the asset for the period of the lease. The preservation of the lessor's ownership is aimed to secure the lessor's interest in the transaction and the asset, in events which might detrimentally affect the performance of the lessee under the agreement of the finance lease.

This chapter will ask the following questions with regard to the nature of the lessor's right over the asset in various cases. Firstly, can the lessor enforce his right of repossession in the lessee's insolvency? Secondly, what is the lessor's right over the asset when the asset is affixed to the land and becomes part of the land? Thirdly, what is the lessor's right when the lessee disposes of the asset and when a third party wrongfully interferes with the asset? Finally, what are the advantages and disadvantages of the Law Commission's proposal to regard the finance lessor's interest in the asset as a security interest, in comparison to the current law in respect of the lessor's interest?

6.2 *The lessor's repossession right in the case of the lessee's insolvency*

6.2.1 Introduction

It is evident that the lessor reserves ownership of an asset so that he can repossess the asset from the lessee and dispose of it to recover his loss when the lessee fails to fulfil his obligations. Insolvency could be the worst situation which adversely affects the lessee's ability to fulfil his responsibilities under the contract. He might pay the rentals late, if at all, or lose the ability to pay not only temporarily but also in future. Moreover, the leased asset might be taken by a third party and realised without the consent of the lessor. Even if the lessor wants the lease agreement to continue, it is unlikely that the insolvent lessee would be able to continue to fulfil his obligation to pay till the maturity of it. The lessee may abruptly end his business and leave little worthy of realisation. In order to avoid any unexpected loss, it is common practice that the lessor would intend to repossess the leased asset from the lessee in the event of the latter's insolvency.

This section will consider how well the lessor may exercise his right of repossession of the asset and recover the rentals, if at all, when the lessee is insolvent.

In general, when a company is insolvent, all actions for the recovery of debt against the company will be restricted except those with the consent of the court; a similar effect applies to individuals in their bankrupt proceedings. Accordingly, when the lessee is insolvent, the lessor cannot sue for damages to recover the unpaid rentals because the claims for them are actions for debts. But, being the owner of the asset at law, the lessor can claim for return of his own property, for the purpose of the

recovery of his loss. This may be the primary reason that the lessor retains the ownership of the asset.

However, in principle, if no term of the finance lease agreement stipulates the effect of the insolvency and the agreement is not one governed by a special insolvency regime, the insolvency of the lessee in itself would not have any effect on his existing contracts so that his contract with the lessor would *prima facie* continue to bind them.²⁵² For this reason, the lessor often ensures that there are terms in the finance lease agreement which provide that the insolvency of the lessee constitutes repudiation of the lease agreement. In this case, if the lessee goes into insolvency, the lessor can regard the agreement as being repudiated and therefore claim for repossession of the asset.

The following discussion will cover the procedures which may apply to an insolvent lessee. It includes liquidation, bankruptcy, receivership and administration, although administration is strictly speaking not a procedure of insolvency. The lessor's claim to exercise his right to repossession of the asset and his claim for payment of the rentals often mingle together so both of them will be considered where applicable.

6.2.2 Liquidation and bankruptcy

Liquidation is a court procedure applicable to solvent or insolvent companies. It is also known as 'winding-up' and may be voluntarily initiated by a resolution of the members of a company or compulsorily brought by a court order.²⁵³ A third party will then be appointed to be the liquidator to administer the assets of the company, aiming

²⁵² N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 787-788.

²⁵³ S 84 of the Insolvency Act 1986 (voluntary liquidation) and S 122 of the Act (compulsory liquidation).

to ensure that all assets of the company are obtained, realised and distributed to the company's creditors. Once the procedure starts, the company in liquidation will cease to carry on its business except where it is necessary for the beneficial winding up of the company, for example, to complete work in progress. Meanwhile, all actions for the recovery of debt against the company will be restricted except those with the consent of the court.

Essentially similar to liquidation, bankruptcy applies to insolvent individuals. A trustee will be appointed to realise the insolvent debtor's assets. Similarly to liquidation, once the debtor is in the procedure of bankruptcy, other proceedings may be restricted²⁵⁴ and without the consent of the court, no expenses can be paid ahead of other unsecured creditors.²⁵⁵

In both procedures, proceedings for debts are restricted. As a result, if the lessee of a finance lease becomes insolvent and goes into bankruptcy or liquidation, in principle, the lessor cannot claim for damages in respect of the unpaid rentals, except with consent of the court. As to the current rentals during the procedure, if the asset is needed for assisting the purpose of liquidation or bankruptcy, the lessor can claim for these, which may be payable as an expense of the liquidation or bankruptcy.²⁵⁶

As to the asset, it is generally believed that the lessor's right to repossession of the asset should be allowed in the liquidation or bankruptcy of the lessee, because the

²⁵⁴ S 285 of the Insolvency Act 1986 states the restriction on proceedings and remedies against the bankrupt.

²⁵⁵ Rule 6.208 of the Insolvency Rules 1986, No. 1925, states the court's power to stay proceedings.

²⁵⁶ N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 792.

lessor claims a right against his own property, rather than against the lessee's.²⁵⁷

However, there appears no record of cases where disputes arise between the liquidator and the lessor of a chattel in relation to the repossession of it.

In contrast, land law cases show that where tenants go into liquidation or bankruptcy, landlords are allowed to repossess their premises.²⁵⁸ For example, in *General Share and Trust Co v Wetley Brick and Pottery Co*²⁵⁹ and in *Re Blue Jeans Sales Ltd*,²⁶⁰ where the lessees were in liquidation, the courts granted order for the landlords to re-enter the leased premises on the ground that the lessees had no defence to the landlords' claim.

Likewise, in cases where lessees went bankrupt, landlords were also granted an order to re-enter, although defences were raised. For example, in *Ezekiel v Orakpo*,²⁶¹ the defendant failed to pay the rent under a lease of premises and the plaintiff claimed for forfeiture of the lease and damages. The defendant argued that this action should be prevented by an earlier bankruptcy proceeding, in which he had been sued. The Court of Appeal upheld the judgment of the first instance judge that the bankruptcy was aimed to stay claims for monetary remedies and should not be applied to prevent the owner from repossessing his own property.²⁶² The principle was cited and clarified in a later case *Razzaq v Pala*²⁶³ in that the scheme of the Insolvency Act 1986 did not treat the right of re-entry as a security and that the right to forfeit was not a remedy

²⁵⁷ A Keay and P Walton, *Insolvency Law: Corporate and Personal* (Pearson Longman, London 2003) 433.

²⁵⁸ N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 792-793.

²⁵⁹ (1882) 20 Ch D 260, CA.

²⁶⁰ [1979] 1 WLR 362, Ch D.

²⁶¹ [1977] QB 260, CA.

²⁶² [1977] QB 260, CA, per Shaw LJ, at 267-268.

²⁶³ [1997] 1 WLR 1336.

against the property of the tenant but merely served to prevent a recurrence of the breach of covenant arising from non payment.²⁶⁴

Given that there is no judgment known in the case of chattels in contrast to those in relation to land, one may suppose that the lessor of chattel leasing can repossess the asset from the insolvent lessee simply because he is the owner of it. However, it is submitted that, it is doubtful whether the land law principle should apply to a finance lease, where the lessee is the economic owner of the asset during the term, because there would be likely a defence raised by the liquidator or trustee against the lessor's request for repossession, particularly if the lessee has paid a substantial amount of rentals. For example, the liquidator or trustee of the lessee might claim for relief from forfeiture, such as a certain percentage of the proceeds of the sale of the asset. Or, alternatively, he might argue that the nature of the finance lease is a secured transaction and that therefore, being a lender, the lessor has no right more than a claim for a secured debt. Whether or not the lessee's defence is good, the court might be reluctant to grant consent for the lessor to repossess the asset before a decision is made on the substantive matters. Thus it is doubtful whether the lessor of a finance lease could simply obtain the court's consent for him to repossess his asset when the lessee goes into liquidation or bankruptcy.

6.2.3 Receivership

When a company fails to pay the debt effectively, the holder of a floating charge over all or substantially all of the company's assets can appoint an administrative receiver to run the company and to realise sufficient money from the company's income and

²⁶⁴ [1997] 1 WLR 1336, at 1341-1342, per Lightman J. Although the landlord eventually was asked by the court to return the property to the lessee when the rentals were paid by the trustee of the lessee, in principle, the landlord had effectively exercised his right of re-entry.

sales of assets to pay off the debt of the holder.²⁶⁵ The receiver then acts for the best interest of the debenture holder, rather than that of all the creditors collectively.²⁶⁶ For this reason, in law there is no restriction on the bringing of other proceedings.

Therefore, if the asset is needed for the purpose of receivership, with the help of a threat to repossess it, the lessor can receive payment of the overdue rentals and also the current rentals occurring during the period of receivership, after the lessor and the receiver enter into a new contract of lease.²⁶⁷

However, it is not clear, if the receiver refuses to return the asset or pay the rentals, whether the lessor may get the consent of the court immediately. There is no relevant case law in relation to finance leases. The judicial decisions concerning retention of title clauses show that, in the case of the buyer's receivership, if damages would be an adequate remedy to the owner and the receiver is willing to offer undertakings to pay out of the sales proceeds, the seller who reserved the ownership of the goods would not be granted consent for repossession but the receiver would be given permission to deal with or dispose of the goods, on the condition that the proceeds would be used to pay the balance.²⁶⁸

Due to the similarities between sales with retention of title clauses and finance leases in their functions as securities, it is likely that a similar principle would apply in the

²⁶⁵ N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 787.

²⁶⁶ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 334.

²⁶⁷ N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 793. The receiver's liability for a new contract is regulated in s 44(1) of the Insolvency Act 1986.

²⁶⁸ N Furey, 'Goods Leasing and Insolvency' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's Commercial Law Library, LLP, London 1998) 793, with reference to *Lipe Ltd v Leyland DAF Ltd* [1993] 1 BCC 385 (CA) and *UCA France Champignon v Fisher Foods Ltd* [2002] EWHC 1906 (QB).

cases of finance leases. Hence, when the lessee goes into receivership, the lessor might not be able to repossess his asset but instead be given the chance to recover his loss, if there is possibility to cover the lessor's loss by damages and the loss can be paid out of the proceeds of the asset.

6.2.4 Administration

Administration is an interim and temporary regime for a company in financial difficulty to be possibly rescued by placing its affairs in the hands of an administrator to carry on the business. The procedure of administration orders was established by Part II of the Insolvency Act 1986 ("the Act") and then was replaced with a new Part II set out in Schedule B1 and came into force on 15 September 2003.²⁶⁹

When a company is becoming insolvent and before it goes to liquidation, a court order may be obtained to appoint an administrator to manage the affairs, business and property of the company for the purpose of the survival of the company.²⁷⁰ The administrator will facilitate the making of a voluntary arrangement or obtain a more advantageous realisation than it would be affected in liquidation. The administrator is expected to act responsibly and to act speedily insofar as he can in conducting for the purposes of administration.²⁷¹

Since the objective of administration is to enable the company to operate the business as a going concern, it is likely that, where possible, the lessor may obtain the consent of the administrator or the court and thereby receive payment of the overdue rentals and the current rentals during the period of administration. The administrator could be

²⁶⁹ S 248 of the Enterprise Act 2002.

²⁷⁰ Paragraph 3 (1) of schedule B in the Insolvency Act 1986.

²⁷¹ *Fashoff (UK) Limited t/a Moschino, Forall Confezioni SPA v Martin Henry Linton, Baron Jon Menswear Ltd* [2008] EWHC 537 (Ch), per Toulmin J, para 94.

held liable personally if he makes a wrongful refusal to the lessor's request for repossession.²⁷²

The administrator may obtain a permission of the court under para 72 of Schedule B1 to dispose of the leased assets as if the company were the owners of the assets, provided that the net proceeds would be paid to the creditors under hire purchase agreements.

Under para 43 of Schedule B1, the lessor may repossess his asset on lease to the lessee in administration, either with the consent of the administrator or the permission of the court. If the lessor's attempt to repossess the asset is refused by the administrator, his request will be decided by the court; the administrator may not be released from liability before the court's order is made respectively. If the lessor applies for leave, the court needs to clarify whether the asset remains in the possession of the lessee and, if so, the court will take into account all the circumstances of the case in reaching a decision.

The case *Re Atlantic Computer Systems*²⁷³ concerned whether the headlessor could obtain payment arising from the sublessee or repossess the equipment for sublease. A company acquired computer equipment on lease or hire-purchase from funders for subletting to end users. The company assigned by way of charge to some of the funders the benefit of the subleases. The company ceased to be able to pay its debts and an administration order was made under section 8(3)(d) of the Insolvency Act 1986. At the funders' request for directions and other relief in the administration of the company, the judge held, inter alia, that they were entitled to receive sums due

²⁷² *Barclays Mercantile Business Finance Ltd and Another v Sibec Developments Ltd and Others* [1992] 1 WLR 1253 (Ch).

²⁷³ [1992] Ch 505 (CA).

from the company under the headleases as expenses of the administration in respect of equipment used in the company's business during the administration.

Guidelines were laid down by the Court of Appeal on exercising discretion to grant leave to the lessor's request for repossessing the asset in *Re Atlantic Computer Systems*.²⁷⁴ Firstly, the onus of proof is on the party who seeks leave. Secondly, unless the repossession is likely to impede the purpose of rescuing the company, leave will be granted. Thirdly, if the effect of the repossession is unclear, the legitimate interests of the lessor and other creditors need to be balanced. The lessor's proprietary interest should be emphasised and the prospective losses and parties' conduct should also be considered. Fourthly, if a secured party is fully secured, leave will not be granted, because prejudice is unlikely to happen to a secured creditor by delay in enforcement and it is not appropriate to solve disputes over the existence, validity or nature of a security in a proceeding such as the application for leave. Nicholls LJ emphasised that each case should be decided on its own merits, taking into account of the purpose of the statutory provisions, the parties' interests and all the circumstances of the case.²⁷⁵

The general observations made in *Re Atlantic Computer Systems* have been seen as very useful in assisting the courts to reach their conclusion when the owners seek to repossess the goods which, subject to a hire purchase agreement, remained in the possession of the company which went into administration. According to para 111(1) of Schedule B1, "hire-purchase agreement" includes a conditional sale agreement, a chattel leasing agreement and a retention of title agreement. For example, the guidelines have been considered in *Fashoff (UK) Limited t/a Moschino, Forall*

²⁷⁴ [1992] Ch 505 (CA).

²⁷⁵ *Ibid*, at 542, per Nicholls LJ.

Confezioni SPA v Martin Henry Linton, Baron Jon Menswear Ltd,²⁷⁶ a case concerning a title retention clause after the modification of the 1986 Act.

However, if the asset is in use by the administrator, he would be likely to refuse the lessor's request for repossession. The administrator should give reasons for his refusal of consent to an application.²⁷⁷ The court has ample powers to ensure that the application is not prejudiced by an unreasonable decision of the administrator.²⁷⁸ According to para 43(7) of Schedule B1, the court has the right to impose a condition on or a requirement in relation to the permission sought by the lessor.

It is notable that the judgment of the Court of Appeal in *Re Atlantic Computer Systems*²⁷⁹ also set out another requirement that, if the lessor wishes to make an application for either the consent of the administrator or the court order in order to repossess the asset, he should do it promptly. This was followed by a later case *Re David Meek Access Ltd*.²⁸⁰ In that case, the court held that it was inappropriate to give leave to the lessors to repossess their assets as the effect on the company would render the administration pointless, with the exception that leave to repossess should be granted to two creditors, because their request for repossession were brought for consideration before the petition of the administration order was made but were unreasonably refused by the administrators.

The importance to make a prompt request for repossession was also illustrated by *Fashoff (UK) Limited t/a Moschino, Forall Confezioni SPA v Martin Henry Linton*,

²⁷⁶ [2008] EWHC 537 (Ch), per Toulmin J, para 93.

²⁷⁷ *Ibid*, per Nicholls LJ, at 529.

²⁷⁸ *Ibid*, per Nicholls LJ, at 530.

²⁷⁹ *Ibid*, per Nicholls LJ, at 543.

²⁸⁰ [1993] BCC 175 (CD).

*Baron Jon Menswear Ltd.*²⁸¹ In the case, the owners of the goods under title retention clauses lost their cases significantly due to the delay of making their applications to the court.²⁸² The owners applied for leave in order to repossess the goods which were in the possession of the buyer. The applications were based on paragraph 43(3) of Schedule B1 under a “hire purchase agreement”, which is defined in paragraph 111 to include a retention of title agreement. However, it appeared that, the goods had been sold to a third party a substantial time before the applicants made their applications. Therefore, there was no basis on which to give permission, since the goods were no longer in the buyer’s actual or constructive possession at the time when the applications were made.²⁸³ The application failed also because the owners did not prove a seriously arguable case of their ownership of the goods in question.²⁸⁴ Of greater importance than a mere prompt action of application, the lessor must also have a solid ground of title to sue.

Also in the case *Fashoff, Forall v Linton & Baron Jon*, the owners might have been granted leave if they could prove a seriously arguable case of their ownership of the goods.²⁸⁵ However, *Fashoff* failed to provide compelling evidence to show that it was entitled to pursue a claim on its behalf²⁸⁶ and *Forall* did not appear to have any standing in relation to the retention of title claim until two months after the administrator had sent his statement of proposals to the Registrar of Companies.²⁸⁷

The deciding factor as to whether leave should be granted is whether the granting of leave would impede the purpose of the administration. The judge in the case *Fashoff*,

²⁸¹ [2008] EWHC 537 (Ch).

²⁸² [2008] EWHC 537 (Ch), per Toulmin J, para 98.

