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Secured Transactions and the Leasing Industry- A
comparative analysis of the US and Serbian Leasing
Industry and Legal Framework

by

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ABSTRACT

Present thesis goes on two tracks. On one hand, it tries to demonstrate the crucial role of the legal framework of secured transactions law in relation to the leasing industry. On other hand, it examines also the economic factors, which impact the leasing industry. Following this line, the main purpose of the thesis is to find instruments which could further improve the position of the Serbian leasing industry.

The analysis places high importance on the success of the US leasing pattern. It stresses that the key of US leasing industry's success is that it has an efficient secured transaction law, an efficient market and highly specialized leasing companies. In relation to the Serbia it will first show the significance of the Financial Leasing Act which gives at a certain level a secured transaction framework to the Serbian leasing deals. Then the analysis goes on to explore how the Serbian leasing industry functions, with a focus on the weaknesses of the legal framework and the economic environment.

The key finding of this thesis points out that despite the significant boom in the Serbian leasing market, following the adoption of the Financial Leasing Act, there is still substantial room for improvement, in particular regarding the legal framework and the application of the laws.

INTRODUCTION

My thesis deals with the operation of leasing from both a legal perspective and a management perspective. The legal analysis sheds light on leasing as an efficient security device, whilst the management perspective examines how leasing companies operate in a highly complex and competitive specialized industry. In addition, my research has a comparative character. In other words, what I will try to achieve is to shed light on the legal framework and business aspects of leasing in the US and Serbia.

Personally, I was driven to choose this topic for several compelling reasons. First of all, although there are previous works which provides insight to leasing issues from both a legal and a management perspective, still usually one or the other aspect is neglected. This could be explained on the ground that researcher focuses mainly only on his/her own field.

In this respect I try to present a work which attaches equal importance to both. I do believe that both aspects are crucial in order to make the operation of a leasing company successful. From a legal point of view, we could perceive the leasing as a security device. Since the leasing company retains the ownership of the good, many serious legal problems can be avoided. Potential disputes between different creditors are excluded. The repossession procedure, gives an effective enforcement mechanism instead of a costly and lengthy litigation. If we do not understand these legal aspects, the operation of a leasing company could not be efficient and safe.

On the other hand, pure positive legal understanding of the notion of leasing is hardly enough for a company which wants to be successful in the highly specialized leasing industry. There are so many business elements which have to be taken into account. How to reach the possible customer target? How to asses the risk of depreciation? How to find a prospective lessee who will have the proper credit standing? These are just some of the practically unlimited number of questions. But if only one element is overlooked the whole leasing operation could fall. Therefore, leasing companies must have highly specialized management knowledge.

For all these reasons I will make an effort to demonstrate the high-value of both aspects. But there is also another reason which has driven me to choose this topic. Namely, despite the fact that leasing is still a very new device in Serbia, it shows radical growth. On March 2008, the total balance sheet assets held by financial leasing providers were about at 101.5 billion Dinars. This means that leasing has a significant share in the Serbian GDP. Consequently, proper understanding of leasing is crucial not only for special leasing companies, but also at the macro level. This very true fact has been realized by the National Bank of Serbia, which constantly supervises Serbian leasing companies. In this respect it is important to stress that leasing in Serbia is still a very new device. Leasing could not work during the 90's since the legislator did not recognize leasing as a security device with the retention of title and repossession mechanisms. This way the leasing was an extremely costly and risky device.

In 2003, with the enactment of the Serbian Financial Leasing Act the situation became much better. However, apart from that now there is quite a safe legal framework, there are still many things to improve. The legislator, courts, companies, individuals still do not understand many complexities of the leasing operation.

Therefore, I do believe that adopting certain elements of the US model could add substantial value to the Serbian leasing system for several reasons. First of all, the United States has perhaps the most developed system of secured transactions set out in the Uniformly Commercial Code. Namely, UCC Article 9 provides flexibility, transparent registry of movables and efficient enforcement of secured transactions which creates a business friendly environment. Secondly, the US has perhaps the most specialized and qualified leasing industry with an advanced market framework and a perfect operational knowledge.

The thesis has the following structure. First it will introduce in the first chapter the basic leasing puzzle, what is leasing and what are its main features. The author considered that this step is inevitable in order to understand the rapid extension of leasing as a modern business device. Then the second chapter will analyze the US legal framework of secured transactions and the US leasing as retention of title mechanism. Both, the general US secured transaction law and the more specific retention of title mechanism contributed a lot to the success of the US leasing industry. The third chapter

will elaborate the leasing under Serbian Law. It particularly stresses the importance of the Financial Leasing Act which provided retention of title mechanism and repossession procedure and therefore it established the initial necessary legal framework for the Serbian leasing industry. The fourth chapter deals with the US leasing industry. It demonstrates that it has complex structure where all the players and leasing products have their own economic rationale. It also highlights that US leasing industry has a developed financing structure which includes not only banks but also the instruments of the capital market. Finally, it shows that the key of the US leasing industry's success is that the leasing companies have a niche market specialized and targeted approach. The last chapter will be devoted to the Serbian leasing industry. It will analyze how the Serbian leasing industry works. Emphasis will be placed on the significant role of the National Bank and on what should the Serbian leasing industry do better.

The main purpose of this thesis is to offer something meaningful to the Serbian leasing market. I will try to find the answer on the following very challenging question: what could the Serbian leasing market learn from the US model. I hope that at least in part I could answer this extremely difficult question.

1. GENERAL FEATURES OF LEASING

Leasing is obviously a very popular and widespread business device. It showed a significant growth and a rapid extension in the global commercial world. But what exactly is leasing? Is it more a form of renting agreement or a sale? Is it a form of financing through loan? Is there any difference in relation to credit? What unique advantages could a leasing deal offer to the parties? What are the differences between an operating and a financing leasing? As a first step it would be highly beneficial to answer these questions since this would help in better understanding legal nature and economic purpose of leasing. Therefore, I will try to answer at least some of the above questions in relation to the leasing puzzle.

1.1. The notion of leasing

Generally speaking, leasing is a complex device which is not easy to define. However, it is common to all leasing transactions that one party is obliged to give the possession of the object for its commercial use, while the other party in return has to make rental payments. Usually, the lessee after the expiry of the contract has several options: to extend the contract, to return the object or to buy it. All this implies that it is not easy to determine the legal nature of leasing. This is quite obvious when we compare it with other contracts. For example it has some elements of hire contract, but a hire contract never contains the option of buying. Secondly, the close link with sale contract is also undermined if we take into account that a leasing contract does not necessarily involve transfer of ownership. Thirdly, some legal scholars argue that it is similar to a service agreement, because the lessor is often obliged by different clauses to maintain, repair and even substitute the leased equipment. Although this is true it is overlooked that these clauses have only accessory nature compared to the basic leasing contract.¹ Finally, there are some resemblances with credit but again the differences are sharp. Namely, loan is concluded on fungible good-money. So you have to return the same amount of money at the end of the loan agreement. Leasing on the other side does not require the lessee to return the whole economic value of the leased good, because amortization costs are taken

¹ Vladimir Kapor and Slavko Caric, *Ugovori robnog prometa* (Centar za privredni consulting, Novi Sad 2000), 265.

into account.² In addition, while leasing involves a retention of title mechanism and therefore there is no need for additional collateral, a loan requires additional collateral since it does not involve a retention of title mechanism. Therefore, leasing could be a more flexible and less costly device than a loan.

For all these reasons, we can conclude that a leasing contract is a sui generis contract, with its own nature, purpose and history. In order to better understand this contract we should go back to its historical roots. Therefore, I strongly believe that it is crucial to enlighten its economical and legal development.

On one hand, if we consider this issue from an economic perspective, we could posit that leasing developed in the United States when the needs for capital exceeded the value of equity. A new way of financing has occurred, namely the finance without own capital sources. This has become a practical solution to the companies, which do not have enough equity to buy the equipment or they could buy only with the risk of insolvency.³ Although, the enterprises could get the capital also through conventional bank loans, leasing showed some crucial advantages. The companies realized that they were at higher risk with credit given the fact that they had to return the whole amount of loan which imposed a particular risk in the case of depreciation of the equipment. When the equipment depreciated it was harder to generate cash flow, which in turn meant that it was harder to pay back the loan.⁴ On the other hand, leasing takes into account the amortization of the leasing asset so the payment obligation performance was facilitated in this respect. In addition, there is one more significant reason of leasing's rapid extension in the last couple of decades. Leasing provides a flexible approach, as *"It is based on the proposition that profits are earned through the use of (leased) assets rather than from their ownership. It focuses on the ability to generate cash flow from business operations to service the lease payment, rather than on the balance sheet or past credit history."*⁵ This means that new enterprises who had good business idea could borrow through

² Ivanka Spasic, *Ugovor o lizingu* (Multiprint, Beograd 1990), 110.

³ Barta and Fazekas and Harsányi and Miskolczi and Osváth and Ujváriné, *Kereskedelmi szerződések* (Novotni, Miskolc 2000), 175.

⁴ Ivanka Spasic, *Op.cit.*, 11-12.

⁵ Matthew Fletcher and Rachel Freeman and Murat Sulatnov and Umedian Umarov, *Leasing in Development, Guidelines for Emerging Economies*, 2. see at http://rru.worldbank.org/Documents/Toolkits/Leasing/Leasing_in_Development_Full.pdf

leasing under less stringent rules in terms of credit standing and credit history than it is the case of a conventional bank loan. Under these circumstances, leasing has become a new way of equipment supply and new business integration model between the manufacturers, traders, financiers and consumers.⁶

On the other hand, leasing appeared first in American law. Under the US law leasing together with other devices like conditional sale and hire purchase is part of title financing. The basic feature of title financing devices is that they are based on the retention of title mechanism. The important question, which arises here, is that if the US leasing uses the retention of title mechanism than does it mean that it is also a security device? Obviously a positive answer would give leasing a special dimension. It would mean that leasing is not just a *sui generis* contract but also a special security device which could provide certainty and flexibility to the parties. Since this question has significant importance I will elaborate it in more detail in the second chapter.

1.2. Advantages and disadvantages of leasing

Leasing is a complex business device which is an alternative to an immediate purchase of the good. When the party wants to choose whether he wants to lease or purchase the good he should take into consideration what advantages and disadvantages could the leasing contract bring.

1.2.1. Advantages to the lessee

It is usually emphasized that the lessee has a benefit from leasing that he does not need to obtain additional source of financing. A lessee usually takes recourse to this solution when the capital needs exceed the resources. Therefore, additional financing could be inevitable for the lessee who does not have enough sources to buy the equipment or could only obtain expensive financing.⁷

Moreover, leasing offers flexibility. Namely leasing can be tailored in a way to meet the particular needs of the lessee. For example the rental payments could be scheduled in a way that it takes into account the potential income produced by the use of

⁶ Vladimir Kapor and Slavko Caric, *Op.cit.*, 265.

⁷ Barta and Fazekas and Harsányi and Miskolczi and Osváth and Ujváriné, *Op.cit.*, 175.

the leased asset.⁸ In this sense, the rentals could be also “*reduced or not scheduled when the firm has the greatest need for working capital.*”⁹

Leasing has also the advantage that it provides certainty in terms of its access. Unlike other forms of loan finance, which could be “*subject to annual review, leasing finance can not be withdrawn in the event of a credit squeeze or a change in a market conditions.*”¹⁰ During the agreement the lessor could only accelerate the payment in the event of default by the lessee.¹¹ In addition, easier access means less stringent borrowing rules than in the case of bank financing given the fact that retention of title mechanism applies meaning that there is no need for additional collateral.

Leasing could also help to preserve the lessee’s working capital. The reason is the following. “*When a firm borrows money to purchase the good the lending institution rarely provides an amount equal to the entire price of the asset to be financed.* Instead, the lender requires from the borrower to make a down payment. On the other hand, *leasing provides 100% percent financing since it sometimes does not require (the lessee) to make a down payment (at all).*”¹² This is reasonable because leasing works in a line of retention of title which is a very good security device. Therefore, the lessor does not have to require a down payment or additional collateral from the lessee.

Moreover, the Lessee’s credit standing could be enhanced by using the leased equipment which could generate a substantial amount of cash-flow. This way the Lessee could not only pay back its obligation but also enlarge its initial capital.¹³

Furthermore, following the line of the American model it worth’s noticing that leasing could have significant tax and accounting benefits. Namely, when the lease is structured as a true lease, the lessee has the indirect tax benefit because he will pay lower rent payments owing to the fact that the lessor as the owner of the good will be entitled for tax benefits.¹⁴ True lease is also preferable in a way that rental payments are not

⁸ Derek R Soper and Robert M. Muro and Ewen Cameron, *The leasing handbook* (Mcgraw-Hill Book Company, Berkshire 1993), 6.

⁹ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing* (Frank J Fabbozi Associates, New Hope 2000), 12.

¹⁰ Derek R Soper and Robert M. Muro and Ewen Cameron, *Op.cit.*, 6.

¹¹ *Ibid.*,

¹² Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 9.

¹³ Ivanka Spasic, *Op.cit.*, 20.

¹⁴ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 5.

perceived as a debt in the balance sheet and therefore the lessee will have a much better credit standing.¹⁵ On the other hand, in the case of conditional sale lease the lessee could claim direct tax benefit as the economic owner of the good.¹⁶

This contract has also the unique character that the lessor is often obliged to service the leased good; in other words to maintain, repair, substitute the obsolete equipment and even to educate the lessee how to handle the equipment. These clauses are particularly useful when the lessee does not have the adequate knowledge of the particular equipment.

It also worth mentioning, that the lessee usually has the right to choose the equipment and to make further specifications in terms of warranties, delivery, installation and services.¹⁷ This way the lessee is able to adjust the contract to his particular business needs. Finally, it provides significant *“price competitiveness compared with alternative source of finance. (Particularly tax benefits and the lack of need for additional collateral) often provide significant cost advantages over traditional forms of financing.”*¹⁸

1.2.2. Advantages to the lessor

The advantage of leasing compared to the ordinary purchase is obvious. The lessor in the case of ordinary purchase gets immediately the purchase price of the good. However, leasing could provide much more in the long run. Namely, if the lessor runs an adequate price policy including interest rates and amortization costs then the profit could be significantly higher.

Moreover, the lessor could claim capital allowances on leased asset against their own taxable profits. Therefore, he could claim lower rental payments and enhances its competitive strength on the market.¹⁹ It is also very important for the lessor that leasing is based on a retention of title which is a very good and protective security device. It is sound and close to the common sense that the third party could not claim something from the lessee what is the ownership of the lessor. In this sense administration costs could be

¹⁵ Alfred W Meyer and Richard E Speidl, *Sales and leases of goods* (St Paul, West Publishing Co, 1993) 238.

¹⁶ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 5.

¹⁷ *Ibid.*, 3-4.

¹⁸ Derek R Soper and Robert M. Muro and Ewen Cameron, *Op.cit.*, 7.

¹⁹ *Ibid.*, 7-8.

reduced because retention of title does not require additional collateral.²⁰ The lack of additional collateral requirement could also mean that lessor could set low rental obligation which could of course enhance its competitive position on the market.

Finally, all the lessee's benefits from the leasing (tailor-made rental payments, no down payment, low rental payments, package of services, specification of equipment and terms) helps the lessor to attract the customers and develop a good market position.

1.2.3. Disadvantages of leasing

Notwithstanding all this advantages of the leasing, it has also some serious disadvantages, which should not be overlooked. First of all, the lessee usually pays much more through rental payments than the ordinary purchase price. The reason for this is that rental payments include amortization costs and interest.

Furthermore, since leasing is primarily a finance method of equipment which changes rapidly with the technological changes, there is a risk that the equipment will depreciate earlier than it was calculated. If the risk is borne by the lessee (financial leasing) then the lessee will have the problem of generating the necessary cash flow, by which it could perform its rental payment obligations to the lessor. On the other hand, if the risk is borne by the lessor (operating leasing) then he will be probably not able to recover the return of the investment.

The consumer lease could present a particular problem because the lessee does not have an adequate business experience, but wants to obtain a valuable good. The trouble is that the lessee as an ordinary consumer could not plan in the long run how to pay all the rental payments. Consequently, occurs many times that consumers fall in a default, which eventually generates a repossession procedure. All this implies that leasing could be a very costly device for consumers and of course this could have a negative impact on the lessors and maybe even on the entire national economy.

Leasing companies could suffer seriously from this situation because payment defaults and repossession procedure take a lot of time and money. Therefore it is essential for both parties to make an adequate credit appraisal and a good rental payment schedule which take into account the borrower's economic power.

²⁰ *Ibid.*,

1.3. Basic types of leasing

In understanding the nature and purpose of leasing it is also essential to grasp at least the basic classification of leasing activities. The direct and indirect leasing shows us that leasing could involve simpler and more complex structure. The other landmark division to operating and financial leasing demonstrates us that with different leasing types the parties could achieve different business purposes.

1.3.1. Direct-indirect leasing

This classification depends on the number of parties involved in the leasing contract. Direct leasing is a simple two party contact where the lessor is a manufacturer and financier of the good at the same time. In other words, the lessor not does not purchase the asset from a manufacturer-supplier, after the conclusion of a leasing agreement, the lessor simply delivers the good to the lessee. Indirect leasing as its name suggests involves a third party because the lessor purchases the good from a manufacturer-supplier. Consequently this leasing involves two contracts: the sale contract and the lease contract.²¹

The sale contract is between the lessor and the supplier. The lessor purchases the good from the supplier. After that it will be leased to the lessee. This way everybody benefits from the agreement. The supplier benefits because he immediately gets profit from the sale. The lessor on the other had is ready to finance the equipment because he will obtain significant economic benefit in the long run from the rental payments of the leased agreement. Finally, the lessee benefits as well. Namely, he chooses the supplier, the leased good and makes some further specifications of the agreement (terms of warranty, delivery, installation, services).²² In other words, he could adjust the leasing agreement to his own business needs equipment so he is able to organize his own business strategy.

The procedure is usually the following. First of all, the lessee decides on the equipment needed and on the manufacturer. He also specifies any special features

²¹ Ivanka Spasic, *Op.cit.*, 44.

