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Regulating buyout financial leasing based on the credit model: Clarifications provided by the Plenum of the Russian Supreme Commercial Court

Grigory Chernyshov
Partner, Moscow
+ 7 495 787 3045
gchernyshov@whitecase.com

Pavel Boulatov
Counsel, Moscow
+ 7 495 787 3080
pboulatov@whitecase.com

This alert analyses key changes in the regulation of buyout financial leasing, as adopted by the Plenum of the Supreme Commercial Court of the Russian Federation (the "SSC") in its Resolution No. 17, dated 14 March 2014, "On Certain Issues Relating to a Buyout Financial Leasing Contract" (the "Resolution")[1].

The Resolution will contribute to developing financial leasing relations in the Russian market. The most important achievements of the Resolution include:

- defining "financial leasing" through the notion of a facility secured by the transfer of title to the lessor (title financing), in contrast to the former approach where financial leasing was treated as a lease;
- establishing the balance-based method for calculating settlements between the parties to a financial leasing contract if the contract is terminated;
- confirming a principle according to which the parties to a financial leasing contract must cooperate in order to mitigate the risks of the leased object not being supplied;
- providing the lessee with a right to claim reimbursement of losses from the relevant third parties (e.g. the supplier, the insurer) if it is the lessee that bears the risks of incidental loss;
- setting measures to protect a diligent sub-lessee in financial sub-leasing transactions; and
- protecting the lessee's rights if the lessor fails to perform the obligations secured by the pledge of the leased object.

Scope of application

The provisions of the Resolution cover buyout financial leasing contracts[2]. Such contracts provide for the transfer of title to the leased object to the lessee if the lessee has paid all the buyout payments, including the buyout price, even if it is merely a nominal payment. The Resolution does not cover situations where, for instance, the lessee may decide not to buy out the leased object and the lessor, therefore, bears the risk of not being reimbursed for the remaining book value of the leased object.

1 The Resolution was published on the SCC's website on 3 April 2014: *http://www.arbitr.ru/as/pract/post_plenum/106570.html*

2 Clause 1 of the Resolution. The SCC Presidium earlier provided the definition of "buyout financial leasing" in Resolution No. 16533/11, dated 22 March 2012 (CJSC Baltdraga v OJSC Bank Saint Petersburg and LLC Leasing Company Scandinavia; hereinafter – the "Baltdraga's Case").

White & Case LLC
4 Romanov Pereulok
125009 Moscow
Russia
+ 7 495 787 3000

Nevertheless, some provisions of the Resolution can have a wider application and cover, by way of analogy, any financial leasing contracts. Such general provisions include the rules for allocating risk in a situation where the leased object has not been delivered[3], the provisions stipulating the procedures for recovering (i) the penalties from the supplier if it breaches delivery terms[4], and (ii) the insurance compensation if the leased object has been lost or damaged[5].

Credit-based financial leasing model

The Resolution defines "buyout financial leasing" based on the facility that the lessor provides to the lessee. Repayment of the facility is secured by the lessor acquiring the title to the leased object until the lessee buys it out. The lessee's interest lies in acquiring the title to the leased object while the lessor's interest is in receiving its principal amount back with a profit[6].

Hence, the SCC Plenum has overruled the previous case law that treated financial leasing as a lease. Now the Resolution considers financial leasing as financial relations relatively similar to lending against pledged security.

A secured transfer of title to the leased object is specific since this type of security terminates when the lessee has made all the contractual payments, unless the parties have expressly agreed on different terms and conditions for the transfer of title[7].

According to the Resolution, the title to the leased object may still pass to the lessee in the above circumstances if the lessor is undergoing bankruptcy. Therefore, if the lessee has made all the contractual payments, the lessee's claims are not to be included in the creditors' register and the lessee may withdraw the leased object from the bankruptcy estate.

At the same time, the SCC Plenum has not clarified the relationship between the parties in a situation where the lessee has not made all the contractual payments in full, leaving open the question as to whether or not the lessee's claims would be included into the register in this case and whether or not the lessee would enjoy any priority in respect of the leased object it possesses[8]. Nevertheless, it seems that, when a financial leasing contract concluded with a lessor that later becomes bankrupt is terminated and the balance of reciprocal obligations (which will be discussed later) is in favour of the lessee, the latter may retain the leased object according to the rules of lien and it acquires the status of a secured creditor[9].