²⁸³ [2008] EWHC 537 (Ch), per Toulmin J, para 103.

²⁸⁴ [2008] EWHC 537 (Ch), per Toulmin J, para 103-107.

²⁸⁵ [2008] EWHC 537 (Ch), per Toulmin J, para 103-107.

²⁸⁶ [2008] EWHC 537 (Ch), per Toulmin J, para 105.

²⁸⁷ [2008] EWHC 537 (Ch), per Toulmin J, para 112.

Forall v Linton & Baron Jon was satisfied with his decision of refusal to the applications because the granting of leave would impede the purpose of the administration.²⁸⁸

It is submitted that it is likely the lessor would obtain payment of the current rentals during the administration of the lessee company, if the asset is in use by the administrator; otherwise he could repossess the asset if there is no obvious impediment to the company's carrying on business and he makes a prompt request on a solid ground of ownership.

6.2.5 Summary

To summarise, in addition to a general right to recover debt together with other creditors, in finance leasing, the lessor's proprietary right over the asset might in the event of the lessee's insolvency entitle him to a right of repossession of the asset from the lessee. By threatening to exercise this right, the lessor may receive payment for the current rentals and even some outstanding rentals from the insolvency officer, if the asset is used for the purpose of the insolvency procedure.

Overall, it seems that the courts are reluctant to grant consent for the lessor to repossess the asset without having decided on these substantive matters. However, it is likely that the lessee's insolvency officers, e.g. the receiver, administrator, liquidator or trustee, would be given permission to deal with or dispose of the asset, provided that the current rentals would be paid and/or the proceeds would be used to pay the balance. Therefore, the retention of his title to the asset indeed functions as a

²⁸⁸ [2008] EWHC 537 (Ch), per Toulmin J, para 113.

means of security and, being the owner of the asset, the lessor could not repossess the asset without the consent of the insolvency officer or the court.

6.3 The lessor's right when the asset is affixed to the land

Sometimes, the equipment which is the subject matter of a finance lease, especially that involving big-ticket plants and machinery, require affixing to the ground for steady and safe use. The general rule is that, if the equipment lies on the ground because of its own weight, e.g. a printing machine, it is not a fixture; if it becomes an accessory to fixtures, e.g. components to machines, it depends on whether the purpose of the annexation is for the more convenient use and enjoyment of the equipment as a chattel or rather to enhance the enjoyment of the land as real property; if the equipment becomes so attached to the land that it is considered to be part of it, e.g. gully drain system, it belongs to the owner of the land.²⁸⁹

Under the rule of fixture, when a piece of moveable property is allocated and affixed to the land, it becomes part of the land and therefore belongs to the owner of the land. Therefore, when the asset leased under a finance lease agreement becomes a fixture of the land, although the lessor may have intended to retain the ownership of it, at law it becomes part of the land and thereby belongs to the owner of the land, instead of the lessor. This section will discuss the nature of the lessor's right over an asset which becomes a fixture of the land.

In the case *Melluish (Inspector of Taxes) v BMI (No 3) Ltd*,²⁹⁰ a finance company which carried out the business of acquiring plant and hiring out to the end users entered into a master finance lease agreement with the local authorities for installation of plant and machinery into council houses. The lessor claimed to be the owner of the

²⁸⁹ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 253-255.

²⁹⁰ [1996] AC 454 (HL).

installed central heating equipment and crematoria equipment and therefore to be entitled to writing down allowances under s 44 of the Finance Act 1971. The Inland Revenue refused on the ground that after installation the equipment had become fixtures in the local authority premises where they had been installed and so ceased to belong to the lessor. The House of Lords upheld the Inland Revenue's decision.

Delivering the judgment, Lord Browne-Wilkinson said:²⁹¹

“...the intention of the parties as to the ownership of the chattel fixed to the land is only material so far as such intention can be presumed from the degree and object of the annexation. The terms expressly or implicitly agreed between the fixer of the chattel and the owner of the land cannot affect the determination of the question whether, in law, the chattel has become a fixture and therefore in law belongs to the owner of the soil. The terms of such agreement will regulate the contractual rights to sever the chattel from the land as between the parties to that contract and, where an equitable right is conferred by the contract, as against certain third parties. But such agreement cannot prevent the chattel, once fixed, becoming in law part of the land and as such owned by the owner of the land so long as it remains fixed.”

Although the case concerned the owner's entitlement to a tax benefit, Lord Browne-Wilkinson's dictum has general application to the law with regard to fixtures.

Accordingly, once the asset on lease is affixed to the land, it becomes part of the land and belongs to the owner of the land; hence the lessor is no longer the owner at law, despite the fact that he intended to preserve the ownership of the asset. The lessor may have a contractual right to sever the asset from the land and such a right gives rise to an equitable right in the land.

Their Lordships rejected the argument that the lessor had only a contractual right because whilst the legal title to the fixtures was vested in the local authority, in equity

²⁹¹ [1996] AC 454 (HL), at 473.

the beneficial ownership had at all times been vested in the lessor.²⁹² Lord Browne-Wilkinson said:²⁹³

“In my judgment these cases do provide some support for [the lessor’s] argument since they demonstrate that the rights conferred by the master lease are not purely contractual (and as such only enforceable between the parties) but also confer on the taxpayer company *an equitable right* in the equipment enforceable against any subsequent taker of the land to which it is affixed other than a bona fide purchaser for value without notice.”

Therefore, it was decided in the case *Melluish (Inspector of Taxes) v BMI (No 3) Ltd*²⁹⁴ that, after the asset becomes the fixture of the land, the lessor’s right over the asset becomes a right in the land, and that this right is an equitable right limited in nature as against any subsequent third parties except those who act in good faith without notice.

In addition to the right of severance and removal in the event of default, it is alleged by Davies, by analogy to the lessor’s right in real property, that the lessor of equipment leasing should have a right of entry onto the equipment lessee’s land, if a clause of the lease confers on the lessor such a right in the contract.²⁹⁵ Such a right of entry was decided to be an equitable right by the House of Lords in *Shiloh Spinners Ltd v Harding*.²⁹⁶

Both the right of entry and the right of severance arise at the point of annexation and are equitable in nature. Until that time no interest of any kind in the land can arise in favour of the equipment lessor.²⁹⁷ The lessor’s right over the asset changes from his contractual rights to enter the lessee’s premises and to remove the asset to two

²⁹² [1996] A.C. 454 (HL), per Lord Browne-Wilkinson, at 473.

²⁹³ [1996] A.C. 454 (HL), per Lord Browne-Wilkinson, at 475.

²⁹⁴ [1996] A.C. 454 (HL).

²⁹⁵ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 257.

²⁹⁶ [1973] AC 691 (HL), per Lord Wilberforce, at 721.

²⁹⁷ RM Goode, *Hire-purchase Law and Practice* (2nd edn Butterworths, London 1970) 738.

equitable rights of entry and of severance in the land, at the time when the asset affixes to the land. However, due to their limited nature and uncertain duration, they would not be considered to constitute a legal estate.²⁹⁸

The priority issues have been much considered by Davies.²⁹⁹ For the purpose of this section, i.e. to examine the nature of the lessor's right over the asset when it is affixed to the land, it is sufficient to say that the lessor of an asset which becomes a fixture to the land has no priority over the holders of any legal proprietary right, e.g. the landlord or mortgagee, but he has priority over those holding subsequent equitable proprietary right, e.g. the holder of an equitable charge.

In the case of disposition of land, it includes all fixtures, so no fixture can be removed as soon as a binding contract of sale or mortgage is purportedly concluded.³⁰⁰ But, before imposition of superior interests in the land and/or the attached asset, it would be possible for the lessor to attempt to exercise his right to sever the asset from the land and to repossess it before other parties take priority over him. When the fixture can be removed from the land, the landlord is protected by the doctrine of waste, under which "the premises must be made good to the extent of being left in a reasonable condition".³⁰¹

²⁹⁸ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 257.

²⁹⁹ *Ibid*, 257-268.

³⁰⁰ *Ibid*, 258, with reference to *Meux v Jacobs* (1875) LR 7 JL 481, *Clarke v Ramez* [1891] 2 QB 456; *Re Yates* (1888) 38 Ch D 112.

³⁰¹ *Mancetter Developments v Garmanson and Givertz Ltd* [1986] 1 QB 1212 (CA), per Dillon LJ, at 1219.

6.4 The lessor's right in the case of wrongful dealings with the asset

During the term of a finance lease, the lessee exclusively possesses the asset and uses it for his business purpose. Sometimes, a third party may interfere with the lessee's possession, or even, the lessee may dispose of the asset to a third party without the lessor's consent. This section will discuss the lessor's right as against the third parties in these cases.

The general rule is the common law rule of *nemo dat quod non habet*. This means that the transferor of goods cannot pass a better title than he himself possesses.

Accordingly, if the lessee disposes of the asset without the lessor's consent and the third party possesses it, the third party could not obtain a better title than the lessee's, unless for compelling reasons.³⁰² In other words, the lessor does not therefore lose his interest in the asset but his title prevails over that of the third party possessor, unless the case is one where an exceptions to the *nemo dat* rule applies. The exceptions include several policy factors: estoppels, ostensible ownership and possession, and protection of purchasers.³⁰³

Without any exception to the *nemo dat* rule in curing the lessee's defective title, the third party commits conversion. The tort of conversion consists of an act of deliberately dealing with a good in a manner inconsistent with the claimant's rights to the use and possession of the good and which thereby deprives the claimant of those

³⁰² "Title" is a relative concept under English law. It does not mean an absolute indefeasible title. Title can pass in property even under an illegal contract. For example, Lord Denning held in *Belvoir Finance Co Ltd v Stapleton* [1971] 1 QB 210, at 218, "Although [the finance company] obtained the car under a contract which was illegal, nevertheless inasmuch as the contract was executed and the property passed, the car belonged to the finance company and they can claim it."

³⁰³ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 183. For a discussion of the exceptions to the *nemo dat*, see I Davies, *ibid*, 189-211.

rights.³⁰⁴ The essence of conversion is unlawful appropriation of someone else's chattel, the features of which are deliberate conduct amounting to an interference with the rights of the owner and so extensive as to exclude the owner from use of the goods.³⁰⁵

The general rule of conversion considers whether the person had at the time of the conversion either actual possession or an immediate right to possess.³⁰⁶ Therefore, it is usually the lessee who can bring an action in conversion against the third party who wrongfully interferes with the asset, whilst the lessor may have an action for reversionary injury.³⁰⁷ For example, if the asset is stolen, the thief commits both trespass and conversion against the lessee and also commits the tort of reversionary injury against the lessor.³⁰⁸

S 3(2) of the Torts (Interference with Goods) Act 1977 provides for specific delivery or damages as relief for conversion. According to s 3(3)(b) of the Act, the court has the discretion to order delivery or the claimant may choose between the options. However, the court will not normally order specific delivery in respect of ordinary articles of commerce for which damages would provide adequate compensation.³⁰⁹

The normal rule with regard to damages in tort is that the claimant is entitled to the market value of the goods together with the consequential damages. The rationale is evident, as Hobhouse J described in *The Sanix Ace*, "As soon as the goods are

³⁰⁴ E Goodwin, "Retention of Title, Conversion and Administrators" (2009) 22(1) *Insolvency Intelligence* 4.

³⁰⁵ *BMW Financial Services (GB) Ltd v Bhagwanani* [2007] EWCA Civ 1230 (CA), per Lloyd LJ, para 15.

³⁰⁶ I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 287.

³⁰⁷ *Ibid.*

³⁰⁸ A Dugdale, M Jones, et al, *Clerk & Lindsell on Torts* (19th edn Sweet & Maxwell, London 2005), incorporating the 4th Cumulative Supplement, §17-01.

³⁰⁹ *Whiteley v Hilt* [1918] 2 KB 808 (CA), per Swinfen Eady M.R., at 819.

damaged the owner of the goods suffers loss. Formerly he was the owner of goods of full value and subsequently he is the owner of goods with only a reduced value. He has suffered a loss. Whether or not he may be able to recoup his loss from others is a separate question.”³¹⁰ However, it appears to be unsuitable to apply this rationale to the case of finance leases, where the finance lessor is the financier and his interest in the asset is actually no more than the remaining unpaid rentals.

The courts noticed the potentially anomalous result in the case of hire purchase agreements, where the owner has a very similar interest to that of the lessor of a finance lease, and decided that the owner’s damages in conversion are limited to his actual loss.

In the case *Wickham Holdings v Brooke House Motors*,³¹¹ the finance company let a car to the hirer under a hire purchase agreement. Their agreement stipulated that the hirer should not assign his rights or interests under the agreement and that any such assignment should be void and should determine such rights. Later, with an intention to settle the transaction, the hirer part exchanged the car for another car with a dealer. The dealer then sold the car subject to the hire purchase agreement but failed to pay the settlement figure to the finance company within the time limit. The finance company claimed against the dealer the return of the car or its value and damages for detention or conversion. The Court of Appeal decided that, if the hirer of goods under a hire purchase agreement sells them, the owner cannot recover as damages the whole value of the goods if it exceeds the value of his interest, even although the agreement provides that, on a sale, all the hirer’s rights in both goods and agreement shall cease.

³¹⁰ *Obestain Inc v National Mineral Development Corp Ltd (The Sanix Ace)* [1987] 1 Lloyd’s Rep 465 (QB), at 468.

³¹¹ [1967] 1 WLR 295 (CA)

The decision indicates that the purported sale is not wholly ineffective, because the hirer can transfer his interest in the goods including, crucially, the option to purchase, irrespective of whether the hire purchase agreement contains a prohibition against assignment;³¹² and the recovery of the owner's interest in the contract and the asset would not be more than what he had lost from the hirer's unlawful act, which was the outstanding balance of the hire purchase price in the case *Wickham*.

The principle was applied in *VFS Financial Services (UK) Ltd v Euro Auctions (UK) Ltd*,³¹³ a case where a hire purchase agreement was entered into by a finance company and the hirer who was a rail, construction and utilities contractor. Their agreement stipulated that three dump trucks were to be acquired by the finance company for the use of the hirer at monthly rentals for a period of four years with an option to purchase at a modest price. The hirer went into administration and, without the consent of the owner, the administrator sold the hirer's business and assets, including the title and interest which he had in the contracts to the fourth defendant.³¹⁴

Following a few onward sales, two trucks, which were the subject matter of the present case, was purchased by the fourth defendant, who purported to sell them by auction organised by the auction companies.

On discovery of the administration status of the hirer, the finance company terminated the hire purchase agreement. It subsequently chased the sales. It received summary judgment in its favour on claims for damages for conversion against the auction companies, based on conversion of the trucks by selling them at the auction, and

³¹² I Davies, *Equipment and Motor Vehicle Leasing and Hiring Law and Practice* (Sweet & Maxwell, London 1997) 185.

³¹³ [2007] EWHC 1492 (QB), Judge Richard Seymour Q.C.

³¹⁴ Strictly speaking, the terms of the sale should be interpreted to exclude the assets belonged by other parties, for example, the trucks owned by the finance company. However, the fourth defendant took over the trucks and arranged onward sales of the trucks.

against the fourth defendant on the ground that it had converted the trucks by purporting to sell them. Then, the trucks were sold by auction, in spite of the court's injunction restraining sale. Being unable to recover the trucks, the finance company contended that, being the sole beneficial owner of each of the trucks, it was entitled to the full value of each of the relevant trucks against the relevant tortfeasor at the date of each relevant conversion. The defendants admitted having infringed the interest of the finance company in the trucks but argued that the assessment of damages should be the entitlement of the finance company to the sums payable under the hire purchase agreement.

During the proceedings, the fourth defendant made payments to the finance company at an amount equivalent to what would have been due under the hire purchase agreement if the hirer had continued to be in existence, while he purported to settle the dispute in respect of the hire purchase agreement. The finance company retained the money.

Judge Richard Seymour QC firstly applied the decision of the House of Lords in *Kuwait Airways Corporation v Iraqi Airways Co (No. 6)*.³¹⁵ In that case, Lord Nicholls of Birkenhead said: "Under the English tort of conversion, every person through whose hands goods pass in a series of conversions is himself guilty of conversion and liable to the owner for the loss caused by his misappropriation of the owner's goods."³¹⁶ The speech of Lord Nicholls of Birkenhead in *Kuwait* highlighted that the key function of tort law was to recover the actual loss.

³¹⁵ [2002] UKHL 19, [2002] 2 AC 883 (HL).

³¹⁶ [2002] 2 AC 883 (HL), at 1093, His speech was agreed by all of the members of the House of Lords, save Lord Scott of Foscote.

Then, Judge Richard Seymour in *VFS* applied the assessment of the damages of the finance company decided in *Wickham*. He decided that, the finance company should recover only his true interest in the trucks, with the effect that nothing further was due to the finance company on top of the money which had been paid by the fourth defendant both voluntarily and by the order of the lower court.

The principles established in the case of hire purchase agreements shed light on the law which would be applied to a case of a finance lease. By analogy to the law of hire purchase agreements, due to the same function of the finance company in both transactions, when a third party interferes with the property right of the lessor in the case of a finance lease, especially if the lessee wrongfully deals with the asset, the third party could be liable for reversionary injury in tort to the lessor. However his liability would be limited. First of all, it is likely that the remedies of the lessor against the third party would be damages, unless the asset is an extraordinary item of the commerce. Secondly, when assessing the damages, the court would look at the true interest of the lessor, which is that he acts as financier, and would therefore grant damages to the extent that rightly reflect the lessor's true interest in the transaction.