²² Peter K.Newit and Frank J Fabbozi, *Op.cit.*, 3-4.

required, the terms of warranties, delivery, installation and services. After the negotiation about specifications with the supplier, the lessee concludes a lease agreement with the lessor. The seller buys the equipment specified by the lessee and delivers it to the lessee.²³ Then the lessee checks whether it is delivered in a satisfactory condition. If it is, the lessor buys the equipment and the leasing agreement becomes effective.²⁴

1.3.2. Financing-operating leasing

A fundamental, widely accepted classification is distinguishing the operating lease from the finance lease. An operating lease is typically a direct lease, which covers only a fragment of the economic life of the good. In other words, the same equipment is subject to a series of different leases where every lessee takes the equipment for a period of time and pays a rent reflecting its use-value.²⁵ Of course, the residual value after the termination of the contract will remain high, given the fact that every lease here is a short term lease. The lessor's underlying argument here is that it is better to retain the economic ownership of the good and to lease the good several times in order to obtain better profit. For exactly these reasons we could perceive operating leasing more as a hire contract than a sale contract. Naturally, all these features of operating leasing have important legal consequences:

- Operating leasing usually does not have minimum term of agreement. Therefore, there is an opportunity to the lessee to rescind the agreement in times stated in the contract. This clearly implies that this agreement does not go towards transfer of ownership. Just the opposite: the lessee like in every hire contract could rescind the agreement in contractually stated times when it considers that it does not satisfy his particular business needs any more.
- The contract will not have particular amortizations costs. This is quite logical since the leased equipment will have a substantial remaining residual value after the termination of the contract.

²³ *Ibid.*,

²⁴ Roy Goode, *Commercial Law* (Penguin books, London, 1995), 779.

²⁵ Roy Goode, *Op.cit.*, 776.

- The Lessor who retains the ownership on the good has to bear (as the owner) all the risks related to leasing deal.²⁶

By contrast, a financial lease is an indirect lease where the lessor leases the good only to one lessee for its entire economic life.²⁷ Of course, this infers that financial leasing is a long term agreement. The result here is that the residual value after the termination of the contract will be only nominal since the good will be depreciated. Therefore, the lessor wants to transfer the economic ownership to the lessee owing to the fact that the good will not have any meaningful remained economic value at the end of the agreement. All this implies that this agreement has some elements of the sale contract. Therefore the basic legal rules which apply here are quite different.

- The lessee cannot rescind the contract during the minimum term of the agreement²⁸ (which usually amounts to the economic life of the good). This rule is necessary in order to secure that the lessee will pay the purchase price through rental payments until the end of the economic life of the good.
- *"The rentals are so structured as to amortize the capital cost over the lease period."*²⁹ Again the logic is simple. The lessor needs to recover the lost economic value of the good through rental payments. For this reason the US law calls financial leasing for a "full-payout lease" because in this case the Lessor expects to recover in one lease agreement the entire investment of the leased good.³⁰
- Finally, since the lessee gets the economic ownership of the good he (as the buyer) should bear all the costs and risks related to the leasing deal.³¹

Clearly, operating leasing and financial leasing have their own economic purposes. Operating leasing could be attractive to a wide range of customers owing to the easy cancellation and short terms. The lessee who wants to satisfy a temporary business need would definitely opt for operating leasing. The lessee could be also attracted by operating leasing since the risks are borne by the lessor. However, since operating leasing is more a

²⁶ Ivanka Spasic, *Op.cit.*, 48-50.

²⁷ Roy Goode, *Op.cit.*, 776-777.

²⁸ Ivanka Spasic, *Op.cit.*, 48-50.

²⁹ Roy Goode, *Op.cit.*, 776-777.

³⁰ Peter K.Newit and Frank J Fabbozi, *Op.cit.*, 7.

³¹ Ivanka Spasic, *Op.cit.*, 48-50.

hire agreement, the lessee wanting to buy a good through long-term borrowing should opt for financing leasing.

Obviously lessors are also having their own rationale to decide for operating financing leasing. Operating leasing could generate swiftly substantial cash-flow given the fact that the term is short but the customer range is wide. Still the huge disadvantage for the lessor in this case that it bears all the risk of the deal. Financial leasing primarily provides stability in a sense that it is a long term agreement and there is no need to constantly search for new lessees. This could be particularly beneficial if the financial leases are concluded with long-term prospective business customers. The shortcoming of financial leasing is the fact that as a long term agreement the risks could rise to a substantially higher level than in the case of operating leasing. It could be particularly dangerous if it turns out that the long term lessee does not have the credit standing or that the leased good depreciates earlier than it was calculated. Still the lessor's position in this case is facilitated in a sense that the risks are borne primarily by the lessee.

2. LEASING UNDER US LAW

Leasing emerged under the US law. It has become an important business device since the US legislator and courts gradually took the position that leasing should be perceived through the retention of title mechanism. The US legislator and court argued that if it has a security purpose then why not treat it as a security device? Following this line the legislator brought eventually leasing contract under Article 9 UCC³² which governs security interest in personal property and fixtures.

Apparently, the leasing agreement got its new dimension under the US law. It is not anymore only a simple contract. It is also a secured transaction. Article 9 of UCC is considered for the most advanced system governing secured transactions. It provides for a unified transparent registry system, clear priority rules and efficient enforcement procedure of secured claims. In addition, secured transactions apart from legal certainty could provide greater economic efficiency in the leasing deals. It is a widely recognized fact that credits are strongly interlinked with secured transactions. In other words, *“without a good system of securities there can not be a good system of credits.”*³³ When the secured transactions system is inefficient, credit could be obtained only under much less favorable terms and higher interest rates.³⁴ In this respect leasing does not differ from credit since it also serves as a form of financing through loans. In contrast, efficient secured transaction system creates a business friendly environment. Of course this implies that under efficient secured transaction framework the business conditions are more favorable for boosting the leasing industry.

For the reasons above, in this chapter I want to show in a nutshell how the US secured system works. This is important for our purposes since the US leasing industry is successful (among other reasons) because it is based on an efficient secured transaction system. I will also elaborate how the US leasing developed and how it eventually involved retention of title mechanism. Finally I will finish this chapter by analyzing how the US leasing works under the current legal framework.

³² UCC: Uniform Commercial Code

³³ Tibor Tajti, *Comparative Secured Transactions Law* (Akadémiai Kiadó, Budapest 2002), 62.

³⁴ Heywood W.Fleisig, *The Power of Collateral* in. Finance and Development (Washington 1996), 44.

2.1. General features of US secured transactions system

The ingenuity of American secured transactions law is very clear, when we take into account the solution of Article 9 of the Uniform Commercial Code. First of all, the great advantage of this system that it follows a functional approach. Namely, *Article 9 states that "it applies to all transactions intended to create security interest in personal property and fixtures."*³⁵ This broad definition provides legal certainty since a wide range of transaction is covered under Article 9. On the other hand, this functional approach also provides flexibility. Simply, the parties could always create a security interest if they want to create it regardless of the title to the collateral or the type of agreement. The parties could easily use new devices under the framework of Article 9 without some particular risk, since Article 9 has well defined rules of rights, obligations and remedies.³⁶ Clearly, this "functional approach" offers great advantages since on the other hand, a "formal approach" would mean that new business devices were left without the proper legal framework.

Secondly, Article 9 offers an efficient unified registry system. It goes on the line to ensure both the burdens of filing and the adequate disclosures of secured transactions. The filing notice only requires signatures of the parties, their addresses, and the description of the collateral type.³⁷ It is a very sound approach that the collateral is not individualized since it would cause paradox result. We could see on the example of some emerging markets that in the case of individualized collaterals the debtor could easily undermine the security agreement since it could remove somehow the individual collateral and escape the enforcement of the secured claim. Moreover, the US registry system is indexed by the borrower and by the description of the security interest so it is quite easy to check the existence of any secured claims.³⁸

Thirdly, floating lien concept is also a unique invention of Article 9 which facilitates the enforcement of the creditors claim. This could provide security interest in

³⁵ Tibor Tajti, *Comparative Secured Transactions Law* (Akadémiai Kiadó, Budapest 2002), 142.

³⁶ Tibor Tajti, *Op.cit.*, 142.

³⁷ *Ibid.*, 146-147.

³⁸ Heywood W.Fleisig, *Op.cit.*, 45.

proceeds, after acquiring property and collaterals subject to future advances.³⁹ In other words, “*the security interest... floats over the present and future asset of the debtor*”⁴⁰ The creditor benefits from this since the floating lien follows the collateral so the security interest could be enforced “*even if the collateral is exchanged, sold or disposed of in some other way.*”⁴¹

Moreover, although the US priority rules are complex the US legislator showed its ingenuity again. Unlike, the civil law system which is accustomed to use simply first in time rule the US priority rules are much more advanced since the priority system is adjusted to a wide range of different personal properties.⁴² Consequently, there are many special rules for the different types of personal property (for example special rules for crops, negotiable instruments).

Although there are many complex rules, still the basic mechanism here is quite logical and efficient. First the attachment occurs. This means that security interest is created only between the parties since no one else knows about this security interest.⁴³ The necessary conditions for attachment are first that the good is in the possession of the secured party or there is a written or authenticated agreement. Secondly that the secured party must give something of value to the debtor, and finally that the debtor must have rights in the collateral.⁴⁴

If the secured party wants to make the security interest enforceable against third parties, he must perfect its security interest. The usual way of perfection involves filing financing statement to the registry. However, in some cases there is perfection of security interest without filing (automatic perfection).⁴⁵ This is the case of purchase money security interest and after acquired property due to their special legal nature. In the case of purchase money security interest the creditor deserves special protection since it

³⁹ Kenneth W. Clarkson, *West's Business Law* (Thomson Learning, 2003) in. Tibor Tajti, *Course reader of Comparative Secured Transaction* (CEU, Budapest), 110.

⁴⁰ Grant Gilmore, *Security Interest in Personal Property* (Little&Brown, Boston&Toronto 1965, reprinted by the Lawbook Exchange, New Jersey 1999), 359.

⁴¹ Kenneth W. Clarkson, *West's Business Law* (Thomson Learning, 2003) in. Tibor Tajti, *Course reader of Comparative Secured Transaction, Ed.cit.*, 110.

⁴² Tibor Tajti, *Comparative Secured Transactions Law, Ed.cit.*, 165.

⁴³ *Ibid.*, 38.

⁴⁴ Kenneth W. Clarkson, *West's Business Law* (Thomson Learning, 2003) in. Tibor Tajti, *Course reader of Comparative Secured Transaction .*, 100-101.

⁴⁵ *Ibid.*, 103-108.

facilitates the borrower's purchase of the asset.⁴⁶ For example the conditional seller deserves to retain the security interest on the collateral given the fact that it enabled the purchaser to buy the good through installments (instead of immediate purchase).⁴⁷ Automatic perfection rule is also clear in the case of after acquired property. Since the floating lien floats over present and future assets it is logical that there is no need for registration of the after acquired property.

Secured creditors have priority over attached creditors. In the relation to two secured creditors the "secured creditors first to file" rule applies. Similarly in relation to two attached creditors, the "first to attach" rule applies. Moreover, in the case of purchase money security interest and floating, lien the creditor is conferred with a super priority (for the above mentioned reasons). Finally, it is important to stress that buyers in the ordinary course of business also enjoy super priority given the fact that it would be unreasonable to require from them to check the register.⁴⁸

Finally, Article 9 UCC provides for an efficient enforcement procedure. It contains all the necessary measures on which the secured party could rely in the case of the debtor's default (repossession, strict foreclosure and disposition). On the other hand, Article 9 also gives some protective rights to the debtor. For example the "60% rule" takes into account that the debtor built up an equity by paying 60% of the price so he has the right to require disposal of the collateral which would produce surplus to him.⁴⁹ Another example of debtor protection is the case when the debtor could exercise the right of redemption of the collateral by performing all his contractual obligations.⁵⁰

In relation to the leasing it is particularly important to stress that Article 9 of UCC provides an efficient repossession procedure. The repossession procedure usually takes from 2-5 days which means that the lessor will incur only minor administrative losses. On the other hand, in the emerging countries it could take even one to two years which

⁴⁶ Donald King and Bradford Stone and W.H. Knight, *Commercial Transactions Under the Uniform Commercial Code and Other Laws* (Matthew-Bender 1997) in: Tibor Tajti, *Course reader of Comparative Secured Transaction*, 89.

⁴⁷ Another case of purchase money security interest would be when a bank lender assists the buyer in the purchase, see: James J. White and Robert S. Summers, *Uniform Commercial Code* (West, 1980) in: Tibor Tajti: *Course reader of Comparative Secured Transaction* (CEU, Budapest), 129.

⁴⁸ Kenneth W. Clarkson, *Op. Cit.*, 111-112.

⁴⁹ Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 186-190.

⁵⁰ Kenneth W. Clarkson, *Op.cit.*, 149.

implies that the lessor could suffer significant business losses.⁵¹ In addition, Article 9 makes possible to the creditors *to use private repossession (self-help) without judicial intervention if this can be done without breach of peace*.⁵² Leasing companies realized that it could be swifter and less costly to recourse to self-help instead of the judicial repossession. Therefore, they often develop their own enforcement office or hire a debt collectors agency who specialized in implementing the self-help without breach of peace.

2.2. The evolution of the leasing under the US law

The US leasing went a long way until its current position. It is interesting to note that leasing was shaped through the transformation of security devices. Possessory pledges brought us to chattel mortgages and then chattel mortgage was transformed to conditional sales which finally brought us to the leasing puzzle. This interesting development could be explained on the ground that the legislator, the courts and the parties to these transactions were searching for constant innovative solutions. This evolution of the leasing development demonstrates us again the American ingenuity in law making and business dealings.

2.2.1. The chattel mortgage

In the early days, the general principle was that the creditor could create security interest on movables only if he took the possession of the collateral. This rule was also accepted in Anglo-American legal system. In the beginning, it only recognized the possessory security device, which was the so-called pledge.⁵³

Later the non-possessory security interest had to be also recognized. Simply, the industrial revolution led to increased commercial activity, which triggered higher credit demands. Of course, higher credit demands also created a need for devices which could secure these demands.⁵⁴ But the underlying problem was that sole recognition of non – possessory security interest would generate the ostensible ownership problem. The debtor retaining the collateral could easily assert that his asset was unencumbered. In other

⁵¹ Heywood W.Fleisig, *Op.cit.*, 45.

⁵² Tibor Tajti, *Comparative Secured Transactions Law Ed.cit.*, 187.

⁵³ *Ibid.*, 124.

⁵⁴ Donald King and Bradford Stone, and W.H. Knight, *Op.cit.*, 84.

words, he could conceal from third parties the existence of the security interest. Thereby, it was inevitable to establish the rule that in the case of non-possessory security interest, the secured party must give public notice about the existence of the security interest.⁵⁵

All this led to the new security device, to the so called “chattel mortgage”. It was a non-possessory security interest, which was publicly recorded. “*Under a chattel mortgage, a seller of goods received the mortgage from the buyer, who was allowed in return to possess the goods.*”⁵⁶ In order to avoid possible abuses from the buyer, the seller recorded its security interest to protect his interest against third parties. “*The seller retained the title and held an equitable lien on the property until the payment had occurred.*”⁵⁷

Although chattel mortgage presented a huge development in relation to pledge still it raised some serious problems. Firstly, the legal thinking was too strict. Every new non possessory device had to fit under the framework of a chattel mortgage. This meant that new devices like consignment, trust receipt, leases were treated as disguised chattel mortgage and led to the voidness of the transaction.⁵⁸ Secondly, at that time “*the law insisted on strict compliance with documentary formalities and absurdly exact description of the collateral.* [For these reasons] “*Chattel mortgage*” *was a burdensome, risky device, which was often wise to circumvent.*”⁵⁹

2.2.2. The conditional sale

In the next phase, a new security device emerged, the conditional sale. It occurred primarily because parties wanted to avoid the burdensome chattel mortgage filing requirement. The underlying idea is that the buyer has the possession of the good, but the seller retains the title of the goods until the full payment.⁶⁰ At the first sight there is a close resemblance with chattel mortgage. Still there is a clear distinction too, as while in the case of chattel mortgage “*the security interest is granted by the debtor on an asset*

⁵⁵ Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 124.

⁵⁶ Donald King and Bradford Stone and W.H. Knight, *Op.cit.*, 87.

⁵⁷ *Ibid.*,

⁵⁸ Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 129.

⁵⁹ *Ibid.*, 130.

⁶⁰ *Ibid.*, 131.

*owned by him, quite the opposite applies to conditional sale, namely the security interest is retained by the creditor on an asset owned by the creditor.”*⁶¹

The advantage compared to unconditional sale was obvious. Namely in regular sales, the seller could only claim the price of the good once he had lost his possession. In contracts, in case of a conditional sale the seller gave the possession to the buyer on the condition of full payment and if the condition was not fulfilled, he could claim back the relevant asset. However, conditional sale had also a serious disadvantage, namely that the seller was faced with the courts’ election of remedies doctrine. This implied that the conditional seller had to choose between suing for the debt or repossessing of goods. If he sued for the debt, he could claim the unpaid price, but lost the claim to repossess the good. On the other hand, if he repossessed the good, he lost his claim for any deficiency judgment⁶² (i.e. claiming compensation for damages).

Still, it was considered that since” *the conditional sale was a device based on title retention, ownership, property* [it was] *stronger than the security interest of a mortgagee (pledge or factory lien).*”⁶³ This is quite logical, as retention of title implies that the ownership is guaranteed and that there is no risk of competing secured creditors. In other cases, there is a risk that the collateral is already encumbered by other, faster creditors. Due to this compelling advantage, retention of title got other forms as well, like trust receipt, consignment and leasing.⁶⁴

It is important to emphasize that this” *device was limited to use in financing sales transactions.* In other words, *it could not be used in any situation where a loan was to be secured by property owned by the borrower at the time the loan was made.*”⁶⁵ If this security structure was to be used to secure a loan, which was not financing a purchase, the parties had to set up the loan transaction as a sale. This meant that the borrower would sell to the lender the property and then buy it back on a conditional sale.

⁶¹ Lecture of Tibor Tajti, *Comparative Secured Transaction Law* (CEU, Budapest 2008)

⁶² Grant Gilmore, *Op.cit.*, 66.

⁶³ *Ibid.*, 67.

⁶⁴ *Ibid.*,

⁶⁵ *Ibid.*, 68.

Nevertheless, this was regarded as a fraudulent act and this type of conditional sale was in the case-law held to be a disguised “chattel mortgagee”. The result was that the contract was void, because it was not filed as a chattel mortgagee.⁶⁶

In relation to the previous characteristic there was also a rule, which stated that *“the only obligation which could be secured was the purchase price of the goods, plus expenses connected with, or incidental to the sale or the financing transaction.”*⁶⁷ The courts argued in this way probably because they considered that the purpose of conditional sale is only the retention of title on the sale goods. Hence wider application would lead to chattel mortgagee under the guise of conditional sale. Of course, this would also deprive the purpose of conditional sale and open the door to potential abuses.

