

LEASING

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Ukrainian Financial Leasing Market

Initially being scarcely developed and poorly regulated type of activity, leasing in Ukraine has developed rapidly in the recent years. One of the reasons for such intensive development has been a heightened interest towards Ukrainian leasing market shown by foreign banks and other participants of the international financial market that are active on the Ukrainian market both directly from abroad and through their Ukrainian subsidiaries. Increased accessibility of credit resources noted in 2005, 2006 and early 2007 also contributed to the domestic leasing market growth.

In particular, as at 31 December 2007, the portfolio of leasing contracts signed up by resident lessors comprised approximately 15,200 agreements in the aggregate amount of UAH 20.23 billion, including approximately 4,200 agreements in the amount of UAH 3.3 billion, which were entered into in 2006, and approximately 9,300 agreements in the amount of UAH 11.7 billion, which were executed in 2007¹. Analysis of the structure of the leasing contracts' portfolio in terms of the value of leased assets demonstrates that, as of December 31, 2007, various vehicles (such as railway transport, aircraft, trucks, and passenger cars) accounted for the largest share in the leasing contracts' portfolio (approximately 64%)². Agricultural machinery and equipment accounted for the second largest share in the structure of the leasing portfolio (almost 7%), while other equipment, including IT, printing, trade and banking equipment, accounted for the remaining 25%³.

Despite the increases in a number of indices, the Ukrainian leasing market is still in its infancy. One of the reasons for this is that legislative measures to promote leasing are not among the government's priorities, and that the pursuit of higher budget revenues has been making Ukrainian decision-makers reluctant to offer tax benefits for leasing.

Legal framework

Leasing relations in Ukraine are governed by the following main legislative acts:

- (i) The Civil Code of Ukraine and the Economic Code of Ukraine, both dated 16 January 2003 (the "**Civil Code**" and the "**Economic Code**", respectively), setting forth general legal rules on leasing;
- (ii) The Law of Ukraine "On Financial Leasing" dated 16 December 1997 (the "**Financial Leasing Law**"), being a special legal act on financial leasing;
- (iii) The Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets" dated 12 July 2001 (the "**Financial Services Law**"), defining financial leasing as a financial service and setting out powers of the Commission as the main regulator of the leasing market;
- (iv) The Law of Ukraine "On Banks and Banking" dated 7 December 2000, governing leasing operations by banks;
- (v) The Law of Ukraine "On Taxation of Corporate Income" dated 28 December 1994, (the "**Corporate Tax Law**"), establishing, together with the Law of Ukraine "On Value Added Tax" dated 3 April 1994, rules of taxation of leasing operations;
- (vi) The Law of Ukraine "On the Prevention and Combating the Legalisation (Laundering) of Income Obtained by Criminal Means" dated 28 November 2002, setting forth the procedure of conducting financial monitoring by lessors (the "**Anti-Money Laundering Law**");
- (vii) "UNIDROIT Convention on International Financial Leasing" dated 28 May 1988 and ratified by the Verkhovna Rada of Ukraine on 11 January 2006, being one of the major international agreements in the sphere of international financial leasing.

¹ Source: Report on Activities of the State Commission for the Regulation of the Financial Services Market in Ukraine in 2007 approved by the Instruction of the State Commission for the Regulation of the Financial Services Market in Ukraine dated 26 June 2008 N 778 and Report on Activities of the State Commission for the Regulation of the Financial Services Market in Ukraine in 2006 approved by the Instruction of the State Commission for the Regulation of the Financial Services Market in Ukraine dated 5 July 2007 N 7572

² Ibid.

³ Ibid.

Despite the existence of the abovementioned acts, Ukrainian legislation in the sphere of financial leasing is generally perceived as not sufficiently developed and containing a number of substantial gaps. Furthermore, inconsistencies between and among laws, governmental and ministerial orders, decisions, resolutions and other acts, ambiguous wording of laws and regulations and their lack of specificity raise difficulties in implementation and interpretation of their provisions. Such gaps and incoherence of legislation complicate operations of entities providing leasing services and make it difficult for the court to consistently implement respective legal rules while resolving disputes.