However, there seems to be an obstacle to the application of this rule from the case of a hire purchase agreement to the case of a finance lease agreement. The two transactions have a significant difference: the hire purchaser has an option to purchase the asset at the end of the hire but the lessee does not. Apparently, when the court in the case *Wickham Holdings v Brooke House Motors*³¹⁷ considered the owner's remedies against the third party purchaser, their decisions were crucially depended on the hire purchaser's interest in the option to purchase. In that case, the hire purchase

³¹⁷ [1967] 1 WLR 295 (CA).

agreement prohibited the hire purchaser from assigning his rights or interests under the agreement but the subsequent sale of the asset was not held to be completely ineffective.

Lord Denning MR held:³¹⁸

“I base my decision on this: In a hire-purchase transaction there are two proprietary interests: the finance company’s interest and the hirer’s interest.”

However, there was no explanation of the exact scope of the hirer’s interest. Did he refer to the hirer’s right of possession, or his right of purchase, or both?

In *Whiteley v Hilt*, which was also concerned a hire purchase agreement and decided on the owner’s damages in conversion from a third party, Warrington LJ said:³¹⁹

“The nature of the interest taken by the hirer under the agreement appears to me to be this: First, a right to retain possession of the chattel so long as she performed the conditions of the agreement. Secondly, an option to purchase the chattel exercisable by payment of the instalments provided for by the contract.”

In *Whiteley*, the hire purchaser’s right to the option to purchase was decided to be an assignable interest.³²⁰ There was no comment on the nature of the hirer’s right to possession.

However the Court of Appeal upheld the decision of the county court judge.³²¹ The judge found that the sale gave no title to the third party purchaser but that the finance

³¹⁸ [1967] 1 WLR 295 (CA), at 300.

³¹⁹ [1918] 2 KB 808 (CA), per Warrington LJ, at 819.

³²⁰ [1918] 2 KB 808 (CA), per Warrington LJ, at 820.

³²¹ [1918] 2 KB 808 (CA), per Warrington LJ, at 822, 813.

company should be paid the outstanding payment under the hire purchase agreement as his loss in detinue.³²²

In both *Whiteley*³²³ and *Wickham*,³²⁴ the finance company was not granted damages equivalent to the market value of the asset, which is the general rule of tort, but those which would reflect its true interest in the transaction, i.e. the outstanding payment under the hire purchase agreement, no more than what it has lost. Thus, it is submitted, the deciding factor of the decision was the real interest of the finance company rather than the nature of the hirer's interest.

Then, what did Lord Denning mean in his statement of the proprietary right of the hirer in *Wickham*?³²⁵ It seems to the author that it was aimed at rejecting the reasoning given in the case *United Dominions Trust (Commercial) Ltd v Parkway Motors Ltd*.³²⁶ In *United Dominions*, it was decided that, because the hirer did not have an assignable interest in the asset, the third party purchaser had no interest in the asset and had no rights against the owner to enable the third party to cut down the owner's *prima facie* right to recover the value of the goods.

Thus, if the hirer's interest in the asset is proprietary, as Lord Denning suggested, does this mean that the lessee of a finance lease also has a proprietary right? This question will be answered in the next Chapter.

For the current purpose, it seems hardly disputable that the lessor's damages from a third party purchaser as to the loss of the asset resulting from wrongful act of the

³²² [1918] 2 KB 808 (CA), at 813.

³²³ [1918] 2 KB 808 (CA). The case *Whiteley v Hilt* was cited in argument of counsel but was not referred to in the judgment of *Wickham*.

³²⁴ [1967] 1 WLR 295 (CA).

³²⁵ [1967] 1 WLR 295 (CA).

³²⁶ [1955] 1 WLR 719 (QB).

lessee would be held to reflect his true interest in the transaction, which is the outstanding payment under the contract, by analogy to that of the finance company in the case of a hire purchase agreement.

6.5 An ownership or a security interest?

The Law Commission has proposed that the lessor's interest in an asset should be regarded as a security interest under the proposed company security registration scheme and therefore should be registered by notice-filing. If a security interest is not perfected by filing, under the proposed scheme, the lessor would risk loss of priority to a buyer or subsequent secured party and, if the lessee becomes insolvent, the lease would not be effective against the administrator or liquidator.³²⁷

This section will weigh the advantages and disadvantages of the Law Commission's proposal to regard the finance lessor's interest in the asset as a security interest, in the light of the current law under which the lessor's interest in the asset is ownership.

On the one hand, the proposal would cause the following disadvantages to the lessor.

Firstly, the proposal would change the nature of the lessor's interest in the asset and this might cause confusion and inconvenience. In the legal sense, the proposal would change "finance lease" from a familiar ownership-based device to an unfamiliar "quasi-security" device.

This might cause confusion as to the legal concepts, because the ownership would no longer rest on the lessor, once he enters into a finance lease agreement with the lessee, even though he obtains the title to the asset by acquisition of the asset; instead, the lessee would be regarded as the owner.

³²⁷ Law Commission, *Company Security Interests a Consultative Report* (Law Com No 176, 2004) para 2.96.

The lessor engaging in international trade might lose the convenience of having his ownership understood and accepted by most jurisdictions. After all, ownership is a well-known concept worldwide. The lessor's ownership of the asset can be recognised in most jurisdictions and provide him with the privilege of realisation before other creditors.

This disadvantage may be, to some extent, remedied by the growing influence of the security registration system on both national and international levels. In the international sphere, the International Registry has been established pursuant to Chapter V of the Convention on International Interests in Mobile Equipment 2001 (the 2001 Convention).³²⁸ The primary aim of the 2001 Convention is to increase the efficiency of financing high-value "mobile equipment", e.g. aircraft objects, space objects, railway rolling stock etc, because such equipment moves from jurisdiction to jurisdiction and, if not all jurisdictions provide equivalent recognition of creditor's rights, creditors would face higher risks and this would increase the cost of obtaining credit. The Convention has successfully encouraged registration of security interests in respect of the expensive mobile equipment; this may in time facilitate the unification of security interest laws in the international sphere.³²⁹

Secondly, the lessor would undertake risk and the expenses with regard to registration.

The effect of the proposal in practice is that the lessor must register his security interest under the proposed registration scheme for the purpose of perfection. Once the lessor's security interest is perfected by filing, he can exercise his right to

³²⁸ See Article 1, 2 and 7 of the 2001 Convention.

³²⁹ The 2001 Convention is based on the principle that a sound legal framework that facilitates the creation, perfection and enforcement of security interests will provide confidence to lenders and institutional investors both within and outside the country concerned, and make it easier to attract domestic and foreign capital. <http://www.unidroit.org/english/workprogramme/study072/main.htm>, 26th November 2008.

repossession and receive payment before other creditors from the proceeds of the sale of the asset. In terms of recovery of his loss from the value of the asset, no substantive change would occur. However, if the lessor fails to file his security interest in compliance with the compulsory requirement, he would lose priority to other creditors who have registered their security interests. The lessor would need to file his interest in the proposed register and pay for it, although the cost is considerably smaller in the proposed advanced electronic notice-filing system.

Thirdly, the lessor would completely lose his chance to receive windfalls, which are occasionally obtainable by the owner of the asset under the current law.

For example, when the asset is repossessed and disposed of, the lessor often exercises his contractual right to forfeit the lessee's interest in the residual of the asset, whether or not the lessee has paid a significant amount of the rentals. This is well illustrated by the case of *On Demand*. In that case, the lessor would have kept a significant windfall while the lessee would have suffered a huge loss, had the House of Lords not allowed an alternative remedy to relief from forfeiture.

Another instance of windfall is that, after the primary leasing period, the lessee usually pays a nominal rental to the lessee for a secondary period, and, when he eventually disposes of the asset, the lessor shares some percentage of the proceeds. Because the lessee will have received all the return of his capital outlay and a margin of profit, the secondary rentals and the share of the proceeds, albeit small, are windfalls.

It is submitted that windfalls should not be encouraged at all, because they come at the price of the lessee's loss. The current law, particularly by means of equitable relief from forfeiture, has hugely eliminated the chance of the lessor to receive windfalls.

On the other hand, the proposal has some benefits to the lessor.

Firstly, the lessor would receive the same level of protection to himself as under the current law. Although, in the legal sense, a security interest is merely a limited interest but ownership is an absolute right as against the world, the registration scheme, either nationally or internationally, would raise the awareness of the public to the lessor's interest as a secured creditor. Therefore, it is hoped that registration of all types of interests functioning as security would hugely reduce disputes on the ground of the false wealth impression of the lessee, for example, between a third party purchaser and the lessor.

Secondly, the change would compel the lessor to choose the device which would most appropriately reflect his true interest in the transaction and this would improve transparency in commerce and benefit all participants. At present, the lessor's interest in finance leasing is purely financial and the purpose of retaining the ownership of the asset is to prevent other parties from taking possession of the asset prior to him. If the lessor wants to repossess the asset at any time, the option is licence rather than lease, because a lease of real property has been recognised to have two aspects of rights: contractual and proprietary.

The House of Lord has distinguished the enjoyment of a contractual right from the entitlement to a proprietary right in *Bruton v London & Quadrant Housing Trust*³³⁰ and recognised that the two aspects of rights in a lease could be considered separately. When someone seeks for protection to a contractual right, what matters to his claim is whether he has a contractual ground, no matter whether his claim qualifies on proprietary grounds. The decision implies that the proprietary aspect of a land lease does not have to be considered and does not prevail in all cases. It seems that this principle would impact on the court's consideration in the following cases where issues as to contractual and proprietary rights arise. If a land lease can be contractual only, it seems less likely that the lessor of a chattel lease could insist on his proprietary right at all times. As has been demonstrated in *Wickham* and *On Demand* etc, it is likely that the lessor's true interest would be recognised to be a pure financial interest in the outstanding payment. There is not much ground for the lessor to insist on his ownership.

Thirdly, the lessor might receive better recognition of his role as financier, with the help of the expanding recognition to national registry and International Registry.

For the reasons discussed above, it is submitted that the advantages of the Law Commission's proposal seem to outweigh the disadvantages in respect of the lessor's right over the asset.

³³⁰ [2000] 1 AC 406 (HL).

6.6 Concluding remarks

This chapter has examined the lessor's right over the asset, particularly as against third parties. The overall impression is that the lessor's interest is no more than a security interest.

It seems that the retention of the ownership does not significantly improve the lessor's chance of being allowed to regain the possession, unless the possession is surrendered by the lessee voluntarily or by the insolvency officer's consent, before the substantive rights of the parties are either decided by the court or the realisation is worked out in the insolvency procedure. Similar to that of a secured creditor, his commercial interest is protected and will be paid out of the realisation of the asset. In the case of the asset being affixed to the land, by law, the asset belongs to the land owner and the lessor is left with a contractual right to sever the asset and an equitable proprietary right over the asset affixed. In the case that the asset is taken, the lessor's right is to claim damages in tort.

Based on these findings, the chapter has also discussed an important question as to whether the lessor's right over the asset should remain as ownership or change to a security interest. The implications of the proposal were considered. The major disadvantage is the change of theory ground, from what is owned to what is owed. Finance leasing could lose its uniqueness as a financing device based on ownership. The other concern to protection in cross-jurisdiction might be remedied by the growing population of the security interest registration system. The loss of opportunity for windfalls should not be taken into account.

The benefits of making this change include the lower chance of losing in an action as against bona fide third parties, the greater transparency of the commercial world and financing devices and the development of national and international security interest registration system.

On a balance of the disadvantages and advantages, it is submitted that, on the whole, to reclassify the lessor's ownership of the asset to a security interest would not be likely to devalue the lessor's interest in the asset or discourage him from participating in the transaction. A relevant question is: "Would the Law Commission's proposal also benefit the lessee with regard to his right over the asset?" This question will be answered in the next Chapter.

CHAPTER 7 THE LESSEE'S PROPRIETARY RIGHT

7.1 Introduction

It was mentioned in Chapter 3, section 3.2.3 above, that, when the court considers equitable relief from forfeiture, one principle is that “Relief is only available where what is in question is forfeiture of proprietary or possessory rights.”³³¹ Although in *On Demand Information plc and another v Michael Gerson (Finance) plc and another*,³³² relief from forfeiture was not granted because the sale of the asset affected the remedy giving effect to their substantive rights, the rationale of the Court of Appeal seems to stand as a good law: the lessee’s right over the leased asset is more than a contractual right; it is a proprietary or possessory right. However, no authority as to the nature of the lessee’s interest was cited to support this indication.

It was also mentioned in the last Chapter, section 6.4 above, that when Lord Denning decided the case *Wickham Holdings v Brooke House Motors*,³³³ his judgment was based on the idea that the hire purchaser’s interest in the asset is a proprietary interest. It was wondered whether the lessee’s interest in the asset, in the absence of the option to purchase, is also a proprietary interest.

Aimed to answer the question, this Chapter will explore the sources where the lessee and, more accurately, the hirer of goods, was said to have a proprietary right under English law, including both authority and judicial and academic opinions.

³³¹ *BICC plc v Burndy Corporation and Another* [1985] Ch. 232 (CA), per Dillon LJ, at 252.

³³² *On Demand Information plc and another v Michael Gerson (Finance) plc and another* [2002] UKHL 13, [2003] 1 AC 368 (HL), rev'd [2001] 1 WLR 155 (CA).

³³³ [1967] 1 WLR 295 (CA), at 300.

It is obvious that, when the lessor purchases the asset from the supplier, he obtains the title to the asset and becomes the owner of it; his right over the asset is a proprietary interest. Unlike the lessor's ownership, it is controversial as to whether the lessee's right over the asset is proprietary. He has a right to possess and use the asset for a period of time. Under English law, there is no option for him to purchase the asset at the end of the leasing period and therefore the lessee will not become the owner of the asset. It is submitted that his right to possess and use the asset is based on a contractual right but is strengthened by the fact that he actually possesses it for the whole leasing period, which is the most useful life of the asset. He is the beneficial owner without the title.

A proprietary right will give rise to a right to sue in conversion for infringement of the right in question. When a proprietary right is injured by a third party, the person who has the right can sue the third party in conversion for recovery of possession of the asset because his proprietary right has the effect of binding third parties. But even if he claims an order requiring the third party to give him possession he might not obtain it, if it seems satisfactory to the court that damages could cover his loss. Therefore, a proprietary remedy indicates the existence of a proprietary right but not all proprietary rights give rise to proprietary remedies. However, the effect of binding third parties is a useful indicator to a proprietary right, if the nature of the right has not been made clear under English law. For this reason, the question as to whether the lessee of a finance lease has a proprietary right will be discussed in this chapter according to whether he is entitled to have an action against third parties.

There are arguments in favour of a proprietary right of the lessee on the ground, for example, that the lessee has an exclusive possession of the asset,³³⁴ or that, being a bailee, the lessee has a “special property”, as opposed to the bailor’s “general property”.³³⁵ The view of the hirer’s proprietary right was criticised by Swadling that, due to the rule of *numerus clausus*, the hirer’s right does not have the nature of a property right.³³⁶

This Chapter will look at the arguments for and against the proprietary right of the hirer and try to answer the question as to whether the lessee under a finance lease should have a proprietary right over the asset and, if appropriate, by what means it can be generated.

The discussion will consider the arguments in favour of a proprietary right of the hirer firstly at law and secondly in equity before finally discuss the various proposals of conferring a proprietary right on the lessee under a finance lease.

³³⁴ RM Goode, *Proprietary rights and Insolvency in Sales Transactions* (2nd edn, Sweet & Maxwell, London 1989) 7.

³³⁵ For example, in *Lee v Atkinson and Brooks* (1609) Croke, Jac 236, 79 ER 204, the hirer’s right over the asset was described by the court as a ‘special property’ against all men.

³³⁶ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 516.

7.2 A proprietary right at law?

7.2.1 Introduction

Ownership and possession are said to be the only legal interests in goods.³³⁷ When this perception is applied to a finance lease, where the lessee has possession of the asset and the lessor has ownership of it, this seems to imply that the lessee's possession can give rise to a proprietary right. However, it is a question whether such a proprietary right of the lessee has been recognised by law. This subsection will examine three existing theories which support the argument in favour of the hirer's legal proprietary right. The first theory is that, being the possessor, the possession itself confers on the lessee a legal right. The second is that, under the rule of *nemo dat quod non habet*, the purchaser's right is subject to the lessee's proprietary right. The last theory is that, being the bailee, the lessee has a "special property" over the asset.

7.2.2 Possession

Possession is defined to be the 'visible possibility of exercising physical control over a thing, coupled with the intention of doing so, either against all the world, or against all the world except certain persons.'³³⁸

Possession has been protected to a considerable degree by English law. The possessor of an asset is usually regarded as the owner of it, unless it is otherwise proved.³³⁹ In some circumstances, possession is even better than ownership. For example, if the

³³⁷ R Kersley (ed) *Goode's Modern Law of Personal Property* (9th edn Sweet & Maxwell, London 1949) 8-9; RM Goode, *Commercial law* (3rd edn, Penguin Books, London 2004) 25; M Bridge, *Personal property law* (2nd edn, Blackstone, London 1996) 11 and 23.

³³⁸ J Burke (ed) *Jowitt's Dictionary of English Law* (2nd edn Sweet & Maxwell, London 1977) 1387.