In order to make the conditional sale more flexible the “add on clause” was established. For example the buyer buys a washing machine on a conditional sale. Before the washing machine payments, he buys a television also on a conditional sale. The core principle here was that both must be paid off in order to release the retention of title. In addition in the case of default both goods could be repossessed even if the purchase price of the first item has been fully paid. The court did not find this clause invalid, but eventually the use of this clause was prohibited by Retail Installment Selling Acts.⁶⁸

The judicial reaction towards conditional sale was quite hostile. The apparent logic behind this lies in the fact that the courts applied the rationale that every new device should put under the framework of chattel mortgagee. The courts were particularly hostile in this issue because some parties tried to avoid the burdensome filing requirements of the chattel mortgagee on the ground of retention of title clauses. The seller simply claimed that he did not create security interest on the chattel of the debtor and therefore, it should not be brought under the chattel mortgage framework. In particular, the parties tried to avoid chattel mortgage by setting up a loan transaction as a sale. The result was that the seller was at the risk that he will lose rights against third parties even when he used the conditional sale in good faith because the courts strictly look at it as a chattel mortgage.⁶⁹

⁶⁶ *Ibid.*, 68-69.

⁶⁷ *Ibid.*, 71.

⁶⁸ *Ibid.*, 72-73.

⁶⁹ Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 129-131.

Therefore, the legislator had to find ways out of this impossible solution, in particular as it was a rapidly extending device in industrial equipment financing and consumer financing. The legislator's solution was sound and practical. The legislator argued that if the conditional sale has a security purpose, then logically it should be perceived as a security device.⁷⁰ Therefore, it should put under the framework of Article 9.

2.2.3. Leases

As mentioned in the previous section, conditional sale was regularly qualified as chattel mortgage. However, with the recognition of conditional sale a new problem raised. In many cases agreements which were called a different name were turned into conditional sales. Of course, the result was again particularly harsh to the lender. The lender could not recognize his right before the court just because the agreement was not brought under the framework of conditional sale. In this context, the lender simply claimed that the transaction is not a security device at all, but a lease. Therefore, a considerable body of law evolved until there was a crystal distinction between true leases and false leases, which tend to disguise that it was a secured transaction.⁷¹

On one hand, there were true leases of chattels, which could not be treated as secured transactions. But on the other hand, in order to get rid of filing and default provisions of conditional sale or chattel mortgage, parties used to guise purchase transactions as a lease. Simply, the seller became lessor, the buyer became the lessee and the purchase price became rent. The incentive to act in this way was the compelling advantage of the lease. Namely it provides full protection without filing against the lessee's creditors and trustee in bankruptcy, because the title does not pass. The lessor's title enjoys priority even against the good faith purchasers from the lessee.⁷²

The judicial and legislative reaction was again obvious and expected. The courts turned the leases into conditional sales which mean that leases were also put under the statutory framework of filing and defaults.⁷³ Following this line section 1 of the Uniform Conditional Sales act included leases into the definition of conditional sale as "*any contract for the bailment or leasing of goods by which the bailee or lessee contracts to*

⁷⁰ Grant Gilmore, *Op.cit.*, 67- 68.

⁷¹ *Ibid.*, 73.

⁷² Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 132-133.

⁷³ Grant Gilmore, *Op.cit.*, 73.

pay as compensation a sum substantially equivalent to the value of the goods and by which it is agreed that the bailee or the lessee is bound to become, or has the option of becoming the owner of such goods upon full compliance with the terms of the contract."⁷⁴

In some other states, which outlawed conditional sale, lease was recognized under the framework of "lease-bailment" and it was perceived as a security device. Therefore, the result was practically the same, except that "bailment-lease" succeeded to avoid the filing requirement. Still, there were also cases where leases were recognized as independent devices. One of the examples according to Gilmore was the case where the manufacturer of specialized equipment was in such a good position that he could refuse to sell his products and instead he could lease it to the users. The court argued that public notice was provided through the public awareness of the monopoly and therefore it does not have to put under the framework of some existing security devices. Instead, the problem should have been dealt with antitrust law.⁷⁵

However, apart from such cases *all security leases were treated as security devices* (and therefore) *rules on conditional law or bailment lease were applicable. In other words, the security lease (was put under) the framework of existing devices.*⁷⁶

2.2.4. The results of the leasing development

After a brief legal history of leasing I think it is essential to make some important conclusions. First of all, I think it is obvious from the previous sections that leasing, leasing-bailment, conditional sale, hire purchase are all different types of title financing. They all have the common feature that they rely on retention of title.

Secondly, we can be positive that title-financing devices should put under the framework of Article 9. Numerous compelling arguments are in favor of this solution. First of all, title financing devices exploit the retention of title as a security device. If these are all security devices, why not put then under Article 9, which provides an efficient, clear and precise secured transaction system? Moreover, the ostensible ownership problem of title financing devices is solved because third parties get public

⁷⁴ *Ibid.*,

⁷⁵ *Ibid.*, 77-79.

⁷⁶ Tibor Tajti, *Comparative Secured Transactions Law, Ed..cit.*, 132.

notice through an efficient unified filing system. Finally Article 9 provides very good unified rules concerning rights after default. This is very important for title financing devices because they could not be successful without good repossession rules and enforcement procedure. We could also infer from the previous section that all these devices are typically installment contracts. This means that they have payment schedules until the end of the contract. In this context it is important to raise the question what is the reasonable limit of title retention? Is it fair to repossess the thing when almost the full purchase price is paid on the ground of retention of title.⁷⁷

Finally, as I already indicated it is crucial in the US law to make clear distinction between true leases and secured leases. This question is essential because these two types of leases impose different legal regimes.

2.2.5. The US leasing under the current law

What is extremely important under the current US leasing rule is to distinguish true leases from secured leases. On one hand, true leases as their name infer do not have a purchase option. Alternatively after the expiry of the contract the party could purchase it only on the fair market price.⁷⁸ All this implies that it is not a sale, but a hire contract and therefore the retention of title as a security device is not necessary. Consequently it is not brought under the Article 9 of UCC, but is regulated in Article 2 of UCC and this indicates that it is an entirely different and independent device. This also means that different default rules apply granted by this article. Of course, there is no registration requirement owing to the fact that it is not a security device. Therefore, as I stated earlier, it provides full protection without filing against the lessee's creditors and trustee in bankruptcy simply because the title does not pass. The lessor's title prevails even against the good faith purchasers from the lessee.

On the other hand, in security leases at the end of the lease there is a nominal purchase option or the title automatically passes to the lessee.⁷⁹ This means that it is a sale oriented transaction under which the payment of the purchase price is secured by retention of title. Therefore it is a security device, which should be brought under Article

⁷⁷ Lecture of Tibor Tajti, *Comparative Secured Transaction Law* (CEU, Budapest 2008)

⁷⁸ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 4.

⁷⁹ *Ibid.*,

9. This further generates the registration requirement. More precisely the secured party could enjoy priority against the lessee's creditors and trustee in bankruptcy, only if he properly and timely filed his secured claim.

However, this issue is not so simple as it seems at the first sight. In both cases one party pays periodic rents for possession and use the property for a certain period, while the other party has a right to take back the goods if payment is not made.⁸⁰ The particularly tricky thing here is that long installment payments usually impose high costs and amortization and therefore they could come close to the market value of the leased equipment. Therefore, it is difficult to decide whether there is a disguised conditional sale or a genuine lease, where the parties could not predict in advance the changed market conditions.

Given the significance of this question the UCC article 1-203 tried to solve this problem by giving some basic guidelines in order to clearly distinguish lease from an agreement creating a security interest.

Basically, this article is based on a residual value test. This means that the important question is whether the lessor gets back a meaningful residual economic interest in the leased good? In other words does he expect to get the property back after the lease term expires? It is clear that if the good does not have value after the termination of the contract then the lessor will not be driven to claim it back. This further implies that the lessee will have the ownership of the good. Therefore, we can conclude that in that case he would be a buyer in a sale contract.⁸¹

First of all, the UCC tests this through economic life. If the contract is for the entire economic life of the asset, it is regarded as a security device. The logic behind this is quite simple as after the expiry of the economical life of the good it will not have any residual value and then it is obvious that the lessor will not want the good back. Therefore, the UCC states that the transaction in the form of a lease creates security interest if:

- (i) *“the original term of the lease is equal to or greater than the remaining economic life of the goods; or*

⁸⁰ Linda J Rusch and Stephen L Sepinuck, *Problems and Materials on Secured Transactions* (St Paul, Thomson/ West , 2006), 102.

⁸¹ *Ibid.*, 102-103.

- (ii) *the lessee is bound to purchase or renew the lease to the end of the economic life of the goods.*⁸²

According to the UCC another way to look on the residual test value is to inquire whether the lessee could purchase the good for nominal consideration. Pursuant to the UCC the transaction in the language of lease should be considered as a security device if:

- (i) *“the lessee has the has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement, or*
- (ii) *the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.*⁸³

The logic is very clear again. The seller does not want the good back because there does not remain any meaningful economic value. On the other hand, the buyer develops equity so it is reasonable for him to opt for the purchase option. The buyer already paid the great part of purchase price through rental payments and therefore he has the option to purchase for a symbolic consideration.⁸⁴

But what is nominal? According to UCC *“additional consideration is nominal if it is less than the lessee’s reasonably predictable cost of performance under the lease agreement if the option is not exercised.”*⁸⁵ This means that we are dealing with a nominal consideration when it turns out that it costs the lessee less to opt for the purchase option than not exercising this option. For this reason the lessee will probably opt for the purchase option and become owner of the good. Although, this solution seems simple and logical there is a particular problem that it is hard to assess what should be included under the cost of performance. In this context the UCC does not help much since it only provides that the cost of performance should be determined by the facts and circumstances at the time the transaction is concluded.⁸⁶

⁸² UCC 1-203 (b)-(1)-(2)

⁸³ UCC 1-203 (b)-(3)-(4)

⁸⁴ Willian D Warren and Steven D Walt, *Secured Transactions in Personal Property* (Foundation Press, New York 2007), 329.

⁸⁵ UCC 1-203(d)

⁸⁶ Willian D Warren and Steven D Walt, *Op.cit.*, 333.

On the other hand the UCC also explains what are “non-nominal leases”, in case of which the consideration for the exercise of the option is to be the fair rent (the option to renew) or the fair price (the option to purchase) determined at the time the option is to be performed.⁸⁷ This provision does not help a lot because there is a wide range of considerations, which are less than market value but higher than nominal. For all these reasons, the case law should make an effort to precisely determine the scope of nominal consideration.

Basically if the above mentioned UCC conditions (economic life and nominal consideration test) are present then there is always a security interest. However, if they are not present, it does not have to necessarily mean that the contract is not a security device. It only means that we should make an even more careful analysis of facts and decide on a case by case basis. For these cases subsection C provides great deal of contractual terms, which could help in searching for the true nature of the lease. Namely the questions raised here are whether:

- (i) *the net present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is it greater than the fair market value of the goods at the time the lease is entered into;*
- (ii) *the lessee assumes risk of loss of the goods;*
- (iii) *the lessee agrees to pay, with respect to the goods, taxes, insurances, filing, recording, or registration fees, or service or maintenance costs;*
- (iv) *the lessee has an option to renew the lease or to become the owner of the goods;*
- (v) *the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; and whether*
- (vi) *the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.*⁸⁸

These clauses are not decisive signs of the existence of a security interest, but could be relevant. In other words, their pure existence does not necessarily infer that the

⁸⁷ UCC 1-203(d)

⁸⁸ UCC 1-203(c)

transaction in the form of lease does create a security interest. These guidelines should be considered on case by case basis and their relevance depends on the factual background.⁸⁹

For example, if there is a short leasing period where the residual value is still high at the end of the agreement it is reasonable to provide a purchase for a fixed price which is equal to the market price. Therefore in this case it would not be a security lease. On the other hand the situation could be quite different when we assume different background. For instance when the lessee practically paid the purchase price by lease payments and at the same time bore the risk of loss and the obligation of paying for maintenance service and taxes then it implies that he holds all the incidence of ownership, except bare legal title. Consequently, it would be probably treated as a security device.

⁸⁹ Linda J Rusch and Stephen L Sepinuck, *Op.cit.*, 105.

3. LEASING IN SERBIA

3.1. Leasing environment in Serbia before the law of financial leasing

The Financial Leasing Act⁹⁰ enacted in Serbia in 2003 is the first legislation which clearly regulates the operation of leasing in Serbia. This is obviously a huge step in Serbian legal reforms since many foreign investors have been attracted by the legal framework of the new statute. It could be argued that the Serbian leasing industry has started its development in 2003, because before that time it was very dangerous to rely on leasing agreements without the proper legal framework. In the lack of precise legal rules, parties relied on the principles of the Law of Contract and Torts⁹¹ which regulates similar contracts to the leasing like hire contract or purchase contract with retention of title.

However, recourse to analogy could not solve many complex questions of modern leasing devices. For example what should be the precise relationship between the, supplier, lessee and lessor? How should be the amortization cost calculated in rental payments? Who will be the owner of the leased good after the expiry of the leased agreement? Parties could of course rely on contractual arrangements, but the statutory legal framework and case law were unclear. Under these circumstances, parties had to face with high level of uncertainty in leasing transactions.

In addition, there was a particular problem with movables which should serve as collateral. The underlying difficulty was that pledge was mainly recognized as a possessory pledge. This means that the lessor could not secure efficiently his claim when the movables were transferred to the lessee's possession. The lessee could easily sell the movable to third party without the knowledge of the lessor. In other words, the retention of title mechanism could not work well when the Serbia did not have an efficient system of registry on movables.⁹²

⁹⁰ *The Financial Leasing Act (Zakon o finansijskom lizingu)*, published in the Official Gazette of the Republic of Serbia 55/ 2003.

⁹¹ *The Law of Contract and Torts (Zakon obligacionim odnosima)*, published in the Official Gazette of SFRJ 29/78, 39/85, 57/89 and Official Gazette of FRJ 31/93.

⁹² Lecture of Tibor Tajti, *Financing, Comparative Secured Transaction Course* (Central European University, Budapest 2008)

All this implied that leasing transactions were a very risky device without the support of the general legal framework. On the other hand, this obviously entailed that leasing could not operate as an effective credit system because lessors imposed high interest rates due to the legal uncertainties of this transaction.

3.2. Justification of the Financial Leasing Act and security issues

Nowadays leasing transactions in Serbia have become a much safer business device. First of all, parties can now rely on the Law on Financial Leasing, which provides a clear legal framework for these transactions. The other significant aspect is that the new law gives some efficient security devices for the leasing company. Namely, the Financial Leasing Act states that the lessor in the case of the avoidance of contract due to non-payment could repossess the good.⁹³ It also states that the lessor should have the right to exempt the leasing object from the lessee's bankruptcy estate.⁹⁴ In addition, the last chapter regulates the registration of financial leasing which makes possible to notify third parties of retention of title.⁹⁵ These articles represent a considerable improvement in Serbia, particularly taking into account that it does not have a comprehensive security system.

A company considering to enter into a leasing business in a certain country always checks whether there is a good retention title mechanism, which provides for priority in case of conflicting claims and a repossession procedure. It is quite plausible that without these articles foreign investors would not enter this specific market and therefore the Serbian leasing industry would not have shown a tendency of growth.

The underlying idea of enacting this particular act was that it is always better to regulate a particular question in one integrated act, then in scattered documents. This is especially true in a case of leasing which is a special transaction with various kinds of aspects: commercial, statutory, tax, accounting, retention of title, registry. It is really hard to imagine that a more general statute (like the Law of Contract and Torts) would be able to incorporate these different elements. Quite the opposite it is much sounder to make a separate law which could deal with these questions.⁹⁶ The Financial Leasing Act was

⁹³ *The Financial Leasing Act*, Article 30.

⁹⁴ *Ibid.*, Article 15.

⁹⁵ *Ibid.*, Chapter VII.

⁹⁶ Jelena Perovic, *Commentary on Financial Leasing Act* (Ip Glosarijum, Belgrade, 2003), 11.

primarily made on the ground of the UNIDROIT Convention on international financial leasing and Law of Contract and Torts. This way the new law incorporated internationally recognized standards to the domestic environment in accordance with the spirit of national law.⁹⁷

However what the Serbian business law generally lacks is an efficient and comprehensive security system. Instead, security devices are scattered around the legal system which creates an element of uncertainty. The new law made a serious effort to better secure the lessor's claim by registration of title and repossession procedure. Still I believe that an independent law of secured transaction would be needed in order to win not only the investors in general, but also the leasing companies' belief in the Serbian positive business climate.

3.3. General provisions of the Financial Leasing Act

3.3.1. Scope of application

As a rule, in every statute the legislator's starting point is the determination of its scope of application. This statute does not make exception in this regard, on the contrary, it states in its first article that *"this Law shall govern financial leasing transactions, financial leasing agreements, the rights and obligations of the parties to a financial leasing transaction and the Register of Financial Leases."*

Apparently, the legislator perception was that the financial leasing with its tripartite structure and complex devices needs to be regulated in a separate law. In order to make clear that this act applies only to financial leasing it expressly states that *"an agreement in which the Lessor and Supplier is the same person shall not be deemed to be a Leasing agreement."*⁹⁸ The very purpose of this provision is to stress that operating leases are excluded from the application of this Law. It is believed that operating lease is far less complex and due to its short-term character it is nothing else than a hire contract. Therefore, the Law of Contract and Torts' provisions of hire contract shall apply.

⁹⁷ *Ibid.*, 12.

⁹⁸ *The Financial Leasing Act*, Article 1.

Other laws shall apply to financial leasing transaction only in a case when some particular questions are not regulated with Law on Financial Leasing.⁹⁹ This also means that if a general statute and the Financial Leasing Act regulate the same matter, the latter shall apply.

The significance of this rule is that it takes into account the unique nature of financial leasing. For example, it provides special enforcement procedure (repossession) with much more discipline and better timing than the general rules of enforcement procedure. It also makes possible to exempt the leasing object from the lessee's bankruptcy estate, which would not be possible under the general scheme of procedural rules of the Law on Bankruptcy Proceedings.¹⁰⁰ On the other hand, there are some important questions which are not regulated by the Financial Leasing Act so it is useful that the act refers to other laws as a secondary source. In this respect, the Code of Obligations, the Law on Economic Associations, tax, and accounting, rules are particularly important.¹⁰¹

3.3.2. *Notion of financial leasing*

Since this law exclusively deals with financial leasing it is significant to determine the precise meaning of this transaction in the light of the Financial Leasing Act. Basically, under the framework of this act financial leasing is made up of two separate contracts, a supply contract and a leasing contract.

The supply contract is concluded between the supplier (manufacturer) and the lessor who purchases the good. The peculiarity of this contract is the participation of the lessee as a third party in the contract. The logic behind this is that whereas the lessor is only a financier of the good, the Lessee is the person who will use the good commercially.¹⁰² Therefore, the Lessee should choose the supplier and specify the good.¹⁰³ The other contract is concluded between the lessor and the lessee, which grants *to the lessee the right to possession and use of the leasing object for the agreed period of*

⁹⁹ *Ibid.*, Paragraph 2.