Unless the parties have agreed otherwise, the title may also be transferred if the lessee has made all the contractual payments but the lessor avoids formalising a transfer and acceptance certificate, a sale and purchase agreement or other documents.

Previously, the lessor could avoid signing the above documents in order to create a cross-default – a situation where the breach by the lessee of its payment obligations for a given leased object caused the lessor to refuse to transfer the title to another leased object. From now on the lessor must agree in advance on the terms and conditions of the transfer of title or use various contractual structures to create a similar situation. For instance, a financial leasing contract may provide that, as of the time when the title to the leased object is transferred to the lessee, the leased object will be regarded as pledged to the lessor to secure the lessee's obligations under another financial leasing contract.

Balance-based calculation method

The Resolution[10] stipulates a balance-based method to calculate reciprocal claims between the parties to a financial leasing contract when the contract is terminated and the leased object is returned to the lessor[11].

3 Clause 5 of the Resolution.

4 Clause 6 of the Resolution.

5 Clause 7 of the Resolution.

6 Clause 2 of the Resolution.

7 Article 19 of Federal Law No. 164-FZ, dated 29 October 1998, "On Financial Leasing (Leasing)" (the "Law on Financial Leasing") allows the parties to agree on different terms and conditions for the transfer of title. In addition, when the SCC Presidium was discussing the draft Resolution, the drafters underlined that the lessee making all leasing payments cannot be regarded as an imperative condition for the transfer of title to the leased object.

8 It should be noted that the status of the lessor's claims against a bankrupt lessee has been regulated by clause 13 of Resolution No. 63 of the SCC Plenum, dated 23 July 2009, (as amended on 6 June 2014) "On Current Payments under Monetary Obligations in a Bankruptcy Case". According to this clarification, if a financial leasing contract had been concluded and the lessor had provided facility to the lessee before bankruptcy proceedings were initiated against the lessee, the lessor's claims against the lessee based on the balance of reciprocal obligations (which will be discussed later in this alert) are treated as claims included in the register.

9 It seems that, clause 29.5 of Resolution No. 63 of the SCC Plenum, dated 23 December 2010, (as amended on 30 July 2013) "On Certain Matters Relating to the Application of Chapter III.1 of the Federal Law "On Insolvency (Bankruptcy)"" may be applied, by way of analogy, to the termination of a financial leasing contract in the case at hand. This clause regulates the relation between restitution and lien of a thing if the transaction concluded with a bankrupt contracting party is null and void or has been recognised as invalid on general grounds provided by civil legislation. It is possible to use such analogy because, when a contract is being terminated, similarly to a situation where the transaction is recognised as invalid or null and void, the need arises to settle reciprocal obligations of the parties.

10 Sub-clause 3.1, Clause 3 of the Resolution.

11 The SCC Presidium previously used the balance-based calculation method in Resolution No. 9860/11, dated 6 December 2011, (LLC IZH-Line v CJSC Evroplan). It noted that courts, while considering claims involving early withdrawal of a leased object, should compare the total payments received from the lessee and the money received from selling the leased object against the costs that the lessor has incurred. Later on, the SCC Presidium supplemented this court practice with its Resolution No. 17389/10, dated 12 July 2011, (LLC Meta-Leasing v OJSC Partner-M) and Resolution No. 1729/10, dated 18 May 2010, (LLC FIS-TEKHNO (LLC Kvadrat after reorganisation) v LLC Evrotekhnika). These Resolutions gave the lessee a legal basis to refund the leasing payments in accordance with the rules of unjust enrichment (Article 1102 of the Russian Civil Code (the "Civil Code")) as the financial leasing contract was terminated early on the lessor's initiative.

The SCC Presidium applied the balance-based theory in a recently published Resolution No. 4664/13, dated 15 July 2014, (LLC TK Intrans v LLC Baltic Leasing) in a case seeking recovery of unjust enrichment on the part of the lessor. The Presidium permitted only the balance of reciprocal obligations between the parties to be recovered from the lessor and reduced the recovered amount by the investment costs of the lessor.

This method is in line with the nature of financial leasing. Financial leasing involves a facility, for which, after the funds have been utilised, the final obligation of one party to the other party, as of the contract termination date, is determined as the difference in the consideration of the lessee (the subtrahend in the calculation formula) and the consideration of the lessor (the minuend in the calculation formula).

If this difference is in favour of the lessor, the lessor may recover it from the lessee and vice versa.

The consideration on the part of the lessee is a sum of leasing payments (apart from the advance payment paid by the lessee) and the value of the leased object returned to the lessor[12].