³³⁹ *Asher v Whitlock* (1865-66) LR 1 QB 1 (QB).

asset is damaged by a third party, the possessor can sue him for conversion and damages but the owner cannot, without the right of immediate possession. The possessor's right of possession is commonly suggested to be a real right or a right *in rem*.³⁴⁰

Lord Campbell CJ in the case of *Jeffries v Great Western Railway Co*,³⁴¹ said that it is a general rule at common law that "as against a wrongdoer possession is title".³⁴² This may be why Bell says, "In certain circumstances possession is conclusive evidence of ownership, and this is the foundation of possessory title."³⁴³

However, mere possession of a chattel does not by itself transfer a title.³⁴⁴ The Court of Appeal in the case of *The Winkfield*³⁴⁵ pointed out, "As between bailee and stranger possession gives title – that is, not a limited interest, but absolute and complete ownership".³⁴⁶ This is because possession cannot be given by one person to another but through a process whereby the bailor releases control and the bailee assumes control.³⁴⁷ When the bailee gains the exclusive control of the asset, his title to the asset is therefore a new interest created by possession, rather than an interest derived from the lessor's ownership of the asset.³⁴⁸ In this case, possession gives rise to a property right as against anyone, except the true owner himself. In this sense, the

³⁴⁰ RM Goode, *Proprietary rights and Insolvency in Sales Transactions* (2nd edn, Sweet & Maxwell, London 1989) 7.

³⁴¹ (1856) 5 El & Bl 802, 119 ER 680, at 805.

³⁴² The 'wrong' required here does not have to be a tort but may be a breach of contract. See NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 181. P Bell, *Modern law of personal property in England and Ireland* (Butterworths, London 1989) 80.

³⁴³ P Bell, *Modern law of personal property in England and Ireland* (Butterworths, London 1989) 76.

³⁴⁴ *Shaw v Commissioner of Police of the Metropolis* [1987] 1 WLR 1332 (CA). The agent of the seller does not pass on good title to the car to a prospective buyer, although he has the possession of the car.
³⁴⁵ [1902] P 42 (CA).

³⁴⁶ *The Winkfield* [1902] P 42 (CA), per Collins MR (Stirling and Mathew LJ concurred), at 60.

³⁴⁷ P Bell, *Modern law of personal property in England and Ireland* (Butterworths, London 1989) 62. RM Goode, *Proprietary rights and Insolvency in Sales Transactions* (2nd edn, Sweet & Maxwell, London 1989) 4.

³⁴⁸ N Curwen, 'Title to Sue in Conversion', [2004] *The Conveyancer* 308, p319, Fn 60.

bailee's right over the asset is nothing more than a finder's possessory title to the asset, because in both cases the possessors obtained the exclusive control of the asset; the only difference is that under the law of obligation the bailee has the owner's permission and the finder does not.³⁴⁹ The finder's title cannot be used against the true owner and his successors. Similarly, the bailee's possessory title cannot bind the third party who purchases the asset from the bailor.

However, apart from a possessory title to the asset as against stranger, it is still doubtful whether possession could give rise to a proprietary right, which is a limited legal interest in the asset, with the result that the lessee could retain the possession of the asset as against the third party purchaser. One of the obvious difficulties of the proposition is the rule of *numerus clausus*.

7.2.3 The rule of *nemo dat*

The rule of *nemo dat quod non habet* means that the transferor of goods cannot pass a better title than he himself possesses.

In answering the question "...can a hirer lawfully retain possession against the new owner to whom the bailor sells the hired goods during the period of hire?"³⁵⁰ Thornley said: "The seller has no such right during the continuance of the hiring so how can he transmit that right to the buyer without the aid of some exception to the maxim *nemo dat quod non habet*?"³⁵¹ Goode also relies on this rule, saying that the purchaser's rights in the asset are subject to "the lessee's existing real rights".³⁵² It

³⁴⁹ *Armory v Delamirie* (1722) 1 Str 505, 93 ER 664 (KB).

³⁵⁰ J Thornley, 'Book Review of Crossley Vaines' Personal Property ' (1974) 13 *Journal of the Society of Public Teachers of Law* 150. *Crossley Vaines' Personal Property* by ELG Tyler and NE Palmer (eds) (5th ed 1973 Butterworths, London).

³⁵¹ Thornley, JWA, (1974) 13 *Journal of the Society of Public Teachers of Law* 150, at 151.

³⁵² RM Goode, *Commercial law* (3rd edn, Penguin Books, London 2004) 35.

seems that the application of the rule of *nemo dat* with the effect that the lessee can retain the possession of the asset as against the third party purchaser is based on the assumption that the lessee's right of possession is a real right.

However, there does not appear to be any authority for the so-called "existing real rights" of the lessee over the asset, other than those decided in the sense of "possessory title".

7.2.4 The rule of *numerus clausus*

The rule of *numerus clausus* (quota of property rights) is a basic rule of the English law of property. It means that a person can create over land or chattels only a limited number of different types of property right. The rule of *numerus clausus* is rooted in land law, which, unlike contract law, allows citizens no freedom to customise new species of right.³⁵³ As Pollock CB states in the leading case of *Hill v Tupper*,³⁵⁴ "New rights or incidents of property cannot be created, nor can a new species of burden be imposed upon land at the pleasure of the owners... In the law of real property, for a right to be recognised as proprietary, it has to satisfy essential characteristics of an easement within the limited class of rights".³⁵⁵ Thus, under the rule of *numerus clausus*, unless an interest falls within the closed list of recognised estates and interests, it cannot be described as a 'proprietary right' under the current legal terminology.

³⁵³ Lord Brougham LC emphasises in *Keppell v Bailey* (1834) 2 My & K 517 at 535; 39 ER 1042 at 1049: 'it must not... be supposed that incidents of a novel kind can be devised and attached to property at the fancy or caprice of any owner.' See KJ Gray and SF Gray, *Elements of land law* (4th edn, Oxford University Press, Oxford 2005) 152.

³⁵⁴ (1863) 2 Hurl & C 121, at pp127-128; 159 ER 51. For a more recent application of this principle see the decision of the Court of Appeal in *IDC Group Ltd v Clark* (1992) 65 P & CR 179 (CA).

³⁵⁵ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998), p493.

Swadling argues that, under the rule of *numerus clausus*, a hirer's right over the asset is excluded from the list, so it is not of the nature of a proprietary right.³⁵⁶ For this reason, Swadling disagrees with Thornely and Goode,³⁵⁷ in respect of the application of the rule of *nemo dat*, saying that a property owner would be able to do exactly what the court in *Hill v Tupper*³⁵⁸ said that he could not and create a new proprietary right outside the limited numbers of proprietary rights recognised by land law.³⁵⁹

Agreeing with Swadling, it is submitted that the rule of *numerus clausus* reveals the complication of land law terminology and principles in their application to personal property. The law of personal property is somewhat under-developed by comparison with land law. A lot of its terminology and principles are adopted from land law. Two examples are given below to provide a glimpse of the confusion existing in respect of the proprietary right of chattels.

Firstly, following the land law terminology, 'proprietary rights' refer to 'real' rights rather than personal ones. When a right is recognised as a 'real' right, it binds others besides the parties to the transaction and survives the insolvency of the person granting the right.³⁶⁰ However, as Dalhuisen states, the distinction between real and personal property in common law in the sense of protection is associated with the distinction between real and personal actions.³⁶¹ A real right with a third party binding

³⁵⁶ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 516. Rudden points out, it is actually not only in English law but also in all 'non-feudal' systems there is a restricted list of entitlements which are permitted to count as property interests, or 'real rights'. See B Rudden, 'Economic Theory v Property Law: The Numerus Clausus Problem' in J Eekelaar and J Bell (eds) *Oxford Essays in Jurisprudence* (3rd edn Clarendon Express, Oxford 1987) 239.

³⁵⁷ The discussion in subsection 7.2.2 above.

³⁵⁸ (1863) 2 H & C 121, at pp127-128.

³⁵⁹ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 516.

³⁶⁰ M Bridge, *Personal property law* (2nd edn, Blackstone, London 1996) 12.

³⁶¹ JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007), p538.

effect was generated from the fact that land was defended by actions *in rem* (and as a consequence called “real property”) and chattels were defended by personal actions (and were then called “personal property”).³⁶² This history has a significant effect on the proprietary rights over chattels, because historically whether a transaction accorded a proprietary right or an obligatory right was not determined by the application of the law of property or the law of obligation, but which remedy, either proprietary or personal, was available in actions.³⁶³ As a result, the category of property is not classified according to the inherent distinction but according to the remedies available to them.³⁶⁴ However, remedies are not reliable indicators of the determination of the nature of the right. A simple example is that a monetary remedy has been the primary remedy to all kinds of losses, including those resulting from breaches of proprietary rights, if sufficient. The courts have been criticised for being liberal in choosing the remedy which they think appropriate to a breach of a right despite the nature of the right. Thus, on the one hand, a disentitlement to actions *in rem* indicates that the right is not a ‘real right’; on the other hand, an entitlement to a particular remedy is not determinate to the nature of the rights in breach. What is or should be the criteria for classifying real property and personal property? Apparently the complication and inconsistency of the terminology and principles of the law of property have not given a clear answer to this question.

³⁶² JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007), p538, footnote 13.

³⁶³ This feature is very different from civilian law. Although evolved from the same origin Roman law, the law of property in civil jurisdictions developed towards another direction. In most civilian countries, rights comprise proprietary and obligatory rights. There are clear definitions and categories of them. JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007), p538.

³⁶⁴ JH Dalhuisen, *Dalhuisen on transnational and comparative commercial, financial, and trade law* (3rd edn, Hart Publishing, Oxford 2007), p538.

Secondly, the law of personal property adopted the terminology of “ownership”, which means “the complete dominion, title, or proprietary right over a thing or claim”.³⁶⁵ In theory, the notion of ‘ownership’ in English common law is indivisible, because it is believed that once ownership is transferred for five minutes, it is gone for ever.³⁶⁶ However, in practice, the law of personal property adopted the concept of relativity of title to property from land law.³⁶⁷ The possessor can have a title to the asset, separate from ownership but also protectable by law. Instead of deciding whether one claimant has an absolute right over an asset, the court tends to decide which of two claimants to a possessory interest has a better claim to possession.³⁶⁸ In this way, the law has got around the difficulty to recognise the source of the possessor’s right as against other parties except the true owner. However, the possessor’s right functions like a proprietary right and the authority for this effect is hard to establish in the light of the notion of indivisible ownership of a chattel.

If the notion of indivisible ownership were to be reformed, as Curwen suggests, the rule of *numerus clausus* would be overcome by the generation of an estate in the case of chattel.

7.2.5 Special property

The other theory which supports the lessee’s proprietary right over the asset is that, being the bailee, the lessee under a finance lease has a “special property” over the asset, which indicates that the right is a property right binding third parties. However,

³⁶⁵ *Black’s Law Dictionary* (6th ed, 1990) 1106.

³⁶⁶ AP Bell, *Modern law of personal property in England and Ireland* (Butterworths, London 1989) 66. According to Pollock and Maitland, as a term, ownership did not appear before 1583. See F Pollock and F Maitland, *The History of English law before the time of Edward I* (2nd edn, Cambridge University Press, Cambridge 1911) Vol 2, p153, Footnote 1.

³⁶⁷ KJ Gray and SF Gray, *Elements of land law* (4th edn, Oxford University Press, Oxford 2005) 355-357.

³⁶⁸ KJ Gray and SF Gray, *Elements of land law* (4th edn, Oxford University Press, Oxford 2005) 356.

the flaw of this theory is that “special property” is used only in some circumstances, distinct from the bailor’s ‘general property’. For example, in *Lee v Atkinson and Brooks*,³⁶⁹ it was held that the hirer’s right over the asset was described as a ‘special property’ against all men.

This was also the case in a commentary to the Bill of the original Sale of Goods Act 1893 by Sir MacKenzie Chalmers, when he identified ownership with the general property, which was to be transferred by a contract for the sale of goods, and distinguished it from a special property, of which he cited the interest of a pledgee as an example.³⁷⁰

The term ‘special property’ mainly appeared in the older authorities on bailments in common law.³⁷¹ The bailee is described as a holder of a ‘special property’, by virtue of his possession of the asset, as opposite to the bailor’s ‘general property’ or ‘reversionary interest’.³⁷² It was more recently echoed by Slade J in *Re Bond Worth Ltd*: “it is of the essence of a bailment that the general property in the goods concerned remains in the bailor, while only a special property passes to the bailee, which entitles him to exercise certain possessory remedies.”³⁷³ According to this statement, the bailee may acquire an interest in the asset by the way of obtaining the possession of it and this interest confers on him certain remedy as against third parties.

³⁶⁹ (1609) Croke, Jac 236, 79 ER 204.

³⁷⁰ N Curwen, 'General and Special Property in Goods' (2000) 22 *Legal Studies* 181, Footnote 1, p181, with reference to M Chalmers, *The Sale of Goods* (Open Libraries, London 1890) 93.

³⁷¹ NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 82, Footnote 26, referring to *Lee v Atkinson and Brooks* (1609) Croke, Jac 236, 79 ER 204; *Ratcliff v Davis* (1610) 1 Bulst 29; *Ryall v Rowles* (1750) 1 Atk 165; *Webb v Fox* (1797) 7 TR 391, at 396-398; 101 ER 1037, at 1040- 1041; *Donald v Suckling* (1865-66) LR 1 QB 585 (QB); *Sewell v Burdick* (1884-85) 10 App Cas 74 (HL); *Re Morritt* (1886) 18 QBD 222 (CA).

³⁷² P Bell, *Modern law of personal property in England and Ireland* (Butterworths, London 1989) 33 and 86. NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 82, Footnote 26; Curwen, Nicholas, “General and Special Property in Goods”, [2000] 22 *Legal Studies* 181, p188.

³⁷³ [1980] Ch 228 (Ch), at 247.

Unfortunately there was no further pronouncement on the point, such as would elucidate the nature and extent of this interest.

The term 'special property' has been historically referred to as the pledgee's interest in the chattel serving as the pledge.³⁷⁴ In a pledge, the debtor preserves the ownership of goods but transfers possession to his creditor as security for the discharge of a debt. The special property of the creditor's pledge is recognised as a proprietary right on the ground that it is transferable and the pledgor can always recover the pledge from a sub-pledgee by tendering the amount owed under the sub-pledge agreement.³⁷⁵ The right of the pledgor's assignee is subject to the special property held by the pledgee.³⁷⁶

Apart from the case of pledges, no authoritative judicial pronouncement has been found in other types of bailments. In particular, on the question whether or not a hire of a chattel confers a proprietary interest on the hirer, there appears to be no such pronouncement.³⁷⁷ On the contrary, however, the current authority of English law is opposite to the argument for a proprietary special property in hires. *Halsbury's Laws of England* speaks of the law in respect of the hire of a chattel that "The proprietary interest in the chattel is not changed, but remains in the owner, although upon delivery the hirer becomes legally possessed of the chattel hired."³⁷⁸ The property of the chattel is not transferred in the case of hire because the owner's ownership of the chattel has to be absolute and indivisible under English law.

³⁷⁴ The pledge is considered as acquiring a special property in the pledge. See *Sewell v Burdick* (1844) 10 App Cas 74; *Carter v Wake* (1877) 4 Ch D 605 (Ch).

³⁷⁵ *Sewell v Burdick* (1844) 10 App Cas 74.

³⁷⁶ *Halliday v Holgate* (1868) LR 3 Ex 299 (Ex); *Donald v Suckling* (1866) LR 1 QB 585.

³⁷⁷ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 492.

³⁷⁸ 4th ed, vol 2, par 1551.

In fact, even in the only case where ‘special property’ is said to be of the nature of a legal right, that is pledges, there is doubt about the proprietary nature of the pledgee’s special property. Lord Mersey, delivering the judgement of their lordships of the Privy Council in a pledge case of *The Odessa*,³⁷⁹ points out that the so-called ‘special property’ of the pledgee’s interest in the asset is in fact not property at all but seems to exclude the notion of that general property which is the badge of ownership and should be better called as ‘special interest’.

Thus it is rightly said in a dictionary: “A person may have a special property in a thing in the sense that he can only put it to a particular use. Thus, in the case of a bailment, the bailee has a special property in the thing bailed, for he is only entitled to deal with it in accordance with the contract of bailment; but he can maintain an action in respect of it against a wrongdoer. So possession is said to confer a special property, by which is meant that the possessor of a thing is deemed to be owner of it as against everyone who cannot show a better title.”³⁸⁰

7.2.6 Summary

It is becoming clearer that the lessee has the possession of the asset and also a possessory title as against strangers and that the possession may well confer a proprietary right on the hirer, if the ownership can be divisible. If the right to possession of a possessor, for example, a hirer, were to be defined to be a proprietary right, like an estate of land, which is a limited proprietary right, the outcome of the application of the rule of *nemo dat* should establish the hirer’s right as against a third party purchaser. However, the lack of authority, the application of the rule of *numerus*

³⁷⁹ [1916] 1 AC 145 (PC), Lord Mersey, Lord Parker of Waddington, Lord Sumner, Lord Parmoor, and Sir Edmund Barton, p158-159.

³⁸⁰ J Burke (ed) *Jowitt’s Dictionary of English Law* (2nd edn Sweet & Maxwell, London 1977) 1447.

clausus and the notion of indivisible ownership of chattels all combine to hinder the law from recognising a proprietary right of the hirer.

7.3 A proprietary right in equity?

7.3.1 Introduction

Equity is often used to bring into effect many ideas which cannot be recognised at common law. In the lack of authority at law, attempts to confer a proprietary right on the hirer have been made in equity.