¹⁰⁰ *Law on Bankruptcy Proceedings (Zakon o stečajnom postupku)* published in the Official Gazette of Republic of Serbia 84/2004

¹⁰¹ Jelena Perovic, *Op.cit.*, 19-20.

¹⁰² *Ibid.*, 22.

¹⁰³ The Financial Leasing Act, Article 2, Paragraph 1.

*time in return for the payment of the agreed rentals in the agreed installments by the Lessee.*¹⁰⁴

One of the special traits of financial leasing is exactly the special three party structures and deviation of classical “inter parties” effect of this contract. Despite that the supply contract is concluded between the lessor and the Supplier still, it has also important legal consequences for the Lessee. Namely, he does not establish a legal relationship only with the Lessor but also with the Supplier. The other remarkable feature of this device is that the leasing contract could never survive without the supply contract. Simply financial leasing always implies incorporation of these two contracts and establishment of unique legal relationships between the three legal parties.¹⁰⁵

3.3.3. *The parties*

The Financial Leasing Act in the second chapter places emphasis on describing precisely who the parties of financial leasing are. This way we can clearly identify their separate roles in the financial leasing transaction.

The Financial Leasing Act states that “*the Lessor shall mean a person who transfers the right to possession and use of the Leasing Object to the Lessee for the agreed period of time in return for the agreed rentals, while retaining the title to the leasing object.*”¹⁰⁶ This definition gives a quite clear and simple picture of the lessor. However, what is unique in this act is that it constraints the lessor in setting up its leasing activity. Namely, the lessor could be only business organization with the minimum capital of 100,000 euros.¹⁰⁷ This minimum capital has to be maintained during the whole period of the company’s leasing activity.¹⁰⁸ The Financial Leasing Act also requires that the lessor needs to get the permission from the Serbian Central Bank,¹⁰⁹ which supervises the leasing companies’ activities. Finally, the Financial Leasing Act requires that the lessor could pursue only financial leasing activities.¹¹⁰ Obviously, the legislator had a

¹⁰⁴ *Ibid.*, Paragraph 2.

¹⁰⁵ Jelena Perovic, *Op.cit.*, 23-24.

¹⁰⁶ *The Financial Leasing Act: Article 10, Paragraph 1.*

¹⁰⁷ *Ibid.*, Paragraph 2.

¹⁰⁸ *Ibid.*, Paragraph 4.

¹⁰⁹ *The Financial Leasing Act, Article 13 a.*

¹¹⁰ *The Financial Leasing Act, Article 10, Paragraph 3.*

strong desire to set up financial discipline in the leasing market. In other words, it aims to attain a proper framework where only the efficient leasing companies with the adequate funds and skills could run leasing operations.

The Lessee according to the Financial Leasing Act is *"a natural or legal person to whom the lessor transfers the right to possession and use of the leasing object for the agreed period of time in return for the agreed rent."*¹¹¹ Again the definition is clear and does not deserve some particular comments. Still, it is important to stress that in contrast to the lessor it could be a natural and a legal person as well. The obvious approach of the legislator was that only specialized companies with sufficient funding could operate successfully leasing activities. On the other hand lessee could be natural person as well given the fact that what is only important in relation to the lessee is to have good credit standing. Of course, both of them natural and legal persons could have appropriate credit standing. The other important remark here is that we should not forget that natural and legal person have different types of responsibilities. While the natural person shall take care at the standard of a *"bonus pater familias"*, legal persons shall demonstrate the diligence of a good businessman. Finally, the supplier usually as a manufacturer of the leased good is a natural or legal person who transfers the title of the leasing object to the lessor. He as a manufacturer of product wants an immediate profit so it sells the product to the lessor who is able to finance the purchase of the leased good just to make a long-run profit. Of course, the supplier delivers the good to the lessee who will use commercially the good and pay rentals to the lessor.¹¹²

Apparently, the Financial Leasing Act does not put much emphasis on the lessee and supplier and describe them only to provide legal certainty about their role. But the Financial Leasing Act does place high importance on the lessor since the legislator expects from them economic growth and stability. Although it could be disputed whether 100,000 Euro is a substantial amount for leasing operations still the other similar requirements might stabilize the economic conditions in the leasing market particularly the requirement of Central Bank permission and control.

¹¹¹ *Ibid.*, Article 11.

¹¹² *Ibid.*, Article 12.

3.4. Rights and obligations of the lessor

3.4.1. *The obligation to acquire the leasing object*

The first and foremost duty of the lessor is to acquire the leasing object. The lessor has to acquire title to the leased good which enables it to transfer the possession of the good to the lease. In order to attain this goal the lessor concludes a supply contract with the supplier who is regularly chosen by the lessee. The lessee also gives further specifications of the good in spite of that he is not a party in the supply contract. This is quite logical since the lessor is only a financier of the good while the lessee obtains economic ownership, since he will use the good during the whole or a substantial part of the economic life of the good. Therefore, the lessee has the legitimate interest to specify questions regarding the goods type, quality and quantity, time and place of the delivery.¹¹³

3.4.2. *Warranties*

The clear exception from the “inter parties effect” in the leasing contract has the inevitable consequence that in many cases the supplier (instead of the lessor) is responsible to the lessee. This could be explained on the ground that the lessor could not be responsible for the specification of the good when he was not actively involved in this process. It involved much more the supplier and the lessee so these questions should be primarily settled between them. Therefore, the supplier not the lessor, should be liable for material defects, non-performance, performance with delay and damages caused by the leasing object’s malfunction.

Still, respecting the parties’ autonomy it is possible that the lessor with the consent of the lessee chooses the supplier or takes an active part in the specification of the good. This would not change the very essence and the character of financial leasing. But this would significantly change the lessor’s responsibility. Following this line the Financial Leasing Act states that the lessor shall be liable to the lessee for damage caused by the leasing object when *“the Lessee has suffered loss as the result of its*

¹¹³ *Ibid.*, Article 13.

reliance on the Lessor's skill and judgment, or due to the Lessor's participation in the selection of the Supplier, or specification of the Leasing object."¹¹⁴ The Financial Leasing Act also provides that *"The Lessor and the Supplier shall be jointly and severally liable to the Lessee if the Supplier was chosen by the Lessor and the Leasing Object is not delivered to the Lessee, or it has material defects."*¹¹⁵

However, apart from this special case when the lessor is actively involved in the choice of supplier or specifications of the good the general position of the Financial Leasing Act is that the lessor does not grant to the lessee any warranties regarding the delivery, quality, purpose, function of the good. All this questions is an exclusive matter between the lessee and the supplier.

But there is still one significant exception. Namely, the lessor always warrants clear title on the good so he will be liable to the lessee for a potential *"existence of a third party's rights on the Leasing Object which exclude, reduce, or limit lessee's quite possession and of which the Lessee was not informed, nor he agreed to accept the Leasing Object under such conditions."*¹¹⁶

The underlying concept here derives from the basic principle of Serbian civil law that the transferor in a bilateral contract is obliged to secure quite possession of the good to the transferee, which will not be disturbed by any third party claim. Simply the logic here is that when somebody transfers a right he needs to make sure that this right could be fully exercised¹¹⁷. The legislator probably also places emphasis on the lessee's protection as the economically weaker party. This argument is supported with the provision which states that *"the Lessor's liability for legal defects of the Leasing Object shall not be limited or excluded by the agreement."*¹¹⁸ In contrast to the rules of Code of Obligations the rules of legal defects are mandatory here, which clearly evidences that the legislator considers that protection of the lessee is of paramount importance.

¹¹⁴ *Ibid.*, Article 17.

¹¹⁵ *Ibid.*, Article 39.

¹¹⁶ *Ibid.*, Article 18.

¹¹⁷ Jelena Perovic, *Op.cit.*, 63.

¹¹⁸ *The Financial Leasing Act*, Article 21.

3.4.3. Protection in the Event of the Lessee's Bankruptcy

One of the *condition sine qua non* for a company to enter into a leasing market is the functioning retention of title mechanism. In this respect, it is significant that the Financial Leasing Act provided that “*the Lessor shall have the right to have the Leasing object exempted from the Lessee's bankruptcy estate.*”¹¹⁹ This provision is quite logical since the lessor as the owner of the good shall have right to protect its good from any third party claim. In addition, this rule is inevitable to the lessor's protection because otherwise under the general framework of bankruptcy proceeding it would have to compete with other creditors which might result in an uncompleted satisfaction of the lessor's claim.

The retention of title mechanism is further elaborated in the Law on Bankruptcy proceedings¹²⁰ which devotes a special provision regarding the situation when a bankruptcy proceeding is raised against the lessee. The Code provides that the lessor has the right for separate satisfaction on the leasing object which means that the leasing object will not become part of bankruptcy estate at all. It also states that he has the priority towards other secured and non-secured creditors.¹²¹

Although this way the company is quite well protected still there is an element of uncertainty for the lessor. Namely the Law on Bankruptcy Procedure states that from the commencement of bankruptcy procedure, no special enforcement procedure could be initiated against the debtor.¹²² In other words, automatic stay is granted to the debtor just to protect the debtor from a pile-up of creditors claims' and to set up a proper discipline in the bankruptcy proceeding. This rule equally applies to the lessor¹²³ which means that in the case of commencement of bankruptcy procedure he can not proceed against the lessee under the special repossession procedure which is granted to him by the Financial Leasing Act. Consequently, the leasing object becomes a part of the bankrupt estate, which itself creates an element of insecurity.

¹¹⁹ *The Financial Leasing Act*, Article 15.

¹²⁰ *Law on Bankruptcy Proceedings (Zakon o stečajnom postupku)* published in the Official Gazette of Republic of Serbia 84/2004

¹²¹ *Ibid.*, Article 75 Paragraph 1.

¹²² *Ibid.*, Article 73, Paragraph 1.

¹²³ *Ibid.*, Article 75, Paragraph 2.

This unenviable position of the lessor is improved in a way that the Law on Bankruptcy Procedure provides that the lessor has the right for adequate security measure *so as to make sure that the value and the status of its estate remain unchanged.*¹²⁴ This is in accordance with *“adequate protection doctrine which aims to protect secured creditors from losing their security as a result of automatic stay.”*¹²⁵

Under these circumstances, it is very important for the lessor to monitor the lessee’s activities in order to recognize potential bankruptcy proceeding on time. In this respect it is good that the Financial Leasing Act prescribes as the lessee and the bankruptcy court’s duty to *notify the lessor, without delay, of the initiation of the bankruptcy proceedings.*¹²⁶

3.5. Rights and obligations of the lessee

3.5.1. Ownership responsibilities

In a whole we could notice that the Financial Leasing Act focuses much more on the obligations of the lessee, than on its rights. The Financial Leasing Act particularly imposes on the Lessee many ownership responsibilities which indicate that this contract has an element of sale. Simply the lessee gets the economic ownership on the good so he has to bear some special obligations for this benefit.

In this respect, the Financial Leasing Act prescribes that *“the Lessee shall maintain the Leasing object in good condition and performs all necessary repairs on the Leasing Object.”*¹²⁷ This maintenance of good does not include only repairs but also bearing all the necessary costs of the service. In other words, the maintained obligation is completely transferred to the lessee which would not be a case in a simple hire contract. Of course, the Financial Leasing Act also states that *“the Lessee shall be liable for all losses suffered due to the failure to maintain the leasing object in good condition.”*¹²⁸ The idea that in this contract there is a transfer of special ownership (economic ownership) is clearly supported by the provision which states that *“the Lessee shall bear the risk of accidental loss of or damage to the leasing object. The risk shall pass to the*

¹²⁴ *Ibid.*, Article 75, Paragraph 3 and Article 48.

¹²⁵ Kenneth W. Clarkson, *Op.cit.*, 214.

¹²⁶ *Financial Leasing Act*, Article 15, Paragraph 2.

¹²⁷ *Ibid.*, Article 26, Paragraph 1.

¹²⁸ *Ibid.*, Article 26, Paragraph 2.

Lessee at the time of acceptance of the Leasing Object."¹²⁹ This situation amounts to transfer of risk from a seller to the purchaser in an ordinary purchase contract which again implies that we are dealing here much more with a sale contract than a hire contract. The lessee's difficult position in terms of bearing the risk is mitigated in a sense that the Financial Leasing Act provides that it is "*Lessee's obligation to insure the leasing object from risks specified in the agreement.*"¹³⁰ This provision clearly mitigates the lessee's position since *de facto* the insurer will bear all the risk.

3.5.2. *The right to require and the obligation to accept the delivery of the leasing object*

The first essential duty of the lessee is "*to accept the delivery of the Leasing Object at time, place and in a manner set forth in agreement.*"¹³¹ The legal consequences of the breach of this obligation is further elaborated in the Law of Contract and Torts which states that if the "*buyer refuses without justified ground to take delivery of the goods, than the seller may have after having a justified ground to doubt that the buyer will pay the price, declare his intention to repudiate the contract.*"¹³² This rule is quite rational in the case of financial leasing since the lessor needs a lessee on whom he could rely on during the whole term of the agreement. He has to be positive that the lessee could bring back to him the whole investment. If the lessee from the commencement of the contract demonstrates lack of responsible legal behavior and reluctance to the contract, then the lessor's right to repudiate the contract serves a completely legitimate aim.

In relation to this obligation, it is important to stress that at the same time the Lessee's main right is to require adequate delivery. This requirement is essential in order to provide the lessee with adequate protection. Without this protection the lessee's right to possess and commercially use the good would be deprived of its purpose. Consequently, the lessee has a right to rescind the leasing agreement and claim damages when the supplier did not deliver the good at all. This is quite obvious since the supplier did not do anything of its essential obligations. He could also rescind the contract when there was late delivery if the time of delivery was an essential part of the contract. Finally

¹²⁹ *Ibid.*, Article 32.

¹³⁰ *Ibid.*, Article 34.

¹³¹ *Ibid.*, Article 23.

¹³² *Law of Contract and Torts*, Article 519, paragraph 2.

in a case of material defect he could rescind the contract or reject the acceptance of that good and require delivery of adequate substitute.¹³³

3.5.3. *Use of the Leasing Object*

The Financial Leasing Act also imposes on the lessee the obligation to use the leasing object with special care. Probably the logic behind this is that the whole lessor investment is based on the proper use of the leasing object and on the anticipated rental incomes. If the leasing object gets damaged it could lose its proper business value, which could make the whole leasing agreement meaningless. For these reasons the Financial Leasing Act prescribes that the lessee needs to manifest the diligence of a good businessman when he is a trader, which triggers stronger level of responsibility. On the other hand if he is a simple natural person he should show the care of a “bonus pater familias” meaning the duty of care of an average rational person.¹³⁴ The Financial Leasing Act also states that “*the Lessee shall be liable for losses suffered by the use of a Leasing Object contrary to the agreement or contrary to the purpose of the leasing object.*”¹³⁵ Of course it is also clear that the “*Lessee shall not be liable for the wear and tear of the leasing object,*”¹³⁶ which is the consequence of its regular use and amortization.

3.5.4. *The obligation of payment the Leasing Rentals*

The rental payment represents the lessee’s main obligation in the leasing transaction. This is quite natural since it is the equivalent of the benefit which the lessee obtains from the use of the object. It is usually paid in installments and determined by the amortization of whole or substantial part of the value of the leasing object. As a rule, the lessor expects from the rental payments the return of the investment and so the lessor is driven to tailor payment solutions which could generate the anticipated cash flow from the leasing object. All this implies that the payment method is extremely important to the lessor. Therefore, the total amount of rental payments, “*the number of rental installments and the amounts and time of payment for each of the rental installments are mandatory*

¹³³ *Financial Leasing Act*, Article 24.

¹³⁴ *Ibid.*, Article 25, Paragraph 1.

¹³⁵ *Ibid.*, Article 25, Paragraph 2.

¹³⁶ *Ibid.*, Article 33, Paragraph 2.

elements” of the leasing agreement¹³⁷ meaning that without these elements the contract could not legally survive.

Similarly, since the lessee’s payment obligation is the economic basis of the leasing agreement, the Financial Leasing Act provides the lessor with proper instruments to avoid the non-payment of the leasing rentals. First of all, the lessor could terminate the agreement “*if the Lessee delays payment of the first installment of the Leasing Rental.*”¹³⁸ This solution is sound given the fact that the lessee did not pay the first installment, which demonstrates clearly that he is not capable to fulfill his general contractual obligations.

The lessor could also terminate the agreement or request default interest if the lessee after the payment of first installment of the leasing rental, “*delays with payment of one or more successive installments of the Leasing Rental amounting to one forth of the total leasing rental.*”¹³⁹ Basically, the Financial Leasing Act followed the rule of Law of Contract and Torts which states that “*the contract should not be repudiated due to non-performance of a minor term.*”¹⁴⁰ This means that there is no ground to avoid the contract when the debtor shows readiness to fulfill his obligations and the partial non-performance does not frustrate the purpose of the contract. In our particular case, the Financial Leasing Act applied this rule stating that non payments of rental does tally with a non-performance of a substantial term of the contract when it amounts to at least one forth of the total leasing rent.¹⁴¹

Finally, the Financial Leasing Act prescribes that the lessor could terminate the agreement in regard to all future payments when “*the Lessee did not pay only one installment provided that circumstances clearly indicate that the remaining installments of the Leasing shall not be paid either.*”¹⁴² Again, this rule is close to common sense and provides a substantial protection to the lessor. It is very rational and economical to terminate the contract when it is objectively clear that the lessee will not be able to fulfill his future obligations.

¹³⁷ *Ibid.*, Article 6.

¹³⁸ *Ibid.*, Article 28, Paragraph 1.

¹³⁹ *Ibid.*, Article 28, Paragraph 2.

¹⁴⁰ *The Law of Contracts and Torts*, Article 131.

¹⁴¹ Jelena Perovic, *Op.cit.*, 84-85.

¹⁴² *Financial Leasing Act*, Article 28, Paragraph 3.

3.5.5. Repossession and claim of damages

In all cases of non-payment, the lessor has the right to repossess and claim damages. In this context, it is important to emphasize that the Financial Leasing Act provides special procedure for repossession of the leasing object. Namely, the parties could request the court to *hold a hearing to confirm in the minutes that the Parties agreed that the Lessor shall have the right to repossess the leasing object in the event of non payment.*¹⁴³ The minutes of the agreement shall be binding and enforceable.¹⁴⁴ Under these circumstances, in the event of non-payment, the lessor simply judicially repossesses the asset by providing the minutes of the agreement to the court.¹⁴⁵ The huge advantage of this procedure is that it saves substantial time and cost comparing to the regular Serbian litigation and enforcement procedure. The Financial Leasing Act prescribes three days for obtaining the decision, three days for objection and three days for enforcement.¹⁴⁶ Under the regular litigation and enforcement procedure it would take the lessor ages to get back the leased good, which would deprive any meaningful purpose of the leasing agreement. Therefore, the repossession procedure provision is crucial in a sense that it secures a safe and efficient leasing market. Without these rule the investor would consider leasing as an extremely risky and costly device.