Importantly, the value of the leased object should be determined as at the time when the leased object is returned to the lessor. This value is to be determined on the basis of the amount of proceeds that the lessor has received upon the sale of the leased object or on the basis of a professional valuation. The lessee may contest the purchase price of the leased object. In this case the court should consider, in particular, the valuation[13] and should also take into account the defects specified in the acceptance certificate formalised when the lessee returned the leased object to the lessor[14].

The obligations and expenses of the lessor include the facility that the lessor has provided to the lessee, annual interest accrued on such facility until it was actually repaid, as well as the losses that the lessor has suffered and other sanctions stipulated by law or the contract[15].

The financing provided by the lessor consists of the purchase price of the leased object (decreased by the advance payment the lessee made) and the expenses on delivery, repair and transfer of the leased object to the lessee, etc.[16]

Payment for the financing that the lessor provided to the lessee is calculated as an annual interest accrued on the facility. The parties may agree on the interest rate in the contract. If no such rate has been agreed, the court will calculate the interest rate by applying the formula provided in the Resolution[17].

12 Sub-clauses 3.2 and 3.3, Clause 3 of the Resolution.

13 Once the Resolution was published, case law has followed the legal position according to which a professional valuation is regarded as proper evidence if the purchase price of a leased object is being questioned (Resolution No. A40-95462/13-35-874 of the Federal Commercial Court (the "FCC") for the Moscow Circuit, dated 10 April 2014).

14 Clause 4 of the Resolution.

15 Sub-clauses 3.2 and 3.3, Clause 3 of the Resolution.

16 Sub-clause 3.4, Clause 3 of the Resolution.

17 Sub-clause 3.5, Clause 3 of the Resolution.

Actual damage of the lessor may include expenses for dismantling, repossession, transporting, storing, repairing and selling the leased object; payment for early repayment of the loan the lessor obtained in order to acquire the leased object[18].

Cooperation by the parties to a financial leasing contract to mitigate the risk of non-delivery

The Resolution[19] endorses the rule already developed by the case law[20] that imposes on the parties to a financial leasing contract a duty to cooperate in mitigating the losses for non-delivery of the leased object.

In particular, when the risk of a failure on the part of the supplier is borne by the party to the financial leasing contract that chose the given supplier[21] (which is, as a rule, the lessee), this will not release the lessor from liability for contributing to increased losses or failure to take reasonable measures to mitigate such losses. This liability arises when the lessor is at fault (fails to act as a reasonable and diligent merchant). If the lessor commits such a breach, the lessee may demand that the lessee's liability be reduced.

18 It is possible to recover contractual losses that the lessor suffered after the contract had been terminated, by virtue of Clause 3 of Resolution No. 35 of the SCC Plenum, dated 6 June 2014, "On the Consequences of Terminating a Contract". According to this clarification, "the terms and conditions of a contract, which nature assumes that they will be applicable after the contract terminates... or which are aimed at regulating the relationship between the parties after the termination..., remain to be in effect after the contract terminates".

At the same time, according to this clarification, a penalty stipulated for failure to perform or improper performance of an obligation to take a future action shall not be recovered for the period after the contract has terminated. Consequently, after the financial leasing contract has been terminated, no penalty for breaching the obligation to make future leasing payments shall be recovered. Previously the SCC Presidium had already expressed a similar position in its Resolution No. 1059/10, dated 18 May 2010 (LLC Regional Company NOMOS-Leasing (LLC Baltic Leasing after renaming) v LLC Sibizoterm and LLC Sibgreit).

The draft Resolution also entitled the lessor to recover lost profit when the financial leasing contract was terminated. However, this provision was excluded from the final version. After the Resolution was published, case law has also confirmed that lost profit may not be recovered (Ruling No. 7081/14 of the SCC, dated 18 June 2014).

19 Clause 5 of the Resolution.

20 Resolution No. 17748/10 of the SCC Presidium, dated 12 July 2011 (LLC Remstroi-2 v LLC Praktika LK) sets the obligation of the lessor to mitigate the risks associated with the leased object not being delivered and to exercise due care and prudence when paying money to the supplier for the leased object. Previously, in its Resolution No. 3318/11, dated 25 July 2011 (CJSC Evroplan v LLC Mashinny Dvor), the SCC Presidium formulated a principle that the parties to a financial leasing contract should act being guided, among other things, by considerations of cooperation.