Such a right has been recognised in some cases, particularly those concerning ships and aircraft. In order to see whether the lessee under a finance lease could thereby have a proprietary right over the asset in equity, this subsection will examine the three ways in which the right of the hirer is recognised to be proprietary in equity. The first one is that a charterparty of a ship was regarded as a restrictive covenant running with the ship and hence bound the third party purchaser. The authority for it can be found in *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*.³⁸¹ The second one is that a hirer's right over an aircraft was regarded as a property right with effect as against a third party under a wider statutory definition of "property", due to the availability of an equitable remedy, namely, specific performance. The authority for it can be found in *Bristol Airport Plc v Powdrill*.³⁸² The third one is a situation where the hirer is entitled to an equitable injunction as against a third party purchaser. However, it is arguable that, rather than a proprietary right of the hirer's own, the hirer's right in the last situation is a new right arising as a result of the third party's inducement to breach of the existing contract.

³⁸¹ [1926] AC 108 (PC).

³⁸² [1990] Ch 744 (CA).

7.3.2 A restrictive covenant running with the asset

It is a rule of land law that a restrictive covenant may run with the land so that a purchaser of the land with notice of the covenant cannot use the land in a manner inconsistent with the covenant. The rule was applied to chattels by the court in the case of *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*.³⁸³ However, it is still controversial as to whether the rule is applicable to chattels in general and whether some of the restrictions put on the analogous rule of land should also apply to chattels.

It is believed that the judicial pronouncement for a restrictive covenant running with a chattel started from the dictum of Knight Bruce LJ in the case of *De Mattos v Gibson*.³⁸⁴ In that case, a ship was chartered to the plaintiff and subsequently mortgaged to the defendant, who threatened and tried to sell the ship. The plaintiff alleged that the defendant's attempt to sell was in violation of the charterparty and applied for an interlocutory injunction to restrain him from doing so.

In allowing the injunction, Knight Bruce LJ said in his dictum: "Reason and justice seem to prescribe that, at least as a general rule, where a man, by gift or purchase, acquires property from another, with knowledge of a previous contract, lawfully and for valuable consideration made by him with a third person, to use and employ the property for a particular purpose in a specified manner, the acquirer shall not to the material damage of the third person, in opposition to the contract and inconsistently with it, use and employ the property in a manner not allowable to the giver or seller. This rule, applicable alike in general as I conceive to moveable and immoveable property, and recognised and adopted, as I apprehend, by the English law, may, like

³⁸³ [1926] AC 108.

³⁸⁴ (1859) 4 De G & J 276; 45 ER 108.

other general rules, be liable to exceptions arising from special circumstances; but I see at present no room for any exception in the instance before us.”³⁸⁵ In other words, Knight Bruce LJ believed that an equitable rule of a restrictive covenant running with the property was applicable to both land and chattels with the effect of binding third parties who had notice of the covenant.

The dictum of Knight Bruce LJ was criticised as being too general and lacking in authority. When he spoke of this rule, he did not cite any case in support of the so-called “a general rule” applicable to land and chattels. But it is generally believed that he bore in mind the case of *Tulk v Moxhay*,³⁸⁶ which was concerned with land and cited by the counsel for the plaintiff in *De Mattos*.³⁸⁷

In *Tulk v Moxhay*, it was held that a covenant, on the sale of land, entered into by a purchaser’s predecessor in title and the original seller, would be enforceable in equity against all subsequent purchasers with notice.³⁸⁸ Delivering the decision of the court, Cottenham LC, said, “the question is, not whether the covenant runs with the land, but whether a party shall be permitted to use the land in a manner inconsistent with the contract entered into by his vendor, and with notice of which he purchased.”³⁸⁹ The doctrine of *Tulk v Moxhay*³⁹⁰ itself attracted criticism for being too general and restrictions were placed on it. After the dictum of Knight Bruce LJ in the case of *De Mattos*,³⁹¹ two qualifications were introduced to the doctrine of *Tulk v Moxhay* in the case of land. Firstly, the covenant must be negative or prohibitive in character, as was

³⁸⁵ (1859) 4 De G & J 276, at 282; 45 ER 108, at 110.

³⁸⁶ (1848) 2 Ph 774; 41 ER 1143.

³⁸⁷ (1859) 4 De G & J 276, at 281; 45 ER 108, at 109.

³⁸⁸ (1848) 2 Ph 774; 41 ER 1143.

³⁸⁹ (1848) 2 Ph 774, at 777-778; 41 ER 1143, at 1144.

³⁹⁰ (1848) 2 Ph 774; 41 ER 1143.

³⁹¹ (1859) 4 De G & J 276, at 281; 45 ER 108, at 109.

decided in *Haywood v Brunswick Permanent Building Society*³⁹². Secondly, the covenantee who claimed the protection by applying the doctrine must retain adjacent land which was benefited by the covenant, decided by *Formby v Barker*³⁹³ and *London County Council v Allen*.³⁹⁴ The second qualification is not suitable to apply to the case of chattels. As Palmer comments, “It was at this point that the law of real property began to leave the law of personal property behind.”³⁹⁵

In the early twentieth century, almost at the same time as when the rule of a restrictive covenant running with property experienced restriction in the case of land, the rule was also refused in some cases in relation to chattels. One particular case concerned the price maintenance clauses. At the time, many agreements made by the manufacturer and retailer included the price maintenance clauses, which stipulated that the goods should not be sold by the retailer or his assignees below a certain price set by the manufacturer. However, having known of the price maintenance clauses, the third parties who purchased the goods from the retailer still sold them at a lower price. Due to the rule of privity, they were not responsible to the manufacturer in the lack of a contractual relationship. However, the manufacturer’s counsel argued that the price maintenance clauses constituted a restrictive covenant running with the goods and therefore had the effect of binding the third parties who had noticed the clauses. But it was held in *Taddy v Sterious*³⁹⁶ and *McGruther v Pitcher*³⁹⁷ that conditions, such as fixing the maximum or minimum price on the future sales, did not run with the goods and the resale price maintenance clauses were unenforceable against the third party purchasers.

³⁹² (1881-82) LR 8 QBD 403 (CA).

³⁹³ [1903] 2 Ch 539 (CA).

³⁹⁴ [1914] 3 KB 642 (CA).

³⁹⁵ NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 1590.

³⁹⁶ [1904] 1 Ch 354 (Ch).

³⁹⁷ [1904] 2 Ch 306 (CA).

The other case where the court refused to apply the rule of a restrictive covenant running with the property was concerned patent and other intellectual property rights.³⁹⁸ In the copyright case of *Barker v Stickney*, it was decided that, not being a party to the deed of assignment, the purchaser was not bound to account for or pay royalties to the author.³⁹⁹ Scrutton LJ expressly refused to apply the rule of a restrictive covenant running with the property to chattels in general and commented that the rule expounded by Knight Bruce LJ in *De Mattos*⁴⁰⁰ was completely redundant in the case of chattel.⁴⁰¹

Besides being too general in principle, the dictum of Knight Bruce LJ is also weak in authority. His dictum was made on an interlocutory motion and did not gain support from his fellow judge and the judge at the further trial of the case. In fact, Turner LJ, who was his fellow judge and also agreed to grant an injunction to the plaintiff, expressly reserved his opinion on the point of the restrictive covenant running with the property, saying that it was a question “deserving of very great consideration”.⁴⁰² At the further trial of the mortgagor’s appeal in this same case, Lord Chelmsford LC treated the question differently. Rather than dealing with a restrictive covenant running with the property, he based his decision on the question whether in the particular circumstances the mortgagee of the ship was guilty of procuring a breach of contract by making it impossible for the owner to carry out the terms of the charter which he had entered into.⁴⁰³ He decided for the mortgagee on the ground that the

³⁹⁸ For example, *King v Allen* [1916] 2 AC 54 (HL) (licence); *Barker v Stickney* [1919] 1 KB 121 (CA) (copyright); *Clore v Theatrical Properties* [1936] 3 All ER 483.

³⁹⁹ [1919] 1 KB 121, at 132.

⁴⁰⁰ (1859) 4 De G & J 276; 45 ER 108.

⁴⁰¹ [1919] 1 KB 121, at 132.

⁴⁰² *De Mattos v Gibson* (1859) 4 De G & J 276, at 284; 45 ER 108, at 111.

⁴⁰³ (1859) 4 De G & J 276, at 299-300; 45 ER 108, at 116.

mortgagee did not in any way interfere with the performance of the charterparty until it was evident that the mortgagor was wholly unable to perform it.⁴⁰⁴

Considering the criticism of and the weakness of the dictum of Knight Bruce LJ, one may think that it would be left to wither on the vine. However, it was somewhat a surprise, when it was cited with approval in the case of *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*⁴⁰⁵ by the Privy Council. The facts of the *Lord Strathcona* case were similar to those in *De Mattos v Gibson*,⁴⁰⁶ save that the ship in question was built in accordance to the charterer's specifications and mortgaged several times before eventually to the appellant. Each succeeding mortgagee had actual notice of the charterparty and in the case of the last mortgage the appellant appeared to have agreed to honour the charterparty, according to a specific provision in the bill of sale.

Lord Shaw, delivering the advice of the Privy Council, held that the general principle laid down by Knight Bruce LJ was not affected by the restriction on its analogy in the case of land.⁴⁰⁷ He said that, being a case concerning a covenant restricting the user of chattels, *Lord Strathcona* should be distinguished from those cases concerning a covenant restricting the condition of chattels.⁴⁰⁸ He said, "the respondent has, and will have during the continuance of the period covered by the charterparty, a *plain interest* [emphasis added] so long as [the ship] is fit to go to sea."⁴⁰⁹ He then added, "If a man acquires from another rights in a ship which is already under charter, with notice of rights which required the ship to be used for a particular purpose and not

⁴⁰⁴ (1859) 4 De G & J 276, at 299-300; 45 ER 108, at 116.

⁴⁰⁵ [1926] AC 108.

⁴⁰⁶ (1859) 4 De G & J 276; 45 ER 108.

⁴⁰⁷ [1926] AC 108, at 125.

⁴⁰⁸ [1926] AC 108, at 123.

⁴⁰⁹ [1926] AC 108, at 123.

inconsistently with it, then he appears to be plainly in the position of a constructive trustee with obligations which a Court of equity will not permit him to violate. It does not matter that this Court cannot enforce specific performance.”⁴¹⁰

Unfortunately, he did not go further to clarify the nature of the so-called “plain interest” of the charterer. Because the interest was said to have the effect of binding a third party, for example, a purchaser, it appeared to be a proprietary right. The decision of the case of *Lord Strathcona* is a highly persuasive authority in English law and, although not binding, is likely to be followed in future cases concerning restrictive covenants running with ships, if not chattels in general.

However, the decision itself was not unblemished. In fact, it attracted severe criticism to its approval to the Lord Knight Bruce’s dictum and its own grounds. The theory of constructive trust and the rule of a restrictive covenant running with chattels were “regarded by the profession as novel if not revolutionary”, says Lord Greene MR in the case of *Greenhalgh v Mallard*.⁴¹¹

Swadling points out that the theory of constructive trustees advanced by Lord Shaw, similar to the reasoning of Lord Denning MR in *Binions v Evans*,⁴¹² was to avoid the doctrine of privity of contract and to effect a transplantation of constructive trust from the law of property to the law of obligations.⁴¹³ He points out that the fallacy of them will be acknowledged by the courts one day but for now it is enough to note that these cases provide no authority for the proposition that a contractual licence to occupy land

⁴¹⁰ [1926] AC 108, at 125.

⁴¹¹ [1943] 2 All ER 234 (CA), at 239.

⁴¹² [1972] Ch 359 (CA). In that case, a contractual licence to occupy land was held to be binding on a third party.

⁴¹³ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 513.

will bind a third party because, in the cases, the effect of the covenant binding on the third party purchaser is hugely dependent on his consent; this seems to indicate contractual instead of proprietary nature.⁴¹⁴

With regard to the rule of a restrictive covenant running with chattels, Swadling says, the ‘plain interest’ of the hirer in the ship in the case of *Lord Strathcona* simply did not exist. He thinks that it is essential that, for the rule of a covenant running with the land to apply, the claimant must have a proprietary right over the neighbouring land to the land in question because, should the new purchaser of the land in question be allowed to interfere with the covenant, it would result in an infringement of the neighbour’s proprietary right over the new purchaser’s land.⁴¹⁵ If the rule were to be so general that any interest could satisfy the criterion of the rule, the case of *London County Council v Allen*⁴¹⁶ could have been differently decided, because the London County Council clearly had an ‘interest’ in the covenant being performed.⁴¹⁷

This analysis by Swadling appears to be based on a notion that the rule of a restrictive covenant running with the property should apply to both land and chattels in consistency. This is however not what Lord Shaw intended to achieve.⁴¹⁸ Lord Shaw expressly refused to apply the restrictions imposed on the rule of a covenant running with the land to the case of chattels.⁴¹⁹ Although that the term “plain interest” is vague in its meaning, Lord Shaw might not have intended to give a wide scope to the definition of the ‘interest’ as if any kind of interest would qualify. He appeared to emphasise that the interest of a user in the thing should be so significant as to

⁴¹⁴ W Swadling, *ibid.*

⁴¹⁵ W Swadling, *ibid.*, p499.

⁴¹⁶ [1914] 3 KB 642.

⁴¹⁷ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 499.

⁴¹⁸ *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd* [1926] AC 108 (PC).

⁴¹⁹ [1926] AC 108, at 124-125.

contribute a unique feature of it and become inherent to the use of it.⁴²⁰ Palmer discerns that Lord Shaw might attempt to construct a general theory relating to the running of covenants with chattels rather than to look for a more limited and appropriate solution to the problem raised.⁴²¹

In addition to the criticism from academia, *Lord Strathcona* was not followed in a first instance decision in England in the case of *Port Line Ltd v Ben Line Steamers Ltd*, which was also a case of ship charterparty.⁴²²

A ship was chartered for thirty months by the plaintiff from Silver Line, who then sold it to the defendant with a stipulation that the latter agreed to charter it back by demise for the residue of the plaintiff's charterparty so that Silver Line could perform its charterparty with the plaintiff. There was a clause in the demise charterparty contract that in case of requisition the charter would cease. However, this clause was not included in the time charterparty between Silver Line and the plaintiff; a fact which was not known by the defendant. The ship was requisitioned and then released to the defendant with compensation. During the period of requisition the plaintiff continued to pay the charter hire to Silver Line, despite the latter's contention that the charterparty was frustrated. Relying on the principle laid down in *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*,⁴²³ the plaintiff claimed to be entitled to share in the compensation, on the ground that the defendant was bound to honour the original charterparty and was therefore liable for its breach. But the claim failed.

⁴²⁰ [1926] AC 108, at 125.

⁴²¹ The criticism to the uncertainty left by Lord Shaw, see NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 1592-1593.

⁴²² [1958] 2 QB 146 (QB).

⁴²³ [1926] AC 108.

Diplock J decided that, either the case of *Lord Strathcona* was wrongly decided, or, even if it was rightly decided, the defendant did not come within its principles as they had no actual knowledge at the time of their purchase. Or, even if the defendant came within its principles, neither was he in breach of any duty to the plaintiff, because the fact that during the period of requisition the ship was used inconsistently with the terms of the plaintiff's charter did not result from the defendant's act but from that of the Crown, which held a title paramount, nor was the plaintiff entitled to any remedy against the defendant except a right to restrain the defendant from using the vessel in a manner inconsistent with the terms of the charter.⁴²⁴

Diplock J said that the interest perceived by the Privy Council in *Lord Strathcona* was little more than "his commercial advantage that the covenantor should continue to use the ship to perform the services which he is covenanted to perform."⁴²⁵ His resistance to the decision of *Lord Strathcona* may be due to two facts, which distinguished *Port Line Ltd v Ben Line Steamers Ltd* from applying the advice of *Lord Strathcona*.⁴²⁶

First, in the case of *Port Line Ltd*, the plaintiff was a time charterer of the ship, who is like a licensee of land, distinct from a demise charterer, who is believed to have a proprietary or possessory interest, by analogy to the lessee of land.⁴²⁷ Secondly, the defendant did not have actual notice of the relevant provision of the charterparty in respect of requisition and this could have distinguished the case from the general rule established in *Lord Strathcona*.

⁴²⁴ [1958] 2 QB 146, at 147.

⁴²⁵ [1958] 2 QB 146, at 166.

⁴²⁶ Palmer also analyses the hostility of Diplock J to the decision of *Lord Strathcona* might be because of his inability to draw a parallel in the case of chattel with restrictive covenants affecting land and to clarify the conflict between it and the resale price maintenance cases. NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 1597.

⁴²⁷ *Port Line Ltd v Ben Line Steamers Ltd* [1958] 2 QB 146, at 168.

Despite resistance in some other cases, the decision in *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*⁴²⁸ was further applied in *Swiss Bank Corp v Lloyds Bank Ltd*.⁴²⁹ Browne-Wilkinson J decided that the principle stated by Knight Bruce LJ in *De Mattos v Gibson*⁴³⁰ was good law.⁴³¹ He also held that the plaintiff's right to have his contract performed was a sufficient interest to entitle him to an injunction, which would stop anyone who acquired the property with actual knowledge of the contract from dealing with the property in such a way to cause a breach of the contract, even if the plaintiff had no proprietary interest in the property.⁴³²

It is submitted that *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*⁴³³ stands as authority for an equitable rule of a restrictive covenant running with chattels. In principle, a contract to allow a party to possess and use the asset during a period of time for a particular use creates a covenant running with it and therefore the succeeding owner of the asset is bound to allow the performance of the covenant. When the succeeding owner is in breach of the covenant, the possessor can claim an injunction against him. This result makes the right of the possessor look like an equitable proprietary right over the asset. However, the law has not given a definite answer to the nature of this right. It is also not clear whether the rule is applicable to other kinds of chattels than ships. Moreover, the reasoning of the rule conflicts with the existing rule of a restrictive covenant running with land. The law has not made it clear whether the rules in relation to land and chattels should be consistent and to what extent the consistency is required. Arising from equity, the remedy of the hirer

⁴²⁸ [1926] AC 108.