However, the Financial Leasing Act deliberately overlooked the provision of self-help. The Serbian legal doctrine perceives it as a risky device which opens door to potential abuses and high level of legal uncertainty. Although self-help works very efficiently in the US it is also clear that this would not be the case in Serbia. The basic formula without breach of peace is quite wide and could involve some arbitrariness. Therefore, self-help could work well only in a legal environment where the rule of law dominates and people do not have the tendency to take arbitrary the law in their own hands. In my opinion, Serbia still needs to prove that the rule of law is its dominant legal principle, so probably it would be too early to transplant such an advanced legal concept to the Serbian legal system.

¹⁴³ *Ibid.*, Article 30, Paragraph 1.

¹⁴⁴ *Ibid.*, Article 30, Paragraph 2.

¹⁴⁵ *Ibid.*, Article 30, Paragraph 4.

¹⁴⁶ *Ibid.*, Article 30, Paragraph 5, 6 and 7.

Generally, the lessor has the right to claim damages in a way that it places it “*in the same position he would have been had the lessee performed its obligations in accordance with the agreement.*”¹⁴⁷ Clearly, this provision was needed since the leasing companies as business subjects naturally want not only to recover their ordinary losses, but their lost profit as well. The Financial Leasing Act allows the parties to determine the way in which the damages are to be measured. However since the Law perceives the lessee as the economic weaker party, it states that it can not exceed the amount which is determined as the lessor’s expected interest.¹⁴⁸

3.6. The rights and obligations of the supplier

What is the dominant pattern in relation to the supplier is the fact that the lessee has important rights towards him despite the fact that he is not the party of the supply contract. This exception of “*inter parties*” effect of supply contract dominates towards the supplier in the whole financial leasing structure.

First of all, “*the Supplier shall deliver (the good) to the Lessee in a good condition with all parts and attachments, at the time, place and in a manner specified in the supply agreement.*”¹⁴⁹ Although the leasing agreement could provide that the lessor shall bear the obligation to deliver the leasing object this is rarely the case. Perhaps what is even more important, the lessee (not the lessor) has the right of specifications in the supply contract regarding the quality, quantity, time place and manner of delivery. As I stated earlier this is logical since the lessor is only the financier of the good while the lessee will obtain economic ownership on the good which means that he has the legitimate interest to specify these issues. Therefore, “*any subsequent changes of supply contract shall not affect the Lessee’s right unless he consented to such modifications.*”¹⁵⁰ Moreover, since the lessee is very concerned about obtaining the good with proper quality and on time the law states that “*the Lessee shall have the same rights he would have had under the law governing contracts and torts as party to the agreement with the Supplier, if the Supplier does not deliver the Leasing Object, delays the delivery... or the*

¹⁴⁷ *Ibid.*, Article 31, Paragraph 1.

¹⁴⁸ *Ibid.*, Article 31, Paragraph 2.

¹⁴⁹ *Ibid.*, Article 36.

¹⁵⁰ *Ibid.*, Article 37.

*Leasing Object has material defects.*¹⁵¹ This means that the lessee could claim the proper performance or damages from the supplier. However he could not avoid the supply contract or claim reduction of prices on the leased good without the lessor's consent.¹⁵² The logic here is that the agreement is concluded only between the lessor and supplier. Similarly, the price is also considered as an exclusive matter between the supplier and the lessor. This rule clearly implies that the Financial Leasing Act set up a rational limit to the exception from the "inter parties" doctrine.

3.7. Termination of the leasing agreement

The method of termination of the leasing agreement is significant because it answers some crucial questions in relation to the leasing agreement. For how long does the leasing agreement exist? Which option the lessee has at the end of leasing agreement? Who will be the owner of the leased good? In fact, these questions also concern substantially the nature of financial leasing agreement under Serbian Law.

3.7.1. Expiry of the Lease period

The first general rule is that the "*Leasing Agreement shall cease to exist after the expiry of the period of time for which it was concluded.*"¹⁵³ This time is mainly determined by the parties' contractual agreement. However, the Financial Leasing Act prescribes the minimum term of the leasing agreement of two years.¹⁵⁴ The underlying idea is that at the same time two years is short enough to include objects which depreciates swiftly but long enough to deter contracts which fictively shows themselves as a leasing contract in order to use the benefit of leasing contract (tax allowances, repossession procedure).¹⁵⁵ This means that that this provision in a way serves similar goal like the rules of UCC which put emphasis on revealing disguised transaction. Of course, in this case, no additional declaration is needed to terminate the contract. The contract will cease to exist after the

¹⁵¹ *Ibid.*, Article 38, Paragraph 1.

¹⁵² *Ibid.*, Article 38, Paragraph 2.

¹⁵³ *Ibid.*, Article 40.

¹⁵⁴ *Ibid.*, Article 3.

¹⁵⁵ Jelena Perovic, *Op.cit.*, 29.

expiry of the agreement ipso iure. A potential judicial act would have only declarative force.

3.7.2. *Loss of the Leasing Object*

*“The Leasing agreement shall (also) cease to exist if the Leasing Object was destroyed.”*¹⁵⁶ The rationale of this rule is very simple. Namely, the main purpose of the leasing agreement is to enable the lessee to use the leasing object during the whole term of leasing agreement. Naturally, if the leasing object were destroyed the leasing agreement would lose its essential element. Therefore, the destruction of the leasing object always results in termination of the contract and the fault of the parties does not have any relevance in this context. The fault matters only in terms of liability. Namely, in the case when the destruction of the object is attributable to force majeure event, the contract will cease to exist and nobody will be liable. On the other hand if the leasing object is destroyed due to the fault of one party, the contract will cease to exist anyway and the other party will have the right to claim damages.

3.7.3. *Option to buy or to extend the duration of the agreement*

The Financial Leasing Act explicitly states that *“the Lessee shall not acquire title to the Leasing Object after the expiry of the period of the time for which the Leasing agreement was concluded.”*¹⁵⁷ The basic concept here is that financial leasing entitles the lessee only with the right of possession and use of leasing object. The lessor does not transfer the title, but retains it which in fact serves a security goal.

However, the Financial Leasing Act also states that *“the Leasing Agreement may specify the Lessee’s right to buy the leasing object for the price determined by the agreement or hold the Leasing Object after the expiry of time for which the agreement was concluded.”*¹⁵⁸ This means that in accordance with international practice the Financial Leasing Act basically provides the lessee with all three options to take back the good, to renew the agreement or to buy at the price determined in the agreement.

¹⁵⁶ *Ibid.*, Article 41.

¹⁵⁷ *Ibid.*, Article 42, Paragraph 1.

¹⁵⁸ *Ibid.*, Article 42 Paragraph 2.

Consequently, the parties could tailor the leasing agreement in a way that it matches their economic interest.

What apparently the Financial Leasing Act did not regulate is the issue of price. The Financial Leasing Act did not place emphasis on this question at all, the parties could provide any price which suits their interest. In contrast, UCC perceives it as a question of pivotal importance since it distinguishes a true lease from a security lease on the ground of the difference between nominal price and fair market value.

Still, the difference is not as sharp as it seems for the first sight. In practice the parties usually provide symbolic price in the case of financial leasing since it is considered that the lessee has already paid substantial amount through rental payments and that the good lost its original value. The rule of symbolic price could even apply stronger in the case of purchase after the expiry of the renewed leased period.

3.8. The register of financial leasing

3.8.1. Notion of the register of financial leasing and its purpose

Probably the provisions of register could be perceived as one of the most important part of the Financial Leasing Act since it enables us to see Serbian financial leasing as a security device. More precisely, as a device which is based on the idea of retention of title. Consequently, the main purpose of this register is to protect the third parties who could check the existence of the financial leasing contract in the register. Of course this way the lessor is also protected since he could easily inform the public about his retention of title.

The financial register is maintained by the Agency for Commercial Register¹⁵⁹ (in Serbian *Agencija za privredne registre*), which agency also has the task to maintain the registry of pledge, registry of financial leasing and the registry of companies.¹⁶⁰ This solution is compelling in a sense that the registry system is centralized. It is quite logical that maintenance of several registers imposes higher costs and the necessity to check data at several places which makes the register system unfunctional. For these reasons the

¹⁵⁹ *The Law on Agency for Commercial Registeres (Zakon o Agenciji za privredne registre)* published in the Official Gazette of Republic of Serbia 55/ 2004

¹⁶⁰ *Ibid.*, Article 4.

legislator's conclusion was that a centralized system is a better solution in a sense that it provides legal certainty, accessibility and efficiency. In addition, the Financial Leasing Act prescribes that the Register of Financial Leasing is an integrated electronic database.¹⁶¹ This means that the register user has easy and swift access to the database. The Financial Leasing Act also brings efficiency by stating that the central database shall be accessible through local units.¹⁶² This way the register is easily available in the whole country.

3.8.2. Registration obligation

Given the fact that the Law imposes registration obligation it is quite clear that the Law places high importance on solving the ostensible ownership problem. For this reason the Financial Leasing Act prescribes that the “*Lessor shall register data within seven days from the day of conclusion of the leasing agreement, its modifications and amendments, and termination of the agreement.*”¹⁶³ This way the third party could always inform himself about the particular position of the leasing agreement, its changes, existence and non-existence. Of course, the “*Lessor shall be liable... to the third party who (acted) in good faith and suffered loss due to the non performance of the registration obligation.*”¹⁶⁴

3.8.3. Basic principles of the financial leasing register system

In order to secure that the financial register is safe and efficient the Financial Leasing Act prescribed some basic principles concerning the operation of the register system. Therefore, first it prescribes that the Register shall be accessible to all persons regardless of the place of access to the register.¹⁶⁵ This principle is realized through local units which are connected with the central database.

Moreover, the Law states that all data filed and kept in the Register shall be public. In accordance with this principle everybody who is interested could check the

¹⁶¹ *Financial Leasing Act*, Article 43, Paragraph 2.

¹⁶² *Ibid.*, Article 43, Paragraph 3

¹⁶³ *Ibid.*, Article 49, Paragraph 2.

¹⁶⁴ *Ibid.*, Article 49, Paragraph 4.

¹⁶⁵ *Ibid.*, Article 45.

register and claim the record which evidences the existence or non-existence of the financial leasing contract.¹⁶⁶

Finally, the reliance principle is also significant. The concept is that the third party is always in a good faith when it relies on the information of the register.¹⁶⁷ Therefore, it should not bear the negative consequences of the data in the register which are not complete or are untrue. Similarly, the third party could never invoke that he was not aware of the existence of the financial leasing, which was registered.¹⁶⁸

But the legitimate question which should be raised is why the financial leasing register is not incorporated to the register of pledges? In my opinion there are several reasons which are in favor of a unified register solution. The Register of Pledges makes it possible to secure non-possessory security interest on movables. At the same time the Financial Leasing Act also deals only with movables. Retention of title on movables could also be perceived as a non-possessory security interest and unifying the two registries could make the system more effective.

¹⁶⁶ *Ibid.*, Article 46.

¹⁶⁷ *Ibid.*, Article 48, Paragraph 1.

¹⁶⁸ *Ibid.*, Article 48, Paragraph 2.

4. OPERATION OF THE LEASING INDUSTRY WITH PARTICULAR FOCUS ON THE US

The US leasing industry constantly demonstrated a successful performance in the last couple of decades. According to the Equipment Finance Market Study there was approximately 600 billion dollar market for leasing in 2006.¹⁶⁹ Inevitably, the current global economic crisis will harshly affect the US leasing industry too. Still the US leasing industry has an enviously better market position than the US traditional banking and financial sector. More precisely, after the US credit crunch there is a greater demand for leasing while demand for conventional credit decreases.¹⁷⁰ David Farrel the managing director for lease syndications claims that *“in today’s tight-credit environment, in which most capital markets are either constrained or shut, the leasing market remains open (as) an alternative source of capital for companies. If a bank won’t lend you money to you a leasing company is a good place to go.”* How could we explain this remarkable tendency? Obviously, in this regard there are several important considerations. First of all, I should emphasize again that even in the normal market conditions leasing is more flexible since it does not require additional collateral. This advantage of leasing are particularly significant today when the banks obtain credits under extremely stringent conditions. The other thing is that companies who have problems with maintaining their liquidity (due to the adverse impact of the economic crisis) probably prefer leasing since that way they could preserve their working capital.

Finally what is extremely important the US leasing industry is highly specialized? It has a unique knowledge of particular equipments and customers. Many US leasing companies keep pace with the technical challenges of those equipments, and know what their particular customers need and what is their credit standing. In other words, they have a niche market approach which means that they have special targets and expertise

¹⁶⁹ Michael A. Leichtling, *US Equipment Finance Market Study* (Equipment Leasing & Finance Foundation, Washington 2007-2008), 3.

¹⁷⁰ Cole David, *Equipment leasing demand grows, as do credit concerns* (published in Journal of Business, February 26, 2009), see at <http://www.allbusiness.com/banking-finance/banking-lending-credit-services-secondary/11813992-1.html>

which in turn enables them to follow the market changes more easily.¹⁷¹ In this context we could notice that the US leasing industry managed to sustain its stable market position in the time of economic turmoil.

For all these reasons, I believe that it is worth providing a basic insight to the US leasing industry. First I will introduce the structure of the US leasing industry. I will try to show who the main players are and which kind of tactical considerations they use for maintaining their strong position. Moreover, I will elaborate some unique US leasing products since it also demonstrates the US leasing industry's ingenuity for new innovative business devices. Finally, I will close this chapter by showing how leasing companies operate and some of their essential policies. I will try to show that operation of leasing business could be complex and that the proper management knowledge is inevitable. In other words, the lessors need to take into account all the important aspects of the leasing deal. Particularly knowledge of equipment and customer is essential. In addition lessor has to continuously follow the market changes and the new customers' needs generated with these changes. Leasing companies who fulfil these essential requirements could flourish while others become of trivial importance or disappear.¹⁷²

4.1. Structure of the US leasing industry

The US leasing industry demonstrates a complex structure with many participants of different type and size. Therefore, various kinds of participants utilize distinct economic logics. In other words, they have different funding structures and different market tactics. However, one thing is common to all of them. All of them have a target approach and specialized knowledge.

4.1.1. Market participants - by types

Basically, the US leasing industry has four main participants by type: independent leasing companies, banks, captive leasing companies, brokers. All of these players have a unique structure and business rationale so it is worth analysing them in more detail.

¹⁷¹ Financial Institutions Consulting, Inc, *State of the Industry 2005* (Equipment Leasing & Finance Foundation, Washington 2005), 13.

¹⁷² *Ibid.*, 14.

4.1.1.1. Independent leasing companies

Independent leasing companies as their name suggest pursue solely leasing business and don not have a parent-subsidiary structure. Independent leasing companies proved to be successful for several reasons. First of all, these companies do not depend on their parent so they could develop their own individual market position. Secondly since they solely pursue leasing business they could develop a niche market position and a target approach. Their key competitive advantages are flexibility, risk underwriting and asset management skills. However, while banks could rely on their own existing customer base, independent leasing companies need to employ internal sales officers or brokers to establish their own customer base which of course imposes higher costs. The other trouble for independent leasing companies is that since they do not have funding parents their financing could completely depend on the current economic conditions. In the market boom, when there is abundance of low-cost capital independent leasing companies could finance themselves at a reasonable cost level. But in the time of economic turmoil, when the funding is scarce and expensive, independent companies could experience serious impediments in their financing.¹⁷³

Still under normal economic conditions they have many ways to finance there operations. For example large independent leasing companies usually get funds from commercial paper, bank loans and securitization of lease receivables. Or to take another example, smaller lease companies get short terms funds from banks to buy the leased good. After the purchase the leasing company sells its leases to a third party. It will obtain profit by a commission fee which charges the third party for the transaction.¹⁷⁴ However, still the main source of revenue comes from their leasing activity which means that they have to aggressively fight for the customers in a highly competitive lease market. This implies that the lessors sometimes are forced to accept lease terms which are not completely beneficial just to get a good customer base.¹⁷⁵

¹⁷³ *Ibid.*, 21-22.

¹⁷⁴ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 15.

¹⁷⁵ Richard M.Contino, *The Complete Equipment Leasing Handbook* (American Management Association, New York 2002), 5.

Basically, we can distinguish two types of independent leasing companies, those that only buy and lease the equipment (financing leasing companies) and those that provide additional services such as maintenance and repair of the equipment (service leasing companies).¹⁷⁶

Financing lease companies focus on the financial aspect of the leasing transaction and consequently they do not differ substantially from banks. Their main function is to provide funds for the acquisition and delivery of the equipment. But this does not mean that the companies have any direct connection with the equipment, since the choice of equipment and the good's special qualities are determined by the lessee.¹⁷⁷

The equipment is usually given for a longer period approximately for 80 percent of the good's economic life. The rental payments should be structured in a way to cover the cost of amortization and to provide a full return of equipment and the profit. The fact that the agreement covers the substantial part of the good's economic life implies that the lessee has the economic ownership and he should have the ownership responsibilities such as maintenance, taxes and insurance.¹⁷⁸

*“Service leasing companies provide non-financial services to lessees in addition to the equipment financing. Services may include equipment maintenance, repair or advice on the equipment design.”*¹⁷⁹ These companies frequently limit their activity to one type of equipment because specialization could impose less costs and lower risk-level. For example, if the company knows exactly how to deal with equipment then the residual value at the end of the agreement could be higher which means that there will be a better resale opportunity. However, the company should be careful because if the specialized industry got faced with hard economic times, then it would be the companies' benefit to have knowledge in other products as well which could obtain them with better economic terms. Service lessors usually enter into leases with much shorter lease terms. This means that the good will be leased several times during its economic life in order to get the return of investment and the profit. Frequently, there is a danger that the equipment will be obsolete sooner than expected. Therefore, in order to cover the costs of services and

¹⁷⁶ *Ibid.*,

¹⁷⁷ Ivanka Spasic, *Op.cit.*, 26.

¹⁷⁸ Richard M.Contino, *Op. Cit.*, 5.