21 Article 22 (1) of the Law on Financial Leasing, Article 8 (1, a) of the UNIDROIT Convention on International Financial Leasing (concluded in Ottawa on 28 May 1988).

Exercising rights under other contracts relating to the leased object

The SCC Plenum has stipulated a procedure for claiming reimbursement under other contracts relating to the leased object, in particular: a procedure for recovering a penalty from the supplier that has breached the obligation to supply the leased object[22], and an insurance recovery from the insurer if the leased object has been lost or damaged[23].

Prior to the Resolution these issues were not clearly resolved in practice, due to the contrary interests that were pursued by the "economic" owner of the leased object (the lessee whose interest was to acquire title to the leased object) and the legal owner (the lessor that was entitled to perform certain legal actions as the owner of the leased object). The SCC took the position that the lessee is entitled to claim the reimbursement of incidental losses if it bears the risk of such losses.

In particular, when the supplier breaches the obligation to deliver the leased object and it is the lessee that bears this risk (since the lessee has to make leasing payments irrespective of whether or not it possesses the leased object), then the lessee is entitled to claim penalty and other sanctions against the supplier for breaching the supply contract.

In situations involving recovery of insurance compensation, the lessee (that bears the risk of accidental loss or damage of the leased object) may demand that the lessor assigns to it the right to claim under the insurance if the lessor refuses to take or avoids taking action to obtain the payment under the policy. In order for the lessee to exercise this right efficiently, the Resolution specifically entitles it to suspend making leasing payments as a remedy if the lessor avoids such assignment. It should be noted that, if the insurance recovery has been paid to the lessee, the lessor may claim from the lessee the amount so paid.

The reimbursement which the lessor received in the form of a penalty or other sanctions for the breach of the supply contract or in the form of insurance compensation should be offset against the lessor's claims against the lessee for leasing payments. If the financial leasing contract has been terminated the above payment should be taken into account while the balance of the reciprocal claims is being calculated. This rule will make it possible to avoid situations where the lessor, having received reimbursement from third parties, additionally claims the leasing payments from the lessee.

According to the Resolution, if an uninsured leased object has been lost, the lessee shall not be released from the obligation to compensate the lessor for the cost of acquiring the leased object and the cost of the facility until these costs are actually reimbursed[24].

22 Clause 6 of the Resolution.

23 Clause 7 of the Resolution.

24 Clause 8 of the Resolution.

Regulating financial sub-leasing relations

The Resolution sets forth a rule aimed at protecting the interests of the sub-lessee if the sub-lessor breaches its obligations to transfer to the lessor the leasing payments which the sub-lessee has paid[25].

Despite the sub-lessor having breached its payment obligations, it will acquire the title to the leased object provided that it has made all the payments under the financial subleasing contract. The functions of a sub-lessor are deemed to be those of an intermediary. The risk of the sub-lessor breaching its obligations to make leasing payments will be borne by the lessor if the lessor knew that the assets were sublet (in particular, if the lessor approved such financial subleasing). This risk may fall on the sub-lessee only if it has been proved that the sub-lessee acted on agreement with the sub-lessor or was legally or economically connected with the sub-lessor from the outset.

This provision drastically changes the practice that had existed previously[26] and will, in many instances, cause financial leasing companies to adjust contractual forms. It is expected that the changes made to contracts will directly prohibit financial subleasing or demand that the sub-lessor provide additional security for defaulting on payment obligations.

In order to comply with the principle of legal certainty and to avoid undermining the reasonable expectations of market participants, this provision of the Resolution will apply to financial subleasing contracts concluded after its publication (3 April 2014)[27].

Correlation between financial leasing "encumbrances" and a pledge of a leased object

The Resolution[28] confirms the previous case law[29] that treated the pledge of a leased object as terminated after the lessee

25 Clause 9 of the Resolution.

26 Previously, the case law assumed a contrary position that the risk of failure to transfer leasing payments was laid on the sub-lessee that did not acquire the title to property because the property was not transferred to the sub-lessor (Resolution No. 16848/11 of the SCC Presidium, dated 24 April 2012, in the case of CJSC Aviation Company Ufa Airlines v OJSC Mezon-Avto and OJSC Leasing Company KAMAZ). However, in its Resolution No. 17388/12, dated 21 May 2013, in the case of OJSC Leasing Company KAMAZ v LLC Avtokolonna N 1 (the "KAMAZ Case"), the SCC Presidium questioned whether this approach was correct.