⁴²⁹ [1979] Ch 548, rev'd [1980] 3 WLR 457, aff'd [1982] AC 58. The first instance judgment was reversed on the facts.

⁴³⁰ (1859) 4 De G & J 276; 45 ER 108.

⁴³¹ [1979] Ch 548, at 573.

⁴³² [1979] Ch 548, at 575.

⁴³³ [1926] AC 108.

to continue to possess and use the asset is bound to be limited. For example, it is subject to the third party's actual knowledge of the hire and other defences in equity.

Regardless, the rule in equity managed to be established to protect the hirer's possession. This fact has manifested that there is a real need to protect the hirer's interest in the asset as against third parties. If, as a general principle, the right of the hirer over the chattel is protectable in equity, how much more to be protected should the right of the lessee under a finance lease, who has the asset specifically manufactured and acquired for his sole use for the useful life of it.

7.3.3 Specific performance

Specific performance has appeared to be another ground on which the right of a hirer is recognised to be a property right. It was decided in the case of *Bristol Airport Plc v Powdrill*⁴³⁴ that the aircraft in question should be regarded as the lessee's property under the Insolvency Act 1986, s11(3), on account of the certainty of the lessee's entitlement to specific performance of a contract to lease the aircraft.

In that case, the defendant airline company leased certain aircraft and was indebted to a number of airports, including the plaintiff, in respect of unpaid airport charges. The lessee became insolvent but continued to trade under an administration order pursuant to s 8 of the Insolvency Act 1986. Under s 88 of the Civil Aviation Act 1982, the plaintiff airport was empowered to detain and eventually to sell any aircraft in respect of which charges were incurred or any other aircraft of which the person in default was the operator. However, s 11(3) of the Insolvency Act 1986 requires such steps to be taken with the consent of the administrator or the leave of the court. The plaintiff

⁴³⁴ [1990] Ch 744 (CA).

airport did not acquire such consent before detaining three aircraft. It argued that the statute did not apply to the case because the aircraft, being held under leases, were not the ‘property’ of the lessee. The Court of Appeal held that the aircraft were the lessee’s property and therefore that leave was required before their detainment.

Browne-Wilkinson VC, who was the same judge as in *Swiss Bank Corp v Lloyds Bank Ltd*,⁴³⁵ said in his decision in the *Bristol Airport* case: “Although a chattel lease is a contract, it does not follow that no property interest is created in the chattel. The basic equitable principle is that if, under a contract, A has certain rights over property as against the legal owner, which rights are specifically enforceable in equity, A has an equitable interest in such property.”⁴³⁶ He went on to say: “I have no doubt that a court would order specific performance of a contract to lease an aircraft, since each aircraft has unique features peculiar to itself. Accordingly in my judgment the ‘lessee’ has at least an equitable right of some kind in that aircraft which falls within the statutory definition as being some ‘description of interest . . . arising out of, or incidental to’ that aircraft.”⁴³⁷

It should be noted that the lessee’s property under the Insolvency Act 1986, s11(3), is defined wider than the property right under the law of property.⁴³⁸ However, in terms of its binding effect on third parties, there is not much difference between them than the roots of such a right.

⁴³⁵ [1979] Ch 548, reversed on the facts [1982] AC 584.

⁴³⁶ [1990] Ch 744, at 759, with whom Staughton and Woolf L.JJ., while not dealing with the point themselves, agreed.

⁴³⁷ [1990] Ch 744, at 759.

⁴³⁸ Section 436 of the Insolvency Act 1986, where “Property” is defined as follows:

“‘Property’ includes money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property.”

The decision of Browne-Wilkinson VC relied on the maxim: “Equity regards as done that which ought to be done”. The maxim is questioned by Swadling as a ground for conferring a property right on the hirer.⁴³⁹ He analysed that equity could anticipate the eventual result at law, provided “eventual performance of the relevant obligation will create property rights recognised by the common law”.⁴⁴⁰ The equitable remedies, like those at common law, issue to protect both personal and proprietary rights and therefore the availability of an equitable proprietary remedy does not indicate that the right is of the proprietary right in nature.

In disagreement with Swadling, Watt supports what Browne-Wilkinson VC decided in *Bristol Airport* with regard to the relation between equitable remedies and equitable proprietary rights.⁴⁴¹ He says that equity has been used to ensure that contracts are performed and therefore the maxim “Equity regards as done that which ought to be done” should be interpreted as “Equity contemplates nothing more in this case than that the contract be enforced according to its terms”.⁴⁴² He argues that “What the Vice-Chancellor used the equitable remedy to protect was the present enjoyment of the property for the duration of the contract...; a right that is by definition proprietary”.⁴⁴³

Indeed, Watt has gone so far as to say that as long as a contractual right gives rise to a right over property and such a right is specifically performable, it does not need to be a legal estate itself for equity to intervene and to recognise it as a proprietary right as against a third party. He even argues that the lack of a doctrine to confer time-layered

⁴³⁹ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 505-507.

⁴⁴⁰ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 506.

⁴⁴¹ G Watt, 'The Proprietary Effect of A Chattel Lease' (2003) *The Conveyancer* 61.

⁴⁴² G Watt, 'The Proprietary Effect of A Chattel Lease' (2003) *The Conveyancer* 61, p65.

⁴⁴³ Watt, Graeme, “The Proprietary Effect of A Chattel Lease”, [2003] *The Conveyancer* 61, 66.

estates in the case of chattel makes equity more necessary for the purpose of conferring a proprietary right.⁴⁴⁴ This argument employs equity, which is to ensure that the promisor will keep his promise, to the end that an equitable proprietary right will be generated.

Watt's analysis is criticised by McFarlane in that the conferral of a proprietary right by equity is beyond what specific performance could generate. He points out that, being one of the remedies, specific performance may happen to be chosen by the court to cure the hirer's damage. But the mere fact that specific performance is available against one party to a contract does not prove that the other party's right must be proprietary.⁴⁴⁵ For a right to be a proprietary right, the need for protection must be so strong that it should bind a third party who has made no contractual promise and also that it should overcome the disadvantages of the proprietary right that a burden will be imposed on the property and will restrict the ease of its transfer.⁴⁴⁶ Hence, McFarlane says, the mere fact that the hirer is entitled to specific performance against the owner does not mean that his right has proprietary status as against third parties.

It is submitted that, although being a useful method to protect the lessee's interest in the asset, specific performance is itself a mere remedy. The employment of it happened to combine with the wide definition of 'property' under the insolvency statute and thus gave rise to the conferral of a property right on the lessee in the case of *Bristol Airport Plc.*⁴⁴⁷ However, as a general rule, specific performance should not

⁴⁴⁴ Watt, Graeme, "The Proprietary Effect of A Chattel Lease", [2003] *The Conveyancer* 61, 69.

⁴⁴⁵ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 474.

⁴⁴⁶ McFarlane, Ben, "Identifying Property Rights: A Reply to Mr. Watt", [2003] *The Conveyancer* 473, p474.

⁴⁴⁷ [1990] Ch 744 (CA).

be confused with the status of a right protected by it. The authority arising from the case of *Bristol Airport Plc*⁴⁴⁸ for the lessee's property right over the asset is weak due to the application of the specific statute and the controversial function of equitable remedies. However, it did not appear to be material to the decision the question as to whether the subject matter of the case was aircrafts or other kinds of chattels.

7.3.4 An equitable right resulting from the third party's own conduct

Apart from the current rules concerning specific performance and a restrictive covenant running with the chattel, another rule of equity has been suggested to apply to chattels with the effect of binding a third party.

The theory is that, with notice of the hirer's contractual right over the asset, the third party is guilty of inducing the owner to breach his contract with the hirer and therefore equity should intervene to protect the hirer's contractual rights.

In the case of *De Mattos v Gibson*,⁴⁴⁹ when after the trial of the action the matter came before Lord Chelmsford on appeal, he dealt with it without any reference at all to the views of Knight Bruce LJ which concerned the restrictive covenant running with the ship. Instead, he treated the question as being whether in the particular circumstances the mortgagee of the ship was not guilty of procuring a breach of contract by making it impossible for the owner to carry out the terms of the charter which he had entered into. Based on the fact that there was no possibility of the original mortgagee performing the charterparty whatever the purchaser did, it was decided that there was no question of any act by the purchaser constituting an interference by him with the charterer's contractual rights. In addition, at first instance in *Swiss Bank Corp v*

⁴⁴⁸ [1990] Ch 744 (CA).

⁴⁴⁹ (1859) 4 De G & J 276; 45 ER 108.

Lloyds Bank Ltd,⁴⁵⁰ Browne-Wilkinson J relied on the case of *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*⁴⁵¹ as authority for an injunction restraining a subsequent purchaser of a chattel from using it so as to cause a breach of a contract of which he had notice.⁴⁵² It is therefore doubtful as to whether the rule can exist on its own or it has to combine with the rule of a restrictive covenant

The hirer's right as against the third party under this rule of inducement to breach of contract is said to be different from a proprietary right of his own. The right is, as McFarlane says, a new right arising as a result of the third party's own conduct and is separate from the necessity of the existence of a proprietary right.⁴⁵³ Such a right is neither derived from the contract nor proprietary in nature but is a new and direct right. It arises as a result of the third party's conduct in purchasing the chattel with notice of the covenant, either acting inconsistently with his undertaking of his purchase to allow the lessee use of the property, or persuading the lessor to breach the contract with the lessee.⁴⁵⁴ McFarlane says, "If such a right exists, there is no need for [the lessee] to show that his original right is proprietary, or even that he had *any* right before the transfer to [the third party]."⁴⁵⁵ It is therefore for the third party to show a defence to the new rights, rather than for the lessee to prove that he has a proprietary right. Such a cause of action is therefore subject to equitable defences.

⁴⁵⁰ [1979] Ch 548.

⁴⁵¹ [1926] AC 108.

⁴⁵² [1979] Ch 548, at 573. In addition, there are two land cases cited as authority in this respect. The Court of Appeal in the case of *Manchester Ship Canal Co v Manchester Racecourse Co* [1901] 2 Ch 37 (CA) decided that the court would restrain a person from enforcing his contractual rights so as to cause a breach of another contract of which he had full knowledge when he entered into his own contract. In another case *Binions v Evans* [1972] Ch 359 (CA), at 371, the Court of Appeal, per Megaw LJ, indicated that he thought the case could properly have been decided on the basis that an injunction to restrain the tort should be granted.

⁴⁵³ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 481.

⁴⁵⁴ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 483.

⁴⁵⁵ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 477.

McFarlane warns that, since there seem to be two ways in which the lessee's enjoyment of property may be protected against a third party, either by his own proprietary right or a third party's inequitable conduct, it is impossible to assume that cases protecting the lessee's enjoyment of property from interference by the new owner necessarily indicate the proprietary nature of the lessee's original right.⁴⁵⁶

His analysis is right in pointing out the nature of the right to restrain a third party from interfering with the performance of the contract. His analysis also contributes to the methodology by which a proprietary right is derived. However, although it is true that a mere effect of binding a third party cannot prove the right of proprietary status, it is submitted, it is also true that a right without such an effect does not certainly mean that it is not a proprietary right. This is the problem with the conception of property under English law. There is no unified definition and criteria of recognition to it.

English common law provides damages to be the primary remedy for breaches of or infringement to an owner's right. A proprietary right is not necessarily protected by a proprietary remedy at law; and a proprietary remedy available to a right does not certainly prove that it is a proprietary right. However, for the current purpose of discussion, it is enough to prove that, if the purchaser's own conduct is considered by the court to induce the lessor to breach the contract with the lessee with actual notice of the existence of the contract, the lessee may be able to be protected in equity as against the purchaser based on a new right resulting from the purchaser's conduct.

7.3.5 Summary

This subsection discussed three cases in which the hirer has been protected from intervention of a third party. In the first two cases, a proprietary right of the hirer was

⁴⁵⁶ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 477.

recognised by the court in equity. Equity has intervened in these cases to provide the hirer with an effect as against a third party, in the absence of authority for a legal proprietary right of the hirer over the asset. Firstly, a hire of the asset may be considered to impose a restrictive covenant running with the asset and therefore be binding third parties with actual knowledge of the hire. This approach was approved by the Privy Council in the case of *Lord Strathcona Steamship Co Ltd v Dominion Coal Co Ltd*.⁴⁵⁷ Secondly, where specific performance is available to a hire of an asset, the court may regard the hirer's right as an equitable proprietary right with the effect of binding third parties. This approach was taken by the Court of Appeal in deciding the case of *Bristol Airport Plc v Powdrill*.⁴⁵⁸ However, the second approach is rather limited in its efficacy, mainly because of the wide definition of 'property' under the Insolvency Act 1986. In contrast, the first approach is stronger in authority and in reasoning, although it has its own weakness in clarity and certainty. It is likely that the first approach could be employed by the lessee under a finance lease to claim for an injunction, which would stop interference to the lease by a third party purchaser who has actual knowledge of the lease but purports to stop the performance of it. Interestingly, to the same effect as against a third party, injunction may be granted purely on the third ground that the third party's inducement to breach the contract should be restrained by equity. It is said that the right of the hirer in this situation is different from a proprietary right of his own. However, it is doubtful to what extent, if any, it combines with the rule of a restrictive covenant running with the land to the effect of binding the third party.

⁴⁵⁷ [1926] AC 108.

⁴⁵⁸ [1990] Ch 744 (CA).

7.4 Why not a proprietary right over the asset?

Section 7.2 above showed several arguments in favour of a proprietary right of the hirer over an asset at law. Despite their flaws, all have demonstrated that the hirer's possession calls for protection against third parties. It is hoped that a proprietary right will be conferred on him to allow him to preserve his possession against third parties.

Section 7.3 above introduced the endeavours in some cases to confer a proprietary right on the hirer in equity as a remedy to the lack of authority for a proprietary right at law. The criticism to this approach is not with regard to whether such a proprietary right of the lessee should be granted but with regard to the intervention of equity in order to generate such a right. In fact, commonly, all agree to the need for a proprietary right. For example, Swadling says that there seems no reason in principle why an analogy between a lease of land and a hire of goods could not be made so that a proprietary right of the hirer, like an estate of the land, might be generated over the asset.⁴⁵⁹ McFarlane highlights that the law has been developing by means of a process from a passive defence of restrictive covenants to a proactive proprietary status and that one day it may become law that the possessor's proprietary right can be generated in the cases of chattel leases and licences of land.⁴⁶⁰

The hindrance of recognising such a proprietary right is due to the fact that the concepts of property law arose from land law and hardly fall squarely within personal property law. However, there appears a trend of "a major reconstruction of landlord

⁴⁵⁹ W Swadling, 'The Proprietary Effect of a Hire of Goods' in N Palmer and E McKendrick (eds) *Interests in Goods* (2nd edn Lloyd's commercial law library, LLP, London 1998) 526.

⁴⁶⁰ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 480.

and tenant law along contractual lines”.⁴⁶¹ The House of Lords has said that the principal emanations of exclusive possession are exclusory power and immunity from supervisory control. Exclusive possession is also suggested as being a relative concept. In this relative sense, the *Bruton* tenancy is proprietary.⁴⁶²

Property has been criticised to be a circular definition. Gray says: “If naively we ask which rights are proprietary, we are told that they are those rights which are assignable to and enforceable against third parties. When we then ask which rights these may be, we are told that they comprise, of course, the rights which are traditionally identified as ‘proprietary’. ‘Property’ is ‘property’ because it is ‘property’.”⁴⁶³ Gray argues that property is about *control over access*.⁴⁶⁴ This view has been accepted by many scholars⁴⁶⁵ and even the High Court of Australia.⁴⁶⁶ This suggests that the concept of property is not absolute, but relative depending on the extent to which control over access is afforded legally-enforceable protection.⁴⁶⁷ Property is a relative term to be regarded as a ‘continuum’. The decision of the case of *Bruton* accords to the conception of ‘property’; in other words, if property means

⁴⁶¹ J Brown and M Pawlowski, 'Bruton: a new species of tenancy?' [2000] 4 (6) *Landlord & Tenant Review* 119, with reference to a series of cases, i.e. *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] AC 675 (HL); *Hussein v Mehlman* [1992] 2 EGLR 87 and *Nynehead Developments Ltd v Fibreboard Containers Ltd* [1999] 1 EGLR 7 (Ch), as well as *Bruton v London and Quadrant Housing Trust* [2000] 1 AC 406 (HL).

⁴⁶² J-P Hinojosa, 'On Property, Leases, Licences, Horses and Carts: revisiting *Bruton v London & Quadrant Housing Trust*' [2005] *Conveyancer and Property Lawyer* 114, 121.

⁴⁶³ K Gray, 'Property in Thin Air' (1991) 50 (2) *CLJ* 252, 293.

⁴⁶⁴ K Gray, *ibid*, 294.

⁴⁶⁵ J-P Hinojosa, 'On Property, Leases, Licences, Horses and Carts: revisiting *Bruton v London & Quadrant Housing Trust*' [2005] *Conveyancer and Property Lawyer* 114.

⁴⁶⁶ With reference to J. Hinojosa, *ibid*, 118-119.

⁴⁶⁷ M Pawlowski, 'Meaning of property in the leasehold context' (2006) 10 (3) *Landlord & Tenant Review* 63, referring to J-P Hinojosa, *ibid*, 118-119.