¹⁷⁹ *Ibid.*,

the risk of the asset becoming obsolete, the service lessor will usually impose higher rents than finance lessors. Notwithstanding the fact that there is a higher rent payment charge, the lessee does choose a service leasing company when it wants to obtain a special service or shorter lease term. In this respect it is worth mentioning that if the lessee anyway wants to return the good early then it should compare the higher rents of short term lease of service lessor with lower rents and early termination penalty under the long term lease of financial lessor.¹⁸⁰

4.1.1.2. Banks

Many banks are involved in the leasing business. Some of them participate indirectly by providing funds to independent and captive leasing companies. Other banks established leasing subsidiaries. Therefore, these subsidiaries depend in a large extent on borrowing funds for their leasing activity from their parent banks. Of course, the parent banks get the funds from credit, deposit and other traditional ways of bank financing. But at the same time leasing subsidiaries could also finance themselves independently from the parent bank. For example the subsidiaries tend to sell their leasing receivable as a way of getting the necessary funds.¹⁸¹

Leasing business through banks provides two essential competitive advantages. One is that bank-owned lessors could utilize the banks' existing –customer base. Secondly, since banks have an advanced system of financing structure lessors could get low-cost deposit funds from their bank-parent.¹⁸²

Basically the general advantage and disadvantage here is at the same time is exactly the parent-subsidiary structure. Bank subsidiaries do not depend so much from the leasing activity revenue since they enjoy the parent support. Consequently, they could miss out deals which do not fit their business purpose. In this respect, they have a better position than independent lessors who have to aggressively fight for every leasing deal. But on the other hand, the subsidiary's long term position is less stable. Namely, since

¹⁸⁰ *Ibid.*, 5-6.

¹⁸¹ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 15 and 145.

¹⁸² Financial Institutions Consulting, Inc, *Op.cit.*, 20.

leasing is not perceived as the banks' the main line of business, the banks might close their leasing departments first if they face with general financial difficulties.¹⁸³

4.1.1.3. Captive leasing companies

“Captive leasing companies are.... subsidiaries of equipment manufactures so their main task is to secure financing for the customers of the parent company.”¹⁸⁴ The advantage of this structure is that the parent company earns a sale profit while the captive leasing company could charge lower rental payments since the acquisition of the leased good is cheaper.¹⁸⁵ These leasing companies have also a competitive advantage in terms of the knowledge of equipment's residual value since they could get a full picture of the equipment's quality from the parent company.¹⁸⁶ Finally, an important characteristic of this scheme is that the subsidiaries do not have to be consolidated with their parents for accounting purposes. Thus, they are able to borrow externally.¹⁸⁷ This implies that even captive leasing companies which are initially financed by their parents, latter on could obtain independent financing. They could eventually take recourse to conventional borrowing sources such as bank loans, commercial paper or securitization, which is not supported by their parent.¹⁸⁸

4.1.1.4. Lease Brokers

The growth of leasing industry generated a demand for intermediaries to match the lessors and lessees and in the case of a leveraged lease, even the third party lender. One of the key things for the lease broker's successful performance is its knowledge of the leasing industry. Consequently, it can easily find cooperative and prospective participants.¹⁸⁹ In addition, both the lessee and the lessor could save costs by relying on the broker who establishes the proper connections for the lease agreement instead of them.

¹⁸³ Richard M.Contino, *Op.cit.*, 8.

¹⁸⁴ Peter K. Newit, Frank J Fabbozi, *Op.cit.*, 15.

¹⁸⁵ Richard M.Contino, *Op.cit.*, 7.

¹⁸⁶ Michael Fleming, *The US Market*, in. *Leasing and Asset Finance* edited by Chris Booyer (Euromoney Books, London 2003), 423.

¹⁸⁷ Derek R Soper and Robert M.Muro and Ewen Cameron, *The leasing handbook* (Mcgraw-Hill Book Company, Berkshire1993), 338.

¹⁸⁸ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 16.

¹⁸⁹ Richard M.Contino, *Op.cit.*, 7.

However, the institution of broker could raise several problems. One of them is the broker's conflict of interest given the fact that its service fee depends primarily on whether he can sell the transaction to its clients. In addition, it is sometimes difficult to control the broker's conduct. This could mean that the broker could present itself as if it had the mandate to conclude the agreement, despite the fact that it is not the case.¹⁹⁰

4.1.2. Market participants by size

In contrast to the emerging leasing industries where leasing companies basically finance small and middle size companies the US leasing industry shows a different tendency. First of all it is much more specialized. Namely, leasing companies decide in which market-size they want to participate and consequently they develop their target and strategy. Secondly, the US leasing industry also participates in much larger markets where it finances extremely expensive equipments like aircrafts, rails or power generation projects.¹⁹¹

4.1.2.1 Small ticket leasing

Small ticket leasing companies are high volume specialist. Their strategy is to lease to a wide range of customers generic assets, whose economic life is short but predictable. Therefore, the leasing company by developing a proper customer base could generate cash-flow swiftly while the depreciation risk is minimum given the predictable life of the asset. For this reason these companies are primarily customer-focused. They endeavour to know their customer credit standing and their customers' particular needs and to provide the best services to attract a high volume of customer base.¹⁹²

4.1.2.2. Middle ticket leasing

Middle market leasing companies invest to a much more expensive and specialized equipment. By definition the equipment price could go from 250000 dollar to several million dollars. Therefore, they are primarily asset category and vertical industry focusers. Asset category approach means that they are expert in the knowledge of the

¹⁹⁰ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 138.

¹⁹¹ Joseph N. Lane, *Sharpening Focus, Market Segmantation in Equipment Finance* (in. Journal of Equipment Lease Financing, Equipment Leasing&Finance Foundation, Washington, 2005), 6.

¹⁹² *Ibid.*, 2-3.

equipment. They have an aggressive residual policy which includes, technical calculation of the end-lease value, remarketing, refurbishment, employing secondary markets. Vertical industry approach means that they endeavour to understand their particular customers business sector. By understanding how that particular customers business sector work they could identify the clients new demands and their credit standing. For this reason leasing companies often employ people who worked in the customers' business sector. It should be born in mind that in this case leasing deals are quite price sensitive. Consequently, the leasing companies need to make a good risk management strategy at the individual leasing deal level. At the same time there has to be a proper risk management at the level of the whole industry since these leasing companies often heavily depend on particular asset type and customer base. The over reliance on a particular industry could be perilous if that industry incurs economic turmoil. Therefore, it is important to avoid dependence on a single asset type or customer base.¹⁹³

4.1.2.3. Large ticket leasing

Large ticket leasing involves huge deals where the equipment cost exceeds 10 million dollars. This implies that these leasing structures involve a couple of sophisticated participants since nobody wants to take the funding risk alone. Usually a broker targets the opportunity for large ticket lease. Then he organizes a team with a main lessor and funding partners. After that the whole team makes a proposal to a prospective lessee to conclude a deal. Since this deal is extremely risky it is of crucial importance to regulate the question of risk-sharing between the multiple parties. For all these reasons large ticket leasing involves a complex process of financial structuring and partnership building.¹⁹⁴

4.2. The US leasing products

The US leasing industry showed particular innovativeness with the creation of different leasing products. The leasing products serve two basic goals. One of them is that leasing companies could achieve their own business aims. For example the leasing company might choose true lease because it wants to have an additional return of investment by tax

¹⁹³ *Ibid.*, 3-5.

¹⁹⁴ *Ibid.*,

allowances. Or it might opt for leveraged leasing due to its low-cost financing. On the other hand, leasing companies by providing different leasing products could attract a wider range of customers. Therefore, US leasing products have also the purpose to satisfy diverse customer needs.¹⁹⁵

4.2.1. Tax and accounting criteria

The parties very often choose on the ground of tax and accounting criteria between the tax oriented true leases and the non tax oriented lease (conditional sale lease). The difference is very sharp. Namely, in case of a true lease, the lessor retains tax benefit for the ownership on the ground of depreciation deduction. The amortization of goods goes together with tax allowances. The lessee benefits from this situation in an indirect way because lower taxes for the lessor can also result in reduced lease payments. In addition, he could deduct the full lease payment as an expense owing to the fact that he is not the owner.¹⁹⁶ Finally true lease has also significant accounting consequences. The payment obligations of a lessee are not accounted for in the balance sheet as a liability, which means that he could obtain better credit facilities¹⁹⁷ (i.e. only the monthly payment is accounted for as a liability, whereas if the acquisition were financed from a loan, the total amount of the loan would be indicated in the balance sheet as a liability).

The conditional sale lease on the opposite side has very different tax and accounting impacts. The lessor does not retain ownership and therefore he could not enjoy tax benefits, which automatically means that he could not offer the lessee with low lease rent payments. Moreover, the rental payments are not deductible by the lessee. Instead, as an owner he could have depreciation tax allowance.¹⁹⁸ Of course, the lessee's ownership also generates that the leased equipment is considered as an owned property on the lessee's balance sheet. This also implies that the outstanding rents are reported as a liability which significantly reduces the lessee's credit strength.

¹⁹⁵ James M Johnson and Barry S Marks, *Power Tools for Successful Leasing* (Leasing Press, Chicago 2000)

¹⁹⁶ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 5.

¹⁹⁷ William D Warren and Steven D Walt, *Secured Transactions in Personal Property* (Foundation Press, New York 2007), 324.

¹⁹⁸ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 5.

4.2.2. *Financing criteria*

In every lease transaction it is an essential question how should the leasing transaction be financed? In other words how should the lessor purchase the equipment which will be leased? Could he buy the equipment from his own funds or is the help of a third party as a financier inevitable?

In the case of non-leveraged lease, the lessor finances the purchase of the leased good from its own resources. This does not mean that the lessor could not borrow from a lender at all. But even when it borrows from a lender it does only on a full-recourse basis, which implies that the lessor bears the risk for all of the capital engaged in the loan.¹⁹⁹

On the other hand, in case of a leveraged lease a third party finances the purchase of the equipment. Usually, the lessor becomes the owner by providing only a fragment of the necessary capital for the purchase of the equipment (usually about 20 percent). The remaining 80 percent is financed by an investor on a non-recourse basis.²⁰⁰ Non-recourse finance usually means that the investor's loan is primarily secured by the leased assets and "*paid entirely from the projected cash flow, rather than from the general assets or creditworthiness of the (borrower)*"²⁰¹ Thus, the financing of the leverage leased "*is secured by a first lien on the equipment, an assignment of the lease and an assignment of the lease rental payments.*"²⁰²

Practically speaking, this implies that the lessor is at risk only for the equity portion of the leased equipment. Moreover, despite that he paid a very small fragment of the purchase price, he is considered as an owner of the good which purports that he receives tax benefits for it. Certainly, both the low risk (20%) and tax benefits enables the lessor to provide to the lessee lower rental rates.²⁰³

4.2.3. *Open end leases*

In order to combine the benefits of a true lease and a condition sale lease parties sometimes take recourse to TRAC (terminal adjustment rental rate) leases. This is a

¹⁹⁹ Peter K. Newit and Frank J Fabbozi, *Ibid.*, 147-148.

²⁰⁰ *Ibid.*,

²⁰¹ See at http://en.wikipedia.org/wiki/Project_Finance

²⁰² Peter K. Newit and Frank J Fabbozi, *Project Financing* (Euromoney Books, London, 2000), 148.

²⁰³ *Ibid.*,

unique lease type which is used to finance motor vehicles.²⁰⁴ As Professor Fabozzi rightly notices TRAC leases work in the following way. First the parties sign the agreement providing precise monthly rental payments and the projected residual values for the leased motor vehicles at the contract termination dates. After the termination of the lease the value of the motor vehicle is determined by the resale value, by agreement, or by an independent appraisal. If the value at termination of the agreement is less than the projected residual value, the lessor gets the difference. If the value of the equipment at termination is higher than the projected value then the lessee may gain from the difference. For exactly this reason this lease is often called an “open end” lease because the liability of the lessee is open ended.²⁰⁵

The reason which could drive the parties to choose this type of lease is numerous. Firstly, the lessee obtains tax oriented true lease rates. At the same time he could gain from the loss of potential upside residual value. On the other hand, the lessor is encouraged to develop large equipment financing. Namely, he could give as collateral an equipment with substantial economic value because he is protected against the loss of potential downside residual value.²⁰⁶

4.3. Operation of the leasing industry

Operation of leasing industry is constantly faced with new challenges. It requires a niche market approach, special targets and specialized knowledge of equipment and customers. The knowledge of equipment present and residual value is crucial. This is a particular hard task in the era of technical innovations. Leasing also requires constantly following the market demands of the customers on a wide variety of assets. For these reasons leasing company need a constant technical and market knowledge. All this tells us that a successful leasing company does not depend solely from capital resources facilities but also some intangible qualities like market knowledge, flexibility, and innovation.²⁰⁷

It is also important to highlight that the modern leasing business could not anymore finance asset purely on a long term predictable basis because there is a constant

²⁰⁴ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing, Ed.cit.*, 6.

²⁰⁵ Peter K. Newit and Frank J Fabbozi, *Project Financing, Ed.cit.*, 137.

²⁰⁶ *Ibid.*, 137-138

²⁰⁷ Parkers Richard, *Equipment leasing: an industry in transition* (Business Credit, 1994), see at: <http://www.allbusiness.com/business-finance/business-loans-business-credit/427776-1.html>

risk of high depreciation due to the new technological devices. Therefore, leasing companies tend to opt for securitization of leasing receivables. This way they attain both: protect themselves from depreciation risk and get swiftly necessary cash flow. Of course this is not simple task since the lease portfolio needs to be packaged in a way that it could attract the potential buyer of receivables.²⁰⁸ What the leasing company particularly needs to show to the buyer is that it has strong and healthy balance sheet.

Generally speaking, the leasing company could be successful through an adequate price policy which predicts correctly the residual value, low-cost funding, risk underwriting²⁰⁹ monitoring, credit policy and market analyse. In other words, the firm success depends primarily on proper management which of course has to involve innovativeness and tactical considerations.²¹⁰ In this section I will make an effort to highlight at least some of the basic operational policies.

4.3.1. Funding

The first and foremost question in establishing and operating a leasing company is financing. Otherwise, if the company could not obtain the proper funds the whole operation of the leasing company becomes meaningless. This means that it is inevitable for every leasing company to have adequate funding strategy which includes several tactical considerations.

First of all, there is a question of credit standing. Investment grade companies have rationale cost access to capital which implies that they will be able to maintain sufficient level of profitability. On the other hand, firms bellow investment grade need to specialize in a smaller market where the price pressures are not so high.²¹¹

²⁰⁸ *Ibid.*,

²⁰⁹ Risk underwriting is a special method by which various risks are measured like credit risk, ownership risk, residual risk, tax risk, funding risk, portfolio risk. Although it is beyond the scope of this work to shed light on the details of this complex process still it should be borne in mind that risk underwriting is primarily based on the risk return model. This means that the leasing company in deciding whether to provide a particular leasing facility measures the rate of risk and return at the same time. It is quite natural that the ideal position is low risk high return while the worst position is high risk, low return.

See at: Malchom Rogers, *Risk underwriting*, in. *Leasing and Asset Finance* edited by Chris Booyer (Euromoney Books, London 2003), 23-43.

²¹⁰ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing, Ed.cit.*, 146.

²¹¹ *Industry Future Council Report 2001*, in. *Equipment Leasing and Finance*, Continued Growth bur Tougher Times (Equipment Leasing&Finance Foundation, Washington, Spring 2001), 73.

Funding strategy should also go together with good liability management meaning that borrowing (liabilities) should match the maturities of the assets. Of course, this is not always a simple task due to the changing market conditions. The task is additionally complicated given the fact that most leasing companies have various kinds of short term, middle term and long term debt. However, leasing companies at least should make a serious effort to discipline themselves to borrow at regular period of time. Obviously, this could help a lot to better match the liability side with the asset side.²¹²

Leasing companies should also constantly follow market conditions since any market change could challenge the financing of leasing companies. In this context, it is worth to mention that when the economic cycle is downward, credit squeeze could lower both, the access and the level of capital. Leasing companies will find themselves in a position that they will have more limited access to the capital or having to pay substantially higher interest rates.²¹³ Since economic down cycles could be predicted, leasing companies should plan in advance how to find alternative financing sources

There are several funding options. It is commonly considered that internal funding is the cheapest form of financing. However, many times firms find that internal financing could not provide the adequate supply. This is especially true for leasing companies with a strong growth tendency. Consequently, notwithstanding the cost advantage of internal financing, external financing is widely used by almost all kind of businesses.²¹⁴

External financing could have both, unsecured and secured sources. Unsecured sources like commercial paper or bank credit lines tend to be used for short-term cash-flow goals. This could be explained on a ground that short term objectives primarily require swift decision making. However, long term capital goals have different nature. What they mainly require is to secure the leasing transaction in the long run. Thus, secured financing is the main source for long-term capital investments.²¹⁵

²¹² Peter K. Newit and Frank J Fabbozi, *Equipment Leasing*, Ed.cit., 144-145.

²¹³ *Industry Future Council Report 2001*, Ed.cit., 68.

²¹⁴ Vernon E Gerety, *Understanding the Equipment Leasing Marketplace* in *Journal of Equipment Lease Financing*, (Equipment Leasing&Finace Foundation, Washington, Spring 1995), 4.

²¹⁵ *Ibid.*,

In the US the most common funding sources are securitization, bank funding, parent funding, syndication²¹⁶ and capital markets borrowing. Particularly, leasing securitization (selling lease receivables through securities) has received wide application. As I have stated earlier the US leasing companies often take recourse to this solution. The logic is simple since securitization helps them to finance efficiently new deals at a low risk level. At the same time they could get ride of the risks by selling their receivables and get swiftly the necessary cash flow for the new deals. Securitization tendency is particularly widely applicable in the case of large leasing companies which could grow even further by this method. On the other hand, small leasing companies more often tend to use bank funding.²¹⁷

4.3.2. Market policy

A successful leasing company needs to make thorough market analysis. This analysis is significant because the company needs to find its customer target and define a strategy which operates efficiently in the competitive market.

4.3.2.1. Long business relationship

The ultimate aim of every company is to develop a long and trusty relationship with prosperous lessees. Namely, a good paying existing customer base reduces the credit risks and operational costs of the new lease agreements. Thus it useful for the company to make the first deal very attractive. Maybe it should even offer rental payment schedule bellow the market price in order to break through the market and develop a long term customer relationship.²¹⁸

One good method to develop a long relationship with a prospective lessee is to conclude a master lease agreement. Under this agreement the lessee could obtain leasing

²¹⁶ Lease syndication could be described as a purchase and sale of equipment lease transactions. The syndicate transaction as a minimum involves the Lessee, the original Lessor and a party purchasing from the Lessor.

See at: Philp R. Rosenblatt and Stephen J. Patterson and Richard S. Rosenstein, *Impact of Bundling on Equipment Lease Syndications From the Purchaser's Perspective* in *Journal of Equipment Lease Financing*, (Equipment Leasing & Finance Foundation, Washington, Fall 2008), 1.

²¹⁷ 2000 Industry Future Council Report, *Focus on the Future*, in. *Journal of Equipment Lease Financing* (Equipment Leasing & Finance Foundation, Washington, Spring 2000), 23.