27 Despite this clause, there is case law where a commercial court applied the Resolution adopted by the SCC Presidium in the KAMAZ Case (as this Resolution provides for the possibility to review judicial acts if they are not in line with the SCC Presidium's legal position) together with clarifications of the Plenum, although the relations that were examined in this case arose out of a financial subleasing contract concluded before the Resolution was published (Resolution of the Eleventh Commercial Court of Appeal No. A65-26130/2010, dated 27 June 2014).

28 Clause 10 of the Resolution.

29 The Baltdraga's Case.

takes possession of the leased object and fully buys it out[30]. This position is aimed at protecting the interests of a lessee in a situation where it becomes aware that a pledge was created either before or after the execution of the financial leasing contract.

It should be noted that, as a general rule, the transfer of title does not terminate the pledge[31]. However, the Resolution specifically stipulates that this rule does not apply to the pledge of leased objects.

Therefore, if the lessor is declared bankrupt, the lessee that has made all contractual payments, will acquire the title to the leased object free from the pledge and the pledgeholder will lose the status of a secured creditor.

Provisions aimed at protecting the interests of a good-faith pledgeholder supplement the above regulation. In particular, if the pledgeholder has not known and should not have known that the object of the pledge is or will be leased out, the pledge shall operate notwithstanding the transfer of title to the object of the pledge to the lessee. The pledgeholder may be aware of the financial leasing if a pledgor is a legal entity carrying out financial leasing operations. In any case, a good-faith pledgeholder should take measures to check if any financial leasing "encumbrances" exist.

The provisions aimed at protecting good-faith pledgeholders preclude the creation of artificial financial leasing "encumbrances" over pledged objects by pledgors seeking to subsequently release the object from the pledge. In general, the legal position to protect a good-faith pledgeholder is in line with the latest amendments made to the legislation on pledges[32].

It is widespread practice to provide lending to purchase leased objects where such objects are concurrently pledged to secure repayment of the loan. Therefore, the Resolution stipulates a welcome provision, according to which a pledge of a leased object simultaneously entails a pledge of the rights to claim leasing payments. It follows from the above that the scope of pledge claims may be determined by the balance of the leasing payments payable before the lessee buys out the title to the leased object[33].

Conclusion

The key achievement of the Resolution is that it has established a uniform approach to financial leasing and recognised it as a financing transaction. This approach is more in line with the nature of the financial leasing relationship than the statutory classification of this type of contract as a lease under § 6, Chapter 34 of the Civil Code.

The SCC Plenum has not determined timeframes for applying the legal positions formulated in the Resolution, apart from the provisions relating to financial subleasing. Consequently, taking into account the above limitation, courts may apply these legal positions when considering cases for which the proceedings have not yet been completed. At present, commercial courts actively apply the clarifications of the SCC Plenum, in particular, the clarifications regarding the balance-based method for calculating and determining the final obligations of the parties to a financial leasing contract on the basis of the calculation formula provided in the Resolution.

Despite the abolishment of the Russian Supreme Commercial Court, the Resolution will remain effective because, under the law[34], clarifications of the SCC Plenum shall remain in force until they are repealed by the Plenum of the newly established Russian Supreme Court.

30 According to Article 23 (2) of the Law on Financial Leasing, the transfer of rights and obligations from the lessor to the acquirer of the lessor's rights includes the obligation to transfer the title to the leased object to the lessee. Since the lessee becomes the owner of the leased object, the leased object is to be forcedly withdrawn from the pledgeholder by way of analogy with Article 354 (2) of the Civil Code.

31 Article 353 of the Civil Code.

32 Article 335 (2, Para. 2) of the Civil Code.

33 Previously, the SCC Presidium took this position in its Resolution No. 17312/12, dated 14 May 2013 (OJSC Sberbank of Russia v CJSC Atlant-M Leasing). This Resolution noted that "if the lessee has made all leasing payments, including the buyout price of the leased object, the value content of the lender's (pledgeholder's) right to the pledged property equates to zero and, therefore, has no economic (value) content".

34 Article 170 (4, Para. 7) of the Arbitration Procedure Code of the Russian Federation of 2002 (as amended on 28 June 2014); Article 3 (1) of Federal Constitutional Law No. 8-FKZ, dated 4 June 2014, "On Amending the Federal Constitutional Law 'On Commercial Courts in the Russian Federation' and Article 2 of the Federal Constitutional Law 'On the Supreme Court of the Russian Federation'".