“control over access” the *Bruton* tenancy may still be characterised as a proprietary tenancy.⁴⁶⁸

Even the meaning of lease is more ambiguous than most people would think. It seemed undisputed before the decision of the case of *Bruton v London and Quadrant Housing Trust*⁴⁶⁹ that a lease must have two aspects: privity of contract and privity of estate. However, the decision robustly opposed the view.⁴⁷⁰ It was decided by the House of Lords that a contractual relationship of lease goes before there could be an estate; whether there would be an estate conferred on the lessee is irrelevant to the question whether the relationship between the two parties is lease or not. Although their agreement regarded it as a licence, it was decided by the House that their relationship was a lease and therefore the landlord was bound to fulfil his repair obligation statutorily imposed on landlords, despite the fact that the landlord did not have an estate at all.

However, if the land lease does not necessarily have estate in its nature, would a chattel lease definitely grant the lessee a proprietary right? If the so-called “loosening of the categories of proprietary entitlement within leasehold law”⁴⁷¹ continues, problems may arise in the context of chattel leasing in general. Pawlowski anticipates: “It is apparent from the foregoing that some leases will be proprietary, whilst others may be purely personal. The former will confer exclusive possession against the whole world, whilst the latter will bind only the immediate landlord and confer no

⁴⁶⁸ J-P Hinojosa, 'On Property, Leases, Licences, Horses and Carts: revisiting *Bruton v London & Quadrant Housing Trust*' [2005] *Conveyancer and Property Lawyer* 114, 118.

⁴⁶⁹ [2000] 1 AC 406 (HL).

⁴⁷⁰ For example, P Routley, 'Tenancies and estoppel - after *Bruton v London & Quadrant Housing Trust*' (2000) 63 (3) *MLR* 424, 425. J Luba, 'The House of Lords and landlord and tenant' (1999) 3 (5) *Landlord & Tenant Review* 115.

⁴⁷¹ M Pawlowski, 'Meaning of property in the leasehold context' (2006) 10 (3) *Landlord & Tenant Review* 63.

exclusivity of possession against persons with a superior title.”⁴⁷² It seems to imply that the lessor of a finance lease would not grant the lessee a proprietary right in any case at all. It accords to the current situation under English law that the lessee merely has the personal right over the asset and he cannot insist on possession of the asset against the title paramount. Then what does exclusive possession mean? Its meaning is pushed towards what Gray’s suggests – “control over access”. In the case of *Kay v Lambeth LBC*⁴⁷³ and *Islington LBC v Green and O’Shea*,⁴⁷⁴ the Court of Appeal confirmed that a personal tenancy granted by someone with no more than a licence to use property is binding on that person (as licensee), but not on the licensor (the freeholder) who is not a party to the contractual tenancy.⁴⁷⁵

Given the specialities of a finance lease, it is submitted that it is a strong case for the lessee under a finance lease to be protected from deprivation of the possession of the asset, by both the lessor and third parties. Firstly, from the point of view of the lessee, it is imperative to protect his interest in the asset. His right over the asset is more than a temporary use and is almost equivalent to ownership. Given that the lessee pays rentals for it, he should be able to enjoy the asset for the most useful life of it without interruption from any parties, including the lessor, the title paramount and a subsequent purchaser. If the lessee’s right over the asset can be recognised as a proprietary right, he can protect his possession of the asset from claims of the title paramount, more effectively than mere damages obtainable from the lessor.

⁴⁷² M Pawlowski, 'Meaning of property in the leasehold context' (2006) 10 (3) *Landlord & Tenant Review* 63, 64.

⁴⁷³ [2004] EWCA Civ 926 (CA).

⁴⁷⁴ [2005] EWCA Civ 56 (CA).

⁴⁷⁵ Quoted from M Pawlowski, 'The Bruton tenancy - clarity or more confusion?' (2005) (May/Jun) *Conveyancer and Property Lawyer* 262, 263.

Secondly, from the point of the lessor, his interest in the asset is a reversionary right, exercisable only in the event of the lessee's default or insolvency. Indeed, from the economic sense, the lessor is a creditor whose interest is secured by the ownership of the asset, instead of the owner of the asset. It is one crucial feature of a finance lease that the benefits and obligations of the ownership of the asset are transferred to the lessee. The lessor's true interest in the transaction is not the asset itself, or the recovery of it, but the payment of the rentals in return of his capital outlay and a margin of profit. When he sells the asset, logically it should be the interest in the return of his money to be transferred, rather than the whole range of ownership. In this sense, it is reasonable to place a burden on the asset in order to restrict the rights of the transferee.

Finally, from the point of the third party, for example, a purchaser, it is usually obvious that the seller/lessor does not have possession of the asset. Where there is an existing lease of the asset, he usually pays for it at a price less than that without.

Therefore, on the whole, it is reasonable to recognise the proprietary nature of the lessee's right over the asset.

7.5 How to confer on the lessee a legal proprietary right over the asset

7.5.1 Introduction

If the analysis in the last section above is correct, the next question is by what means a proprietary right could be conferred on the lessee under a finance lease.

In addition to the current ways in equity mentioned above, there are proposals to give rise to the effect. The next sections are devoted to examining the existing four proposals by which a proprietary right may be conferred on the lessee under a finance lease. Firstly, a legal right of the lessee, like an estate, may be upheld in an appropriate case by analogy to land leases. Secondly, a legal right may be conferred on the lessee by being separated from ownership as a result of fragmentation of the indivisible notion of ownership. Finally, if finance leases were to be regarded as transactions which confer a security interest on the lessor, the lessee's right would respectively be regarded as the ownership of the asset.

7.5.2 An estate by analogy to land leases

Where there is a lack of judicial pronouncement on a particular issue in one area, researchers often seek guidance from a analogous area. In the case of land leases, the landlord should have registered his property with the Land Registry and also have registered himself as a '*proprietor*' of the 'fee simple absolute in possession' if it is freehold and of a 'legal term of years absolute' if it is leasehold.⁴⁷⁶ Strictly speaking, there is no 'owner' in land since only the sovereign can own land; but every holder of

⁴⁷⁶ FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80.

an estate is the practical owner of the land.⁴⁷⁷ Both the landlord/lessor and tenant/lessee have an estate of the land, which fall within the closed list of proprietary rights under the rule of *numerus clausus*.

Many academics support the view that, by analogy to the law in relation to land leases, the hirer's possessory right would be recognised as a real right with the effect of binding third parties in an appropriate case.⁴⁷⁸ The proposal is based on the significant similarities between land leases and chattels.⁴⁷⁹ During the lease, for a certain or an ascertainable period, lessors have the reversionary right over the property and the lessees have the exclusive possessory right over the property. They are essentially the same mechanism, by which the rights of the property are separated in space and for time. As Palmer comments, "The functional and commercial similarities between the lease of land and the hire of a chattel are self-evident."⁴⁸⁰

There appears to be two main reasons hindering the proposed recognition of the analogy between land leases and chattel leases. One concerns the perishable nature of chattels. It is arguable that the chattels are movable, to which different considerations apply, from those to land, which is immovable. It is true that the chattels are generally of low value and short duration and that their identity and whereabouts are usually difficult to ascertain. But the assets for finance leases are not generally as perishable as many other chattels and some of them can last a long time. Although still being limited in nature, most of the assets under finance leases have a substantial life span

⁴⁷⁷ FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80.

⁴⁷⁸ Palmer lists a few academics, who have suggested recognition of the hirer's right of chattels by analogy to the lessee's estate in land. They are Holdsworth, Gutteridge, Thornley, Lawson etc. For details, see NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 81, 99, Footnote 5.

⁴⁷⁹ NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 81-99. FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80, 137-138, 147-158. Stoljar, (1955) 7 *Res Judicatae* 160.

⁴⁸⁰ NE Palmer, *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 83.

so that the period of lease is often long, from a few years to decades. For those assets which are expensive and heavy, it is usually not difficult to make them identifiable and to make certain their whereabouts. In addition, the assets for finance leases are generally worth of substantial value of capital, for example, ships, aircrafts, oil tanks, expensive manufacturing machinery and plant, office equipment etc. They are often of a functional or income-generating character, like land. This makes it possible to divide the income value between the lessor and lessee, critically resembling that in the case of land. The parties thereby have simultaneous interests in them: the lessor enjoys a fixed rental while the lessee makes profits from the possession and use of the asset for the term of the lease.⁴⁸¹ Therefore, the similarities between land leases and finance leases are better justified than those between land leases and chattel leases in general. Even in relation to chattel leases in general, Lawson thinks that the recognition of the analogy to land leases is long overdue, simply due to a lack of opportunity rather than any defect in logic.

The other factor which might have hindered the recognition of the analogy between land leases and chattel leases in general is that there is no concept of tenure and estate in the case of chattel. Tenure is a relationship of lord and tenant which determines the terms upon which land is held. It originated from the feudal system, where the lord gave the use of some of his land to some people, who became his tenants, in return for the tenants' service to him and sharing some of his duty to the crown.⁴⁸² Since the lordship has died together with the feudal system, the survival of tenure merely refers

⁴⁸¹ Palmer says: "The finance lease epitomises the phenomenon" in his book *Bailment* (2nd edn, Sweet & Maxwell, London 1991) 98.

⁴⁸² The lease of land is a commercial deviation to the technique of exchanging the use of land for the contribution to the royal feudal service. It is itself a commercial factor, "which had to be brought into some sort of artificial relation to it and it never really fitted into the feudal system." Quotation was from FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80.

to a relation between the landlord and tenant in a practical meaning, which is mainly contractual, although controlled by modern statutes.⁴⁸³

Privity of estate is a binding relationship, where the covenants between them touch and concern the land, i.e. the covenants affect the nature, quality, or value of the subject matter, or the mode of using or enjoying it.⁴⁸⁴ Lawson describes the position as follows: “There is privity of estate between the landlord for the time being and the tenant for the time being, that is to say, not only between the original lessor and lessee, but also between the lessor and an acquirer of the lease, between an acquirer of the reversion and the lessee, and between any acquirer of the reversion and any acquirer of the lease.”⁴⁸⁵ Privity of estate did not exist from the very beginning of land leases but had a transformation. It started from merely creating rights *in personam* with a personal action.⁴⁸⁶ In time it came to be accepted that the lessee had a right to possession as against third parties, although it was still not ‘seisin’ in a strict sense. Then, the enactment of the Statute of Gloucester 1278 and the steady development of the action of ejectment during the late Middle Ages brought some form of estate to be recognised in land leases and consequently and effectively converted the personal relationship into a new category of proprietary relationship.⁴⁸⁷ By that time, the lessee could be protected by a recovery of possession of the land in addition to damages. He began to have an entitlement which closely resembled a right good against the world.

⁴⁸³ FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80.

⁴⁸⁴ FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80, 121.

⁴⁸⁵ FH Lawson and B Rudden, *The Law of Property* (3rd edn, Clarendon Law Series, Oxford University Press, Oxford 2002) 80, 121.

⁴⁸⁶ KJ Gray and SF Gray, *Elements of land law* (4th edn, Oxford University Press, Oxford 2005), 458-459.

⁴⁸⁷ KJ Gray and SF Gray, *Elements of land law* (4th edn, Oxford University Press, Oxford 2005) 458-459.

The transformation of the lessee's interest from a contractual right into an estate in the land illustrates the chameleonic character and function of the leasing mechanism.

A similar process may well happen to finance leases, given the characteristics of finance leasing and the significant need to protect the lessor's possession. In fact, the development of the law in relation to the hirer's right over the asset from a passive defence of restrictive covenants to a proactive proprietary status indicates the happening of the transformation.⁴⁸⁸ In time it may be recognised by the court that, by analogy to land leases, finance leases may confer on the lessee an estate in the asset, which is proprietary in nature.

7.5.3 A proprietary right separated from the lessor's ownership

Another way to confer a proprietary right on the lessee under a finance lease is by relaxing the notion of indivisible ownership. This method would achieve the same effect of creating an estate of the asset as that by analogy of land leases.

Curwen describes this effect of fragmentation with the illustration of an onion.⁴⁸⁹ The whole onion represents the notion of ownership as a bundle of rights and each outermost layer represents a particular right incidental to ownership. When one outermost layer is removed, the onion merely loses part of its substance but keeps its core or essence as an onion. Similarly, when a particular right incidental to ownership is transferred, ownership remains with the owner because the core or essence of ownership is unaltered. By this means of fragmentation, the interest of ownership would be able to be split and therefore each holder of a particular interest would be granted a proprietary right.

⁴⁸⁸ B McFarlane, 'Identifying Property Rights: A Reply to Mr Watt' (2003) *The Conveyancer* 473, 480.

⁴⁸⁹ N Curwen, 'General and Special Property in Goods' (2000) 22 *Legal Studies* 181, 192

The fragmentation of ownership in the case of chattels has been long hoped for. For example, half a century ago, Lawson said that the fragmentation of ownership had been accepted by English law in the first instance for land and later applied to funds comprising both land and more permanent chattel interests such as stocks and shares.⁴⁹⁰ He anticipated that it would apply in its entirety to physical chattels in the appropriate opportunities.⁴⁹¹

If ownership of a chattel is divisible, the lessor would not lose his ownership, but would transfer some part of its substance to the lessee with the effect that the lessee's interest in the asset is proprietary in nature.⁴⁹² There seems no particular reason why this proposal should not apply to finance leases. As a result of the fragmentation, the lessor would remain as the owner of the asset by holding an ultimate right to possession. The lessee would have a proprietary right over the asset by holding an immediate right to possession. It is submitted that, by virtue of the fragmentation of the notion of ownership, the proprietary rights of the parties in finance leasing could be clearly defined and recognised.

7.5.4 An ownership by the means of reclassification

Another way to confer a proprietary right on the lessee is the proposal made by the Law Commission to regard him as the owner of the asset while the lessor is regarded as a creditor having a security interest in the asset.⁴⁹³ It would change the current

⁴⁹⁰ FH Lawson, *Introduction to the law of property* (Clarendon law series, Clarendon P, Oxford 1958) 59.

⁴⁹¹ FH Lawson, *Introduction to the law of property* (Clarendon law series, Clarendon P, Oxford 1958) 59.

⁴⁹² N Curwen, 'General and Special Property in Goods' (2000) 22 *Legal Studies* 181.

⁴⁹³ The (England and Wales) Law Commission published three Consultation Papers: Law Commission, *Registration of Security Interests: Company Charges and Property Other Than Land* (Law Com No 176, 2002), Law Commission, *Company Security Interests a Consultative Report* (Law Com No 176, 2004) and Law Commission, *Company Security Interests* (Law Com No 296, 2005). The discussion of

situation that the lessee is treated as if he were the lessee of an operating lease. As a result, the lessee would gain the absolute owner's position and unquestionably have a cause of action as against the assignees of the lessor. The section 6.5 above has discussed the advantages and disadvantages of the proposal to the lessor, this section will consider the effect of the proposal to the lessee.

On the one hand, the reform proposal might be opposed from the following points of view. Firstly, if the lessee becomes the owner of the asset in all cases, he might not be able to share some, if at all, of the tax benefits under the current law enjoyed by and transferred from the lessor and his capability to borrow would be considerably negatively affected because the transaction is regarded as a secured loan.

Secondly, although a registration scheme adopting a unitary term of "security interest" would bring transactions of different forms into a simpler form as transactions containing security interests, it does not necessarily bring unification to other areas of the laws concerning other quasi-securities. Rather, the ease of creation of security and quasi-security to suit the parties' needs, which is one of the advantages of English law for domestic and international investors, might be lost.⁴⁹⁴

Thirdly, in order to have priority over other creditors, the lessor would need to register his security interest with the register⁴⁹⁵ and this would add new costs and risks to the lessor and possibly, in turn, to the lessee. Under the current law, failure to register *voluntarily* does not deprive the finance company of his right for conversion in hire purchase agreements. Even with regard to vehicles, which are highly mobile and at

the proposal as to the classification of leases can also be found in Chapter 2, subsection 2.4.4 and Chapter 5, subsection 5.5.

⁴⁹⁴ R Calnan, 'The Reform of the Law of Security' (2004) 19 (3) *Journal of International Banking and Financial Law* 88, 92.

⁴⁹⁵ Law Commission, Law Com No164, *ibid*, para 1.4; Law Com No176, *ibid*, para 2.81

high risk of thefts and wrongful disposition, the finance companies do not have to register their hire purchase agreements with HPI Ltd,⁴⁹⁶ which operates a central voluntary trade registration scheme for providing information on hire purchase agreements outstanding on vehicles. As the case of *Moorgate Mercantile Co Ltd v Twitchings*⁴⁹⁷ stands, a finance company which inadvertently fails to register a hire-purchase agreement with HPI in respect of a car is not estopped from claiming damages for conversion against a person who relied upon a negative response from the central registry in dealing with the car. The approach of the majority of the House of Lords in that case indicates reluctance from the courts to substitute a desirable practice of registration into a requirement.⁴⁹⁸ By analogy, a voluntary registration requirement to the finance lease agreement might face a similar attitude from the court if the proposal can be approved and implemented.

Finally and most importantly, the parties' risks and benefits in the transaction would be completely changed. The lessee would be the owner, instead of the mere possessor, and the lessor would be a lender, instead of the owner. Finance leases would lose the leasing feature and the inherent benefits of it. Calnan comments: "It is difficult to see why parties who have set out to structure a transaction in a particular way should be required to treat it in a manner other than that which they intended. There may be a justification for such an approach in consumer cases, but there can be no justification for it in commercial transactions."⁴⁹⁹

⁴⁹⁶ It was established in 1938 originally called Hire Purchase Bureau and then was called Hire Purchase Information Ltd.

⁴⁹⁷ [1977] AC 890 (HL).

⁴⁹⁸ I Davies, 'Wrongful Dispositions of Motor Vehicles - a Legal Quagmire'(1995) (Jan) *JBL* 35, 44.