²¹⁸ Richard M. Contino, *Op. Cit.*, 177-178.

goods from time to time without having to renegotiate a new contract for each item.²¹⁹ The parties provide basic terms and conditions (such as representations, warranties, maintenance responsibilities) which equally apply for the new leased goods. When a new lease good is incorporated into master lease agreement the parties only provide additional short schedule to regulate issues which could be different in various kind of single lease transactions (equipment type, rent and options). The crucial advantage of this method is that the parties could save substantial amount of time and cost.²²⁰

4.3.2.2. *Type of the equipment*

In developing a market strategy it is also crucial to determine the type of the equipment which should be leased. As Professor Fabozzi notices: " *some companies try to offer a wide variety of products to all market segments. However all things to all people rarely works efficiently.*"²²¹ Although this way the lessor provides the lessee with a wider choice, which could be attractive, it is harder to operate because larger equipment knowledge is required. If the company does not have the precise knowledge of the equipment, the companies associated costs and risks will multiply. Therefore, the key for success is specialization. As I have already told earlier one of the main reasons of the success of US leasing industry is that it utilizes a niche market and target approach. This means that the US leasing companies have a superior knowledge of particular equipment, which implies that they could manage the leasing deals much more efficiently.

4.3.2.3. *Customer base*

Every market analysis has to determine the scope of the customer base. This task has not only a goal to determine the demand and credit standing of the prospective lessee's, but also to understand the business nature of different lessees' activities in order to conceive the proper market strategy.

For example the size of the lessees could be important. If there are ordinary individual consumers then the company should offer leasing with standardized terms with lower prices to attract wide range of customers. But the situation is quite different if the

²¹⁹ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing, Ed.cit.*, 18.

²²⁰ Richard M.Contino, *Op.cit.*, 44.

²²¹ Peter K. Newit and Frank J Fabbozi, *Op.cit.*, 133.

consumer is a large company who wants to lease the equipment in a large big leased ticket market (covers purchase of the equipment over 10 million dollars). Then of course the lease agreement will be very price sensitive and the terms will be individually negotiated. Similarly, it is equally important to know the type of business in which the lessee operates. This is important since each business activity has its own peculiar characteristics. For example in some industries the leasing company could have lower credit risks, save substantial part of the residual value and have a potential for long established customer relationship. On the other hand, in other industries the inherent risks of a leasing deal could be substantially higher.²²²

4.3.3. Credit policy

One of the fundamental issues in every leasing transaction is the creditworthiness of the lessee. This is quite natural since the success or failure of the contract could largely depend on whether the company deals with reliable borrowers. The following criteria indicate customers with good prospects:

1. *The customer has a reasonably low business failure for the type of the business in which it is engaged;*
2. *The customer has been operating successfully for a reasonable period of time.*
3. *The net worth of the prospective lessee is substantial in relation to the debt with sufficient liquid assets to support the credit;*
4. *The prospective lessee is an established business. Lease payments should not be contingent on the success of an unproven or speculative venture.*²²³

4. The customer has no bankruptcy history; and

5. The customer has no significant outstanding balance

In relation to the creditworthiness of the debtor it is also important to determine the lessees' potential repayment sources. First of all, the lessor has retention of title which means that leased equipment is used as collateral itself. The lessor needs to be careful with the choice of the equipment since it will determine the value of collateral in a large extent. In other words, it is crucial to choose the equipment which has particularly

²²² *Ibid.*, 134-137.

²²³ *Ibid.*, 147.

suitable characteristics for leasing purposes: high residual value, marketable, identifiable, low rate of obsolescence, low maintenance cost. Despite that the leased good as a security is a primary source of repayment, still the lessor need some alternative payment sources. This could be explained by the fact that the resale value of the equipment is usually significantly lower than the original purchase value and therefore, the resale value could not cover the outstanding balance of payments.²²⁴

Regarding the lessee's credit standing it should be kept in mind that the lessee's cash flow represents the main source of lease payments. Therefore it is important to make an adequate cash flow analysis. Of course, the lessee's credit strength depends not only on the total amount of the cash flow, but also on the precise timing of the receiving of those funds.²²⁵

Checking the lessee's balance sheet could also provide useful information on the credit worthiness of the lessee. The lessor can make a detailed study of the assets and liabilities according to the checking among others if the accounts receivable are current if the inventory is marketable, the fixed assets, if the debts contain restrictive covenant and whether the investments are liquid?²²⁶

Finally, if the lessor concludes that the lessee does not have a fully adequate credit standing then the lessor could require some form of credit support. In that case lessors prefer to *“get a full and unconditional guarantee of all the lease obligations from a creditworthy entity, such as a parent company, a bank or possibly an underwriter.”*²²⁷

4.3.4. Price policy

Another important aspect of the operation of leasing industry is to have an adequate pricing policy. It is important to determine a precise rental schedule of the lease agreement which will serve as a good profit strategy. Although this seems natural, the question could be complex. For example the lessor could have significant losses if he did not take into account the expected residual value, tax changes or other inherent risks in

²²⁴ *Ibid.*, 154-155.

²²⁵ *Ibid.*, 150.

²²⁶ *Ibid.*, 149.

²²⁷ Richard M.Contino, *Op.cit.*, 27.

this transaction. All this implies that the leasing company has to provide all the important details to obtain profit and avoid potential losses.

As a general rule the rental payment schedule needs to include the recovery for the purchase cost of the equipment and a yield (profit) for the lessor. Of course, this goal is possible only if we provide in advance an overall system of rental payments during the whole lease term which returns the investment in the long run. Therefore, the rental payments need to have two elements. One is the capital element which should help to pay back the capital costs. The other is the interest element which covers other expenses, risks and obtains the yield of the leased product. Naturally, early rentals encompasses a smaller amount of principal and larger proportion of interest than later repayments given the fact that latter the amount of outstanding capital on which the interest is calculated decreases.²²⁸

In this context we should keep in mind that in the US leasing industry in many cases leasing companies recourse to “hell or high water clauses”. This means that the lessee’s rent obligation is absolute and unconditional. In other words “*the lessee must pay the rent in full and on time regardless of any claim the lessee may have against the lessor.*”²²⁹ This clause is particularly preferred by the lessor when he purchases the equipment on a non-recourse basis loan. Simply there is a greater chance that he would get the loan from a third party-investor because potential claims against the lessor would not affect the rental payments that is used for the loan repayment.²³⁰

It is also crucial to determine the expected residual value after the termination of leased agreement. The instalments have to cover the cost of amortization if the good will not have any residual value after the end of the agreed leased period. Otherwise the lessor could suffer significant losses since he would not be able to resell the equipment. On the other hand, if the lessor is aware that the good will have a meaningful residual value at the end of the leased agreement he could attract customers with lower rents facilities owing to the fact that the amortization cost will be smaller. In addition there is a high

²²⁸ Derek R Soper and Robert M.Muro and Ewen Cameron, *Op.cit.*, 56.

²²⁹ Richard M.Contino, *Op.cit.*, 50.

²³⁰ *Ibid.*,

possibility that he will obtain a windfall profit because at the same time he gets a bulk of monthly rental profits and resells the good for valuable price.²³¹

Another important aspect of the pricing is the tax aspect. As I already mentioned in the case of true lease the lessor as the owner of the good has a right for tax allowances in the form of depreciation which makes it possible to offer lower rentals while maintaining profit objectives. Although, this could be very beneficial to the lessor, he had to be careful about the timing of the cash flow attributable to tax benefits because there is a time difference between the requested and the obtained tax relief.²³² In this context a leasing company should establish a pre-tax and after tax target rates of return from leasing on its equity and assets.²³³

Moreover, special risk factors could occur during the term of the lease agreement like credit, tax, capital risk problems which should be taken into account in pricing. There are various solutions for these problems. For example the credit risk apart from a special appraisal could be mitigated if the lessor tailors the rental payments in a way that it meets the specific needs of the lessee, and matches “*the cash inflows (earning capacity of the assets) with outflows (lease rentals)*.”²³⁴ In this way, it could be recognized that in some periods the lessee generates more and sometimes less revenue. The rental payment should be adjusted to these circumstances and the result will be higher economic efficiency since the lessee will less likely fall in a default. Or another example would be when the lessor is afraid of unexpected tax law changes that adversely affect return. Then the lessor could simply provide tax law rental adjustment clause to maintain its yield and after-tax cash flow.²³⁵

Finally, the instalments need to cover various other costs except purchase cost like the cost of booking, billing, collecting, inspecting.²³⁶

²³¹ *Ibid.*, 176-177.

²³² Derek R Soper and Robert M.Muro and Ewen Cameron, *Op.cit.*, 66-67.

²³³ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing, Ed.cit.*, 139.

²³⁴ R Soper and Robert M.Muro and Ewen Cameron, *Op.cit.*, 59.

²³⁵ Richard M.Contino, *Op.cit.*, 50.

²³⁶ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing, Ed.cit.*, 139.

4.3.5. *Control and collection procedure*

Successful leasing companies usually have certain protective mechanism against the lessee's bad performance. Namely, even the best managed leasing companies have occasionally some payment problems which need to be solved in order to maintain the expected profit."²³⁷

Therefore a leasing company has to monitor the lessee's performance for two basic goals. Firstly, to identify the lessee's, eventual financial difficulty because this way the company could plan a defence strategy. In my opinion it is also important to assess whether it is a temporary or permanent difficulty. If it is a temporary difficulty the leasing company may reschedule the rental payments in a way that it burdens the lessee less during the difficult business time. But if it is more likely that the lessee will fall in a permanent difficulty which means that he will not be able to perform its obligations then the leasing company should find a final strategy to protect the leased collateral. Secondly, it is also important to identify the lessees' who from time to time pay late. It is quite obvious that late payment could generate problems to the lessor. Namely, the company expects to get prompt payment since delay means loss in the anticipated cash flow. This further produces loss in the yield. Thus, the companies usually provide high interest rate in the case of delay to discipline the lessee's performance.²³⁸ Although this solution could have a deterrent effect the leasing company should also provide early termination clause in the case of delayed payments. This is quite logical since several delays could mean substantial losses in the anticipated rentals so the leasing company might have interest to find a more prosperous lessee.

Moreover, it is important for a leasing company to closely monitor delinquencies. This could include numerous measures. One of the most efficient measures is to visit occasionally the lessee's premises. This is considered as a highly recommended measure since having direct insight to the lessee company is always worth much more than solely

²³⁷ *Ibid.*, 161.

²³⁸ *Ibid.*, 161-162.

reviewing the lessee reports' and balance sheet data's. Moreover it could be also beneficial to monitor the lessee's sector industry since any economic down cycle in that industry could have a direct impact on the lessee's businesses.²³⁹

Many companies take action already if the lessee is two business days late with the payment. First the customer is called up by a collection officer to whom he should explain the reason for delay. The collection officer will proceed with follow up calls, until the payment is made. If the response is not satisfactory, the leasing company management is warned that additional action should be made to collect the account.²⁴⁰ The additional measures should include termination of the agreement and repossession of the good.

In this context, it worth's mentioning that repossession plays a significant role in the leasing industry. This could be explained by the fact that it works simple. The leased good serves as a primary security and no additional collateral is needed. Therefore, the leasing company in the event of the lessee's default simply repossess and disposes of the goods. It is crucial for the legislator to give a clear regulatory framework of repossession. Without clearly stating this mechanism the lessor might find the lessee claiming that it received equity in the equipment and therefore the inevitable result would be a long and costly judicial procedure.²⁴¹

Under the US framework, this device includes not only judicial repossession, but self -help as well. As I stated earlier leasing companies realized that it could be more efficient and less costly to recourse to self-help. For this reason, they developed their own enforcement office or hired debt collectors' agency that specialized in implementing the self-help without breach of peace.

²³⁹ Malchom Rogers, *Risk underwriting*, *Ed.cit.*, 38-39.

²⁴⁰ Peter K. Newit and Frank J Fabbozi, *Equipment Leasing*, *Ed.cit.*, 162.

²⁴¹ Linda Deelen and Mauricio Dupleich and Louis Othieno and Oliver Walkein, *Leasing for Small and Micro Enterprises*, *A guide for designing and managing leasing schemes in developing countries*, see at: www.ilo.org/public/english/employment/finance/download/leasing.pdf

5. THE SERBIAN LEASING INDUSTRY

The Serbian leasing industry has showed a rapid growth in the previous years. According to the last report of National Bank of Serbia the total balance sheet assets held by the leasing companies was about 106.1 billion RSD.²⁴² Of course, as I have already mentioned this implies that we are dealing with an amount which presents a significant part of the Serbian GDP. It involves a great deal of consumer leases, but it also generates a significant cash-flow operation in several Serbian market sectors like: transport, warehousing and communications, trade, processing industry, agriculture.²⁴³ For these reasons, given that Serbian leasing industry has a pivotal importance for the Serbian economy, the National Bank in Serbia has a special department which exclusively deals with the supervision of financial leasing in order to provide market stability and prosperity. In addition, the leasing companies in Serbia formed together an association which helps them to advocate better their current needs before the government and propose any necessary legal amendments which would help more in boosting the leasing market.

5.1. Basic structure

The first striking thing related to the Serbian leasing industry is that there is a great dominance of the financial sector. Namely, there are 17 leasing companies altogether and almost all of them are branches of banks which are specialized to leasing activities. Only 3 leasing companies do not represent banks, but establish a form of captive leasing companies (Lipaks, Porsche Leasing, Zastava Leasing).²⁴⁴ Obviously, the fact that there is a lack of a more complex and sophisticated industry (which would also involve for example brokers and independent leasing companies) could be explained on the ground that the Serbian leasing market has just emerged recently in the last couple of years.

The other obtrusive feature of this market is that there is an absolute dominance of foreign ownership.²⁴⁵ This clearly tells us that the domestic market players lacks the

²⁴² *Report for Q3 2008* by National Bank of Serbia, 6.

²⁴³ *Ibid.*, 14.

²⁴⁴ *Ibid.*, 3.

²⁴⁵ *Ibid.*, (In a case of 11 leasing companies there is a majority or 100% foreign ownership, in a case of 5 leasing companies there is a majority of domestic ownership but with a foreign capital.)

sufficient funds and expertise to operate leasing activities. In other words, in order to establish the Serbian leasing market the only inevitable solution was to let foreign banks to establish their leasing branches in Serbia given the fact that they are liquid and have the necessary expertise for the leasing activities. Unfortunately, the domestic companies could not expect to compete with the foreign leasing companies in the short run since they lack both the knowledge and the funds.

5.2. The supervision of the Serbian leasing industry

One of the key features of the Serbian leasing industry is that it is under the constant supervision of the National Bank. As I have already stated given the significance of leasing activities in the Serbian economy on the macro level, the National Bank realized that it should constantly review the activity of leasing companies just as it does with the Serbian commercial banks in credit dealings. Therefore, it monitors the performance, prepares quartal reports on the leasing companies' activity and brings secondary legislation by which the leasing companies must comply with. Of course, it has the exclusive authority to grant, but also to revoke licenses for leasing activities.²⁴⁶

Following this line, the leasing companies need to satisfy a lot of technical requirements. First of all, the founders of the leasing companies are obliged to send their request to get the license. The founders need to submit among others: the article of association, proof that the necessary cash is paid (which amounts to the minimum capital requirement), proof of conformity with technical requirements and the business plan for the next three years.²⁴⁷ According to this criterion the National Bank will decide whether to give license to the company. If the relevant company gets the license, it will have to constantly comply with the National Bank's secondary legislation.

The first and foremost duty of leasing companies is to show their cost of financing through the effective lease rates. This way the National Bank gets the comparable data of financing among lessors, and among the lessors and banks. The leasing companies are also obliged to send quartal financial reports to the National Bank by which it could control the activity and remove any disturbance from the market. Finally, leasing companies are obliged to allocate reserves on borrowings from abroad at 20% The

²⁴⁶ see at: <http://www.nbs.rs/internet/cirilica/57/index.html>

²⁴⁷ *NBS zadužena za izdavanje dozvola lizing kompanijama*, 23 September 2005 see at: <http://www.emportal.rs/vesti/srbija/5926.html>

National Bank wanted this way to enhance the stability of leasing companies, to stop the continuously increasing tendency of foreign borrowings.²⁴⁸ However, this created a great discontent from the leasing companies. They consider that with this measure they practically lose 20% source of financing which is hard to recover given the fact that the domestic banks don't have enough funds for financing or their financing is more expensive.²⁴⁹ Under these circumstances, they consider that the refinancing costs have to be passed on to the lessees and given the fact that in almost 90% of the cases the lessees are commercial entities, the whole economy suffers indirectly.²⁵⁰

5.3. Operative and finance leasing

The National Bank prepares reports only financial leasing; however there is also a growing industry in operating leasing, in particular leasing of cars. This implies that the total report of the National Bank would have been substantially different if it had included operating leasing as well.

According to the director of NLB leasing company car leasing companies made a 220 million Euro profit in 2008, which increased in that year the total leasing industry profit by 20 %.²⁵¹ Still the underlying idea of the National Bank and the Serbian legislator is that financial leasing plays the major role in the Serbian leasing industry given the fact that it finances the small and middle sized companies meaning that it drives the whole national economy. However, I do think that it is important to reflect also the operational leasing position in the Serbian leasing market since the 20% contribution to the total income is not a trivial a sum.

The operational leasing is more a way of renting than financing. Therefore, it fits the purpose of companies who have the constant need of changing the car inventory. It becomes popular mainly among consumers since it does not require a particular credit standing. What only matter is that the consumer does not have negative record in the

²⁴⁸ NBS donela Odluku o uslovima za finansijski lizing, 18. January 2006 see at: <http://www.emportal.rs/vesti/srbija/6449.html>

²⁴⁹ Vladimir Jamšek, "Hypo Alpe-Adria Leasing" - za mala preduzeća lizing bolji od kredita, 13. June. 2008. see at: <http://www.ekapija.com/website/sr/page/176013>

²⁵⁰ Vladimir Jamšek, "Hypo Alpe-Adria Leasing" - za mala preduzeća lizing bolji od kredita, 13. June 2008 see at: <http://www.ekapija.com/website/sr/page/176013> and Report for Q3, National Bank, 12.

²⁵¹ Dušan Stankov, direktor NLB lizinga u Srbiji, Lizing u Srbiji porastao 20%, 19 February 2008, see at: <http://www.ekapija.com/website/sr/page/154720>

General Serbian Credit Office (Kredit Biro).²⁵² The lessee probably does not have too have a particular credit standing since the operational term is shorter meaning that the costs and risks are also significantly lower. The assumption that the costs are lower is supported by the fact that in the Serbian leasing market lessees pay lower rental payments for operating leasing, than for financial leasing.²⁵³ In addition, the lessees also benefit from operating leases in a sense that they are charged with monthly invoices which are accounted as expenses and not liabilities. Of course, the leasing companies benefit from operational leasing as well since it does not go under the supervision of the National Bank which implies higher economic freedom.²⁵⁴

However, the Serbian leasing companies could also invoke strong reasons in favor of financial leasing. Namely in the case of operative leasing the Code of Obligations applies meaning that the Leasing Companies could not use in this case the concepts which are inherent in the Law of Financial Leasing. In other words, they could not use the benefits of repossession procedure and super priority creditor treatment. Moreover, leasing companies obviously do not like in operating leasing that the lessee could rescind the contract at the contractually agreed termination dates and that the lessor bears all the risks in relation to the leasing object.

5.4. Balance sheet structure

The National Bank's data about the aggregate balance sheet of leasing companies' are self-explanatory. Firstly, there is an obvious tendency of preferring long-term investments. Namely, whereas long term receivables encompass more than 78 % of the total balance sheet asset, short term financial receivables are less than 1%.²⁵⁵ The legitimate question is whether this sharp disproportionality is justifiable? Long-term investment could provide stability in a sense that they generate regular cash-flow on a long-time basis. But if there is a margin of error in calculating the costs, or it turns out that the lessee does not have the proper credit standing long term investments could be

²⁵² *Lizing na tržištu Srbije ipak, posluje, sve profitabilnije - privreda i građani već zaduženi 8,7 milijardi dinara*, 29. April 2008, see at: <http://www.ekapija.com/website/sr/page/167906>

²⁵³ *Ibid.*,

²⁵⁴ Dušan Stankov, direktor NLB lizinga u Srbiji, *Lizing u Srbiji porastao 20%*, see at: <http://www.ekapija.com/website/sr/page/154720>

²⁵⁵ *Report for Q3 2008*, National Bank of Serbia, 7.

highly unprofitable. On the other hand, short term investments are not so stable but since the stake is significantly lower there is less to lose. In addition, short term investment could generate efficiently and swiftly sufficient amount of cash-flow which is inevitable for a permanent leasing operation. Therefore, the leasing companies should make a slightly better balance between the long and short term investments. Secondly, it is evident that the asset side does not match the liabilities. While the long term receivable is 79 % of the balance sheet asset, the long term liabilities presents 88 % of the liability side.²⁵⁶ The National Bank and the Serbian Leasing Association should be extremely wary about this situation. This disproportionality could be particularly dangerous if the liability side matures before the asset side or if the lessees affected with economic downward conditions could not pay in the regular interval which in turn generates that the lessor could not cover its liabilities.

Furthermore, we could also notice that there is a sharp disproportionality between long term liability and short term liability. The short term liabilities encompass only 3.7% of the total liability side.²⁵⁷ The leasing companies obviously prefer the long-time borrowings from foreign sources, because it is less costly then to find a new source of financing in regular short intervals. However, it should be taken into account that long term liability should go together with a more rigorous discipline. Otherwise, long term borrowings could be accumulated until an unsustainable level which may collapse. In this regard, given the fact that short-term borrowings is easier to discipline the leasing association should reconsider whether there is a need for a slightly different relationship between the long term and short term debt.

5.5. Market share

The National Bank of Serbia monitors the Serbian financial leasing market and rates the position of different leasing companies taking into account their total balance sheet assets and a special index indicator. This way the National Bank could have the exact data about the position of the leasing companies which could help the Government and the National Bank to adopt adequate macro economy measures. On the other hand, leasing companies are driven to attain the best rate they could since better rating goes together with better

²⁵⁶ *Ibid.*,

²⁵⁷ *Ibid.*,

access to the source of funding. Generally, the market share data are not very balanced since the first four rated companies took the position of almost 70% of the market.²⁵⁸ Therefore, the legitimate question which could be raised is whether the Serbian leasing market is not too oligopolical? Do the first four ranked companies leave room for other companies to stay in the business? What gives a light of hope is that the market share data show constant competition between the rest of the 14 leasing companies. In other words, there is a constant up and down movement on the ranking list (except for the first four).²⁵⁹

5.6. Profit and lost account

What is quite particular feature of Serbian leasing industry is the crucial role of foreign exchange rates in both losses and gains. Namely, foreign exchange rate gains encompassed more than 70 % of the overall profit. In comparison to this, 25% total profit of interest income is a trivial gain. Similarly, foreign exchange rate losses provided more 70% of total losses.²⁶⁰ So how could we explain this extraordinary tendency? Obviously, the RSD shows inflantory tendency and exchange rates risk so the leasing companies Endeavour to protect themselves by using a currency clause.²⁶¹ Under these currency clauses the payments are tied to foreign currencies, typically Euros or Swiss Francs. By financing in EUR or CHF, the leasing companies can offer substantially lower interest rates (the RSD interest rates are substantially higher than EUR or CHF interest rates). Nevertheless, the constant fluctuation of the Serbian Dinar in relation to the Euro or Swiss Francs, results in an increased foreign exchange risk for the lessees, who typically have their income in Serbian Dinars. Furthermore, as the Serbian Dinar constantly fluctuates in relation to these currencies, the leasing companies also record significant gains and losses from the exchange rate fluctuations.

5.7. Lessees

It is also charecteristical of Serbian leasing industry that the far greatest portion of financial leasing is approved to legal entities (82% percent), while natural persons encompass only about 8% percent.

²⁵⁸ *Ibid.*, 9.

²⁵⁹ *Ibid.*,

²⁶⁰ *Ibid.*, 11.

²⁶¹ *A guide on financial leasing*, National Bank of Serbia, 6.

Obviously, the reasonable approach here is that legal entities have a far better credit standing since they have larger funds and they could generate cash flow from using the leasing object. On the other hand, natural persons usually do not have such good credit standing given the fact that they lack the fund, the activity which generates cash flow and the plan how to pay back the rental schedule. The National Bank realized the danger that in consumer leases the clients could be easily tempted to jump into deals without sufficient fund covering the debt. Therefore, the National Bank prescribed that natural persons need to pay at the time of the conclusion of the contract 20% of the gross value of the leasing object. This way the National Bank made an effort to eliminate the risk of entering into agreements with natural persons who go into leasing without any prudent considerations, without any plan how to comply with rental schedule obligation. In order to encourage better performance it also prescribed that natural persons rental payment obligation could not exceed 30% of their regular income.²⁶²

On the other hand, the data which evidences that leasing deals are mainly approved to legal entities, strongly suggests that the Serbian leasing industry mainly serves commercial goals. In other words, leasing could be a perfect tool for small and middle size enterprises that have the idea, the plan and the demand but lack sufficient fund to startup the new business establishment. In addition, Serbian small and middle size companies could easily go to new business ventures with less minimum equity requirement than in the case of banks. The logic is simple. In case of banks there is a need of additional collateral and banks would hardly conclude the deal without this guarantee.²⁶³ On the other hand, since leasing relies on the retention of title mechanism, there is no need for additional collateral which implies that the whole deal could be easily concluded.

5.8. Performance indicators

The National Bank of Serbia for purpose of assessing the risks and the performance quality includes a variety of performance indicators like: “*Return on average assets (ROA), Return on average equity (ROE), Total Debt to equity, Long term debt to equity, Coverage of interest expenses, Operating expenses to average investments, Average*

²⁶² *Ibid.*, 2.

²⁶³ Vladimir Jamšek, *Op.cit.*,

lending rate and Average deposit rate and Net interest margin.”²⁶⁴ All these indicators give valuable insight to the current position of Serbian leasing industry. According to the last National Bank supervision report there is a decline in the leasing industry profitability since there is a decrease in return on average asset and average equity. What is particularly striking is that the current total debt is 15 higher than the equity. Still what is a particularly positive result is that there is a decline of operating expenses versus the average investment which implies that there is an increased efficiency in the financial leasing market.²⁶⁵

5.9. Sources of financing

The Serbian leasing market has a very simple structure of financing. Namely the greatest portion of leasing activities is financed through foreign bank borrowings.²⁶⁶ In this relation there is a sharp contrast between Serbian and US leasing industry. On one hand, in the US leasing industry there are many ways of financing (bank borrowings capital markets borrowings, leasing syndication, non-recourse financing), plus a very efficient tendency of leasing securitization which generates swift method of financing. In contrast in Serbia leasing companies almost exclusively finance themselves through classical bank finance.

This produced the result that foreign borrowings encompasses almost 86% of the total liabilities and as I stated earlier there is a particular dangerous mismatch between asset and liabilities owing to this fact. However, this striking fact is not so perilous as it seems since in the most cases the foreign creditors are the founders of their Serbian leasing branches. Secondly, given the fact that there is a constant rise of foreign borrowings the National Bank obliged leasing companies to form their reserve funds to enhance their market independence, liquidity and stability.²⁶⁷ As the National Bank report states:” *the leasing companies are obliged to allocate reserves on credits, other types of borrowings and supplementary payments from abroad.* However, “*since the introduction*

²⁶⁴ *Report for Q3 2008*, National Bank of Serbia, 14-15.

²⁶⁵ *Ibid.*,

²⁶⁶ *Ibid.*,

²⁶⁷ *Ibid.*,

of reserve requirements, the amount of allocated reserve balances rose due to the ever increasing borrowing abroad."²⁶⁸

5.10. Current challenges

The global economic downturn has not avoided the Serbian leasing industry. Several serious problems have risen. How to return the aggregate demand to its previous position? How to tackle the clients' payment problems? How to cover the liabilities when there is a problem in timing of lease payments? All these questions are hard to answer. Still every problem has its answer. Consequently the Government and the Leasing association have numerous proposals. In addition, we should not forget that a hardship period in a particular sector is always a good opportunity to review the whole system and to realize potential mistakes which could be improved.

The Government adopted measures which could stimulate the aggregate demand for some leasing products. It decreased the tariff for import on cars and provided subsidies for consumer leases.²⁶⁹ Again these macro measures are perfect examples of the pivotal importance of leasing for the Serbian national economy.

The Leasing Association claimed that they had to decrease the level of their threshold activity due to the non-regular payment of the clients. They stated that they would endeavor to find a common solution with their client (reprogramming the obligation, extension of the deadline) and only as a last instance will they take recourse to repossession. In relation to the clients' payment problems the president of Serbian leasing association Bojan Basa rightly notices that we are dealing here with two particular problems. Firstly, clients bear the exchange risk which automatically increases the clients' credit risk, which in turn could generate the result that the client will be not able to pay its obligation. Secondly, Serbia still has enforcement procedure problems in relation to leasing contracts.²⁷⁰

Despite the fact that there is a sound legal framework for repossession procedure it still happens as the president of Serbian leasing association notices that the leasing company "waits one year for the enforcement of the decision. (Of course,) it would be

²⁶⁸ *Ibid.*, 16.

²⁶⁹ *Lizing kompanije imaju problem sa naplatom 20 March 2009*, see at: <http://www.emportal.rs/vesti/srbija/82909.html>

²⁷⁰ *Ibid.*,

unthinkable in the developed legal countries where the enforcement procedure lasts not more than six days."²⁷¹ This could be explained on the ground that the courts are overburden with legal cases and that there is a lack of courts enforcements administrators.²⁷² This means that although the proper legal framework is there, it could not be fulfilled due to the poor technical conditions. On the other hand, we could note that the leasing companies are aware of the significance of the repossession mechanism. Namely, similarly to the US pattern Serbian leasing companies hire a special collector agency which helps in the collection of debt. All together, 14 Serbian leasing companies hired VIP SL Security agency which has the task to reach an arrangement with the client and to send report to the leasing company. According to the report the leasing company will decide to proceed with the repossession procedure at the court or to extend the Lessee's payment period. So although this collector does not recourse to self-help still its occasional occurrence at the client's door may have a strong psychological effect on the debtors. The help and the expertise of the collector agency could be particularly important now in the time of global economical crisis when the number of cars being returned to the lessor became 10 times higher than in the previous years.²⁷³

Bojan Basa goes on to say that there is also a problem with decreasing necessary foreign credits. Therefore, he appeals to the National Bank to release at least a part of the reserve fund. He contends that 160 million Euros is placed in the reserve fund. This significant amount of money would be able to better enhance the supply and the market strength of the leasing companies. He states that the release of these funds even under the control of its use would significantly improve the quality of supply of the leasing companies.²⁷⁴

Moreover, leasing companies also consider that it would be inevitable to extend the scope of Law of Financial Leasing to other activities beyond financial leasing. Their firm belief is that by widening the range of services they would enhance their competitive

²⁷¹ *Ibid.*,

²⁷² Dušan Stankov, *Op.cit.*,

²⁷³ *Broj vraćenih vozila u Srbiji, kupljenih na lizing, udesetostručen u odnosu na 2007*, 19. Decemeber 2008, see at: <http://www.ekapija.com/website/sr/page/210240>

²⁷⁴ *Lizing kompanije likvidne, problem likvidnosti privrede*, 21. March 2009, see at: <http://www.biznisnovine.com/cms/item/stories/sr.html?view=story&id=32180§ionId=9>

strength.²⁷⁵ This is a reasonable request especially compared with the US leasing industry which deals with several different leasing activities (conditional lease, synthetic lease, leveraged lease, trac leases, service lease, etc.) In addition, the leasing companies also require to extend their leasing activities also to real estates which is a generally accepted practice elsewhere. For example, in Slovenia, where the total annual aggregate leasing asset was about 1.2 billion Euros, almost 500 million Euros was directed on real estate leasing activities.²⁷⁶ This data clearly shows us that Serbian leasing companies could significantly enhance their position by extending their activities to real estate as well. It is widely considered that it would particularly fit the companies aim to get real estate with preserving their working capital. In addition, this would provide flexibility since if the company wants to get rid of the real estate it simply revokes the leasing contract instead of selling the real estate which would be harder and more costly.²⁷⁷

However, despite the fact that real estate leasing offers compelling advantages it is simply not feasible in Serbia. The great problem is that Serbia does not have an efficient real estate record system. The facts that the records are not maintained properly and that many real estates are not recorded present particular hardships.

The time will show how could the Serbian leasing industry solve the economical challenges and improve its unfinished legal framework. But one thing is for sure. The Serbian leasing industry will always have to find the answer for three major challenges as the president of the Serbian leasing association rightly noted: *“how to maintain the liquidity of leasing companies and its clients, how to manage potential risks and finally how to tackle with the regulatory obstacles which could impede the boost of Serbian leasing market development.”*²⁷⁸

²⁷⁵ *Lizing usluge u Srbiji –moguca unapredenja*, 02. Novemeber 2007, see at: <http://www.mfin.sr.gov.yu/news-srl/1312/>

²⁷⁶ *Sta koci lizing za nekretnine*, 16. December 2005, see at: <http://www.emportal.rs/vesti/srbija/6257.html>

²⁷⁷ *Lizing nekretnina u Srbiji- bez regulative*, 27. June. 2008, see at: <http://www.ekapija.com/website/sr/page/178680>

²⁷⁸ *Lizing kompanije likvidne, problem likvidnosti privrede*, see at: <http://www.biznisnovine.com/cms/item/stories/sr.html?view=story&id=32180§ionId=9>

CONCLUSION

Leasing is obviously a complex business device which could boost the entire national economy. In Serbia, as well, as the US, leasing has a significant share in the total GDP. In both countries leasing is a serious competitor to conventional bank credits. In the US we could notice rapid extension of leasing through securitization of leasing receivables, which meant that the leasing company could swiftly undertake new deals since selling the receivables generates the necessary cash flow to finance new deals. On the other hand, Serbia leasing companies finance themselves through the classical banking system owing to the fact that the Serbian capital market is still in an infant stage which does not use widely the instrument of securitization of receivables. However, still the Serbian leasing industry showed a rapid growth since 2003. The reasons are pretty obvious.

One of the main reasons is that with the enactment of the Financial Leasing Act provided the leasing industry with the proper legal framework. It was particularly important since then leasing companies have been able to rely on the mechanisms of repossession procedure and the super priority of the lessor versus other creditors. Without these legal devices leasing companies could hardly operate efficiently. The pivotal importance of the legal framework for the leasing companies is obvious when we take into account that 17 leasing companies were set up in the Serbian market after the enactment of the Law of Financial Leasing and their total balance sheet assets exceeded 101,5 billion RSD.

In addition, the rapid extension of leasing deals in Serbia could be also explained on the ground that leasing works with less rigorous conditions than the credit. It is much easier to acquire an asset through leasing, than through traditional bank financing, because the retention of title mechanism applies meaning that there is no need for additional collateral. Of course, given the fact that there is no need for additional collateral, leasing is less costly (Serbian leasing rates are on lower level than interest rates on traditional bank loans).

Still sound legal framework is not sufficient when it is not properly enforced. The Serbian Leasing Association complained that despite the adequate legal framework, the repossession procedure does not work efficiently since the courts, who are overburden

with cases do not react promptly and there is also a lack of sufficient number of enforcement administrators. In other words, it would be extremely important to provide the technical requirements for effectively applying and enforcing the proper legal framework.

However, the proper legal framework is not worth much if the Serbian market is not efficient and the leasing companies do not show proper expertise in the management of their company. Obviously, the Serbian market is still an emerging market which means that the conditions of financing the leasing companies are more costly and less efficient. We could see this when we compare the US and Serbian leasing market. In the US there is a swift method of financing through securitization of leasing receivables. Through selling the receivables the company swiftly gets the necessary funds for new deals. Of course, the US uses many other ways of financing such as bank funds, syndication, capital markets borrowing and non-recourse financing.

On the other hand, the Serbian leasing industry almost in 88% finances itself with foreign banks borrowings. It could be explained on the ground that domestic borrowings are more expensive and that there are no developed alternative financial instruments. This way the Serbian leasing companies too heavily depend on foreign bank borrowings so they are less independent. The foreign borrowing took such a serious impetus that the total liabilities to foreign creditors became higher than the total book value of fixed assets in the balance sheet of Serbian leasing companies.

Apart from the poor Serbian market conditions, the Serbian leasing companies themselves made some serious mistakes in managing their companies. One of their serious mistakes is that they let the liability side to grow to such an unsustainable level. The other thing is that in the first couple of years some leasing companies let some clients to borrow through leasing despite the bad credit standing. In addition some greedy leasing companies charged natural persons with too high rentals which were not sustainable. The effect of these mistakes could be felt today when large number of clients could not pay and leasing companies could hardly cover their liability side.

Fortunately, the National Bank realized these dangerous steps so it implemented proper measures. It obliged lessee's natural persons with an initial minimum down payment of 20 % and with the maximum rental obligations of 30% of the regular income.

It also obliged the leasing companies to form reserve funds to enhance their market independence and competitiveness.

All in all, for a successful leasing industry we need the proper legal framework, a developed market, expert management and an efficient supervision of the whole industry. The US leasing pattern shows us that it is possible to provide all these conditions. The Serbian leasing industry has proved a lot taken into account that it is still an infant industry. However, the Serbian leasing industry still has to do a lot to face the challenges efficiently and to improve its market position. It would be crucial for the Serbian leasing association to realize that the Serbian leasing industry could not pass the test successfully without implementing these extremely important conditions.

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