⁴⁹⁹ R Calnan, 'The Reform of the Law of Security' (2004) 19 (3) *Journal of International Banking and Financial Law* 88, 92

However, on the other hand, the reform proposal could have the following benefits on the lessee's interest. He would have more control of how to use and improve the asset. He might possibly get a lower interest rate because the lease would be considered a mere secured loan. In addition, the lessee would have undisputable proprietary right over the asset and therefore avoid unnecessary risks as against third parties, when the third parties could be equipped with better information about the asset.⁵⁰⁰ The proposal happens to be in line with the approach to recognise the security function of finance leasing in the taxation law and the accounting G4+1 proposal. Thus the law pertaining to finance leasing under English law might share the unitary term of "security interest" and achieve unification to a significant extent in these areas.

To sum up, taking account of the problems resulting from the lack of a legal proprietary right of the lessee, the proposal to shift the ownership from the lessor to the lessee is a good way and does not conflict with the economic reality of the parties. However, the benefits have to be balance with the costs, especially the structural change of the transaction.

7.5.5 Summary

Three means have been suggested for conferring a proprietary right over the asset on a hirer: by analogy to the lease of land, fragmentation to the notion of ownership and the Law Commission proposal to regard the lessee's right as ownership while the lessor's as a security interest. The first two from different approaches aim to give the same effect of divisible ownership that both the lessor and lessee have a proprietary

⁵⁰⁰ Calnan comments: "In practice, the benefits to be derived from registration are likely to be better information (although this is not the focus of the Law Commission's proposals) and fairer priority rules." R Calnan, 'The Reform of the Law of Security' 19 (3) *Journal of International Banking and Financial Law* 88, 91.

right over the asset. The last one will preserve the current notion of indivisible ownership but shift the ownership from the lessor to the lessee.

There has not much criticism to the first two proposals. Instead, the ideas of conferring a proprietary right over the asset on the lessee have always been welcomed. If any of these proposals could be accepted, the lessee's right over the asset would be better protected than it is at present. For example, under the two proposals, the lessor and lessee would both have a proprietary right, which is a form of ownership divided on the plane of time. One benefit is that, applying the familiar terms of 'estate' and 'ownership', the law pertaining to finance leasing would keep consistent with the current English legal terminology. Another benefit is that the rights of the parties would reflect the commercial reality, i.e. the lessee is the beneficial owner and the lessor is financial owner. The adoption of the proposals might happen in due course in an appropriate situation. In comparison, the last proposal is more controversial, due to its significant impact on the transaction of finance leasing. From the legal point as to the harmony of the legal principles of property law, it is not compelling that the proposal would prevail to the others. However, it might find more favour on the policy ground than the others would.

In summary, the three proposals all meet the call for recognition to the lessee's proprietary interest at law. Each one has its own merit. It is not clear how the law would develop.

7.6 Concluding remarks

Finance leasing is a useful tool to facilitate trade of equipment. It has the form of a lease and is a financing device based on ownership. The lessee has the right to possess the asset for his own use during the leasing period, which is the most useful life of the asset. Therefore, significantly distinct from the interests of the lessee in an operating lease, the interests of the lessee under a finance lease calls for protection against third parties. Clear and certain law pertaining to finance leases will stimulate the usage of it in the equipment trade.

To this end, this Chapter has tried to assess the law in respect of the lessee's proprietary right by answering four questions: "Is there a proprietary right of the lessee recognised at law?", "Is there such a proprietary right in equity?", "Why should he have a proprietary right?" and "How to confer on him such a right?".

The answer to the first question "Does the lessee under a finance lease have a legal right?" is "No." Having examined the two grounds on which a legal right is argued to base, it is submitted that neither possession nor "special property" has conferred a proprietary right on the lessee at law. The answer to the second question "Does the lessee have an equitable proprietary right?" is "Yes". The lessee may have an equitable proprietary right over the asset under three principles, namely by analogy with a restrictive covenant running with the land, specific performance and as a result of the third party's inducement to breach the contract. The answer to the third question "Why should the lessee under a finance lease have a proprietary right over the asset?" is that the lessee's interest in the asset is so significant that it deserves a

right with the effect of binding third parties. To answer the final question “How to confer?”, three proposals have been examined. Firstly, by analogy to land lease, a proprietary right, similar to an estate of land, may be conferred on the lessee.

Secondly, if the indivisible notion of ownership is changed to divisible, a proprietary right may be separated from the ownership to be conferred on the lessee. Thirdly, the Law Commission proposal would give rise to reclassification of finance leases and therefore the lessee would be regarded as the owner of the asset for the purpose of security registration.

The discussion above is based on a hypothesis that the nature of a right was examined as to whether it gives effect to a right protectable at law as against third parties. This hypothesis is questionable in itself, because a proprietary right may well be protected by an award of damages rather than other remedies. In the case of an award of damages, the physical possession of the chattel does not transit from one hand to another. If merely to determine the nature of a right by its proprietary remedy, a large range of proprietary rights may have been overlooked. For example, if my car is damaged by another car and therefore is dragged to a garage for repair, I may be very happy to receive the damages paid for the value of the car but at the same time to let go of the damaged car itself. The car was owned by me but was not recovered by me. My ownership of it does not necessarily give rise to a proprietary remedy, e.g. the repossession of it. Seen from this point, we can say that ownership is not detectable by proprietary remedy. Thus, the discussion could not extinguish the possibilities where a proprietary right of the lessee might exist and protected.

As to the purpose of discussion in this Chapter, which was to discover under what circumstances the finance lessee might have a proprietary remedy as against third

parties, it was found that the law has recognised that the lessee should be protected against a third party and has granted protection to him in various ways. In this sense, the law is satisfactory, although it is arguable that the lessee should have a proprietary right at law, instead of the current situation that he has a proprietary right in equity.

The findings did not gratify the author's attempt to detect a clear trend of English law in respect of proprietary rights of the parties of a finance lease. However, the evaluation of the existing proposals leads to a benign conclusion that all the three proposals could satisfy the need to reform the current law, i.e. to confer a legal proprietary right on the lessee and that no particular proposal has shown to be more appropriate than the others.

CHAPTER 8 CONCLUSION

8.1 Conclusions on English law

The aim of this thesis is to answer a research question: “How well does English law recognise and encourage the use of finance leasing in equipment trade?”

In order to answer the question, Chapter 2 attempted to examine the nature of finance leasing and then the next five chapters endeavoured to assess how well English law has encouraged the purposes to be achieved in a finance leasing transaction.

It was found in Chapter 2 that all the parties in the finance leasing arrangement would aim to obtain some benefits from the transaction. The supplier would sell his equipment outright to the lessor. During the most useful part of the life of the asset, the lessee would obtain exclusive possession and use of the asset. The lessor would receive payment of the rentals to cover his capital outlay and bring a financial return. He retains the ownership of the asset throughout the term so that his interest would be recoverable from the residual value of the asset in the event of the lessee’s default or insolvency.

Therefore, a finance leasing transaction would usually have the following characteristics.

- The term of the finance lease is equivalent to the most useful part of the life of the asset.
- The rentals are calculated to amortise the capital outlay and provide a margin of profit.
- The lessee’s obligation to pay the rentals is irrevocable.

- The lessee selects the supplier and provides the specification of the required asset so that the lessor may proceed to acquire the asset.
- The lessor brings no expertise to the selection of the asset.
- The lessor has a security interest in the residual value of the asset.

These characteristics mainly concern the financial role of the lessor and establish a close connection between the supply agreement and the lease agreement. Thus, these two essential features of finance leasing are the lessor's role as financier and the triangular relationship between the three parties to the transaction.

But the current definition applied by the courts is provided by the accounting standard SSAP, which is less specific than the description of financial leasing provided by the Unidroit Convention and the Model Law. Thus, it was submitted that it is desirable to have a clear legal definition of finance leasing and that these two features should be two elements of the definition.

Based on the proposed definition, subsequent chapters discussed whether the commercial expectations of the parties in general, the financial nature of the arrangement and the triangular relationship in particular, could be achieved in one area of English law.

Chapters 3, 4 and 5 concerned the relationship between the three parties. Chapter 3 mainly discussed the lessee's obligation to pay the rentals. It was found that the lessor could recover all the rentals from the lessee in breach by inserting into the agreement certain clauses, such as an acceleration clause, or one which provides for payment on occurrence of a specific event, or a clause under which an obligation to duly pay is a condition of the contract. It was also found that the court protected the lessee's

interest by granting equitable relief from forfeiture or penalty when the agreed damages would exceed a reasonable amount, for example, greater than the amount the lessor would receive if the contract were adhered to. Thus, it was found that the lessor's role as financier and the lessee's interest as the beneficial owner were recognised and protected. The law in respect of the parties' payments is considered satisfactory. The Unidroit Convention is silent as to whether the lessee's obligation to pay is irrevocable but the Unidroit Model Law requires the obligations of both the lessor and lessee to be irrevocable. By comparison, the position in English law is clearer, although it is felt that the law pertaining to finance leasing would be more precise and distinct, if the lessee's obligation to pay were overtly required to be irrevocable.

Chapter 4 considered the lessor's obligations. He has a statutory obligation to ensure that the lessee enjoys the use of the asset free from disturbance, during the period of the lease and also that the asset is fit for the lessee's purpose, being of satisfactory quality, and conforming to the description given and/or a sample provided. The discussion showed that the obligations as to the condition of the asset were allowed to be excluded by contractual terms; but practical difficulties existed making such exclusion uncertain at law. Reform is needed. The duty of ensuring that the condition of the asset is satisfactory should not be the lessor's obligation. The Unidroit Convention and its Model Law are better on this point and should be incorporated into English law.

Another statutory obligation laid on the lessor, *viz* to ensure the lessee's quiet enjoyment of the asset, appeared to be reasonable, although there would be more clarity, if this obligation were simply specified as a duty to ensure that the lessor has

the right to lease the asset in the first instance and that there is no title paramount to the lessor's title. The Unidroit Convention and its Model Law impose such an obligation on the lessor but allow it to be excluded by contract, unless the disturbance results from the lessor's own fault. In addition, because they provide that the lessor acts purely as a financier and that the lessee can seek remedies directly from the supplier, this approach is favoured.

The last obligation of the lessor is to convey the possession of the asset to the lessee. As an obvious requirement at common law, its application to finance leasing gives rise to the following effect: the lessor's obligation to transfer the possession of the asset is performed by the supplier's delivery of the asset under the supply agreement and, in the case of his default with regard to delivery, the lessee can seek remedies directly from him under the supply agreement. The law is fairly clear in this area but somewhat indirect. It was submitted that English law should speak out overtly about the direct relationship between the supplier and lessee as to delivery. In the Unidroit Convention and the Model Law there are clear provisions concerning how to deal with such a situation and these should be adopted by English law.

The discussion, in Chapters 3 and 4, on the lessor and lessee's obligations to each other shows that English law recognises the financial nature of finance leasing in the contractual relationship. On the one hand, the lessor can be excluded from the most important duty of a supplier, which is to ensure that the asset is supplied in good condition and maintained to a good standard. He still takes some risks and enjoys some of the rewards of ownership. He has an obligation to ensure the lessee's peaceful use of the asset. He has the right of payment of the rentals and the right of repossession of the asset, should the lessee be in breach of contract. On the other

hand, the lessee receives many of the benefits of the ownership of the asset, through his exclusive possession of it, but also the greatest responsibility of ownership by undertaking the duty of maintenance and repair after he accepts the asset. The law of England and Wales is considered generally satisfactory on this issue.

Chapter 5 embarked upon a consideration of the triangular relationship through an examination of the possibilities afforded by a direct relationship between the lessee and supplier. It was found that in general the supplier would not be seen as the agent of the lessor and thus the lessor would not be responsible for any misrepresentation or promises made by the supplier to the lessee. The supplier, however, would be liable to the lessee in the following cases. Firstly, a contractual relationship may arise, within which the lessee may have reason to instigate certain actions. Secondly, the lessee may have a right of action against the supplier under the supply agreement between the lessor and supplier, acting as the assignee of the lessor at common law or as the beneficiary of the supply agreement under the Contracts (Rights of Third Parties) Act 1999. Thirdly, the lessee may have a cause of action against the supplier for recovery of his pre-payment under the law of restitution if the finance lease agreement becomes void. Thus, because the law provides remedies to the lessee against the supplier in various cases and recognises the possibility of these interactions between the supplier and lessee, as well as those between them and the lessor, it appears that a triangular relationship between the parties exists in all but name under English law.

However, such recognition is limited in that a triangular relationship has not been explicitly acknowledged in the finance leasing transaction under English law. Also, it is restricted by the various principles applicable to it, for example, the lessee must have been identified in the supply agreement in order for him to sue the supplier

under the supply agreement under the 1999 Act. In contrast, the Unidroit Convention and the Model Law contain a clear statement that the lessee and supplier have obligations to each other as if the lessee were the buyer of the asset under the supply agreement. This approach should be welcomed.

Therefore, the discussion on the contractual relationship showed that English law has recognised the financial nature of finance leasing and its triangular relationship but blemishes remain in some areas of the law, particularly as to the certainty of the exclusion of the lessor's obligation concerning the condition of the asset.

Then, Chapters 6 and 7 considered the impact of two features on property rights of the parties. Chapter 6 mainly discussed the question as to how effectively the lessor could exercise his right to repossession of the asset in various events when his interest is wrongly affected and repossession became desirable. It was found that, when the lessee becomes insolvent, the lessor might not be able to repossess the asset without the consent of the court or the receiver/liquidator/trustee/administrator. In addition, the lessor's right over an asset which becomes a fixture to land is an equitable right to severance. As against third parties who wrongfully take possession without the lessor's consent, the lessor usually can recover the economic loss but cannot repossess the asset. Thus, as against third parties, it seems that the lessor's retention of ownership of the asset does not necessarily provide him with any better chance of recovery of his losses than if he were a secured creditor.

This is a significant finding regarding the understanding of the English law pertaining to finance leasing. It indicates that, through the retention of ownership, the lessor merely obtains a right of self-help to repossess the asset, should the lessee default on

payment; but if the repossession of the asset would affect a third party's interest, the lessor's interest might not prevail. This could be because, in deciding the lessor's action against the lessee, the court does not have to weigh the interest of the lessor against the conflicting interests of creditors, or take into consideration the survival of the lessee's business as a going concern.

Further, the lessor's right of repossession of the asset should the lessee default is also restricted in contract law by the granting of equitable relief from forfeiture or penalty available to the lessee in appropriate cases. This equitable relief has successfully eliminated any chance of the lessor obtaining a substantial windfall by repossessing the asset without giving a proportion of the proceeds of the sale of the asset to the lessee.

The finding that the lessor's right over the asset is no greater than that of a secured creditor follows from the fact that the lessor's role in a finance leasing transaction is simply that of a financier. The law is satisfactory in this area.

The next question is whether the lessee, who is the beneficial owner, is protected as if he were the owner.

The discussion in Chapter 6 concludes that the lessee's interest in the asset is protected in equity as against the lessor and his successor, including a third party purchaser, except in the case of a bona fide purchaser. He is regarded as the holder of an equitable proprietary right over the asset, although the law is ambiguous as to the source of this right.

It is admitted that following the Law Commission's proposal would mean reclassifying finance leasing from being an ownership-based financing mechanism to a security. However, in view of the need to recognise the lessee as a holder of a proprietary right over the asset, together with the fact that the lessor's right over the asset is no more than a security interest, it is submitted that the Law Commission's proposal to regard the interest of the lessor of a finance lease as a security interest required for registration should be accepted in order to remove any uncertainty as to the nature of the parties' interests.

The thesis took the above steps to assess the extent to which English law has recognised the financing nature of finance leasing and the triangular relationship. In conclusion, English law is satisfactory on the whole but reform is called for in the following areas. Firstly, two features should be added to the legal definition of finance leasing: (1) the lessor acts as financier and; (2) there is a triangular relationship between the third parties.

Secondly, English law should expressly confer on the lessee in a finance leasing arrangement the statutory right of a third party under the Contract (Third Party Rights) Act 1999.

Thirdly, English law should clearly require that the lessee has an irrevocable obligation to pay the total rentals after he has accepted the asset.

Fourthly, the lessor's obligation to ensure the quiet enjoyment of the lessee under the Supply of Goods and Services Act 1982 should be modified as follows: "The lessor is responsible for ensuring that he has the right to lease the asset so that the lessee may

enjoy exclusive possession of it free from disturbance by a person whose title is paramount to the lessor's, unless the disturbance stems from actions of the lessor.”

Fifthly, the lessor should be excluded from obligations as to the condition of the asset imposed by the 1982 Act.

Finally, the lessee's right over the asset should be a legal proprietary right.

8.2 *Limitation of the thesis and further research*

This thesis has been limited to research on the use of finance leasing in equipment trade under English law. It particularly discussed the commercial issues.

Consumer protection has not been particularly considered in this thesis, since it falls outside the scope of the research question which the thesis set out to examine, but it is an important issue in the commercial world, particularly as technology has developed to the extent that it is now possible for many consumers to participate in international trade. Therefore a suggested area of further research would be the finance leasing transactions where consumers are involved and specific consumer protection rules need to be put in place worldwide, in the EU and nationally in English law.

Further research might also include the consideration of personal property securities law in the international sphere, particularly as it relates to the registration of international mobile equipment as suggested by the 2001 Convention and the personal property securities laws which have come into force in some jurisdictions, for example, the US, Canadian provinces and New Zealand.

Appendix:

“Leasing Agreement for Equipment Including Motor Vehicles” for use outside the scope of the Consumer Credit Act 1974.

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