Collisions described above may be seen, among other things, in the definitions of terms that are fundamental for leasing regulation. For instance, the world practice identifies two main types of leasing: operational and financial. Such breakdown was also provided for in the Law of Ukraine "On Leasing", effective till 2004; while the Financial Leasing Law, which is currently in force, governs only financial leasing issues. At the same time, the Civil Code operates with such terms as "direct" and "indirect" leasing, and the definition of "financial leasing" given in the Financial Leasing Law is very close (but not similar) to the definition of "indirect leasing" under the Civil Code. As defined in the Financial Leasing Law, "financial leasing" is a legal civil relation based on a financial lease agreement, under which a lessor is obliged to (i) acquire an asset/object from a seller (supplier) in accordance with specifications and terms established by a lessee, and (ii) transfer, in exchange for a consideration (lease payments), such asset for utilization by the lessee during a specified period of time but not less than one year. It should be noted that the Corporate Tax Law contains a more detailed definition of "financial leasing" used for tax purposes, as well as a definition of "operational leasing" meaning any commercial leasing, which does not meet the financial leasing criteria imposed thereby.

Main participants of the financial leasing market

Resident lessors

All resident companies operating in the Ukrainian leasing market could be divided into the following categories:

(1) Leasing companies which qualify as financial institutions and are registered in the State Registry of Financial Institutions (the "Registry") in accordance with the Financial Services Law. As a rule, this category comprises leasing companies whose main business involves rendering, on a permanent basis, financial leasing services, which might be combined with other financial services, subject to certain exceptions (e.g. providing financial leasing services may not be combined with professional activity on the stock market). To be registered as a financial institution, a company

should comply with certain requirements, including having as follows: (a) shareholders' equity of not less than UAH 3 million; (b) qualified staff, including chief executive officer and chief accountant who meet certain educational and professional requirements set by the Commission; and (c) certain computer software and hardware. As any other financial institution, leasing companies have to file periodic reports with the Commission and comply with the Anti-Money Laundering Law and other legislation in this sphere. According to the statistics presented by the Commission, as at 1 January 2008, only 27 leasing companies were registered with the Commission as financial institutions, and only 3 of these companies have been actually conducting leasing transactions.

(2) Legal entities which do not qualify as financial institutions but may from time to time be involved in financial leasing business. These companies are recorded by the Commission in the List of legal entities which are entitled to carry out financial services (the "List"), for the period of participation in financial leasing transactions. Such leasing companies have to meet certain requirements (e.g., their qualified staff which is directly engaged in financial leasing transactions should have higher education in finance, economy or laws) and fall under the reporting requirements set by the Commission. In addition, legal entities should comply with the Anti-Money Laundering Law and other legislative acts in this sphere. According to the statistics prepared by the Commission, as at 1 January 2008, 171 companies were recorded in the List.

(3) Banks, which are entitled to provide leasing services in accordance with a banking license issued by the National Bank of Ukraine and are not subject to any additional registration with the Commission.

Non-resident lessors

Although only resident companies are allowed to be registered in the Registry or recorded in the List, non-resident lessors wishing to lease assets to Ukrainian residents from abroad may undertake such financial leasing transactions without any license or registration, provided that generally applicable currency control rules are complied with, if any.

It should be noted that Ukrainian and foreign legal entities, which are subject to individual licensing regimes or temporary suspension of foreign economic activities imposed by the Ministry of Economy of Ukraine, are not allowed to enter into lease agreements with foreign or Ukrainian entities, respectively.

Leased asset

According to Ukrainian legislation, non-consumable fixed assets (both movable and immovable) with

individual characteristics, which could be freely traded at the market and are not restricted from leasing, could serve as leased assets for the purposes of financial leasing. It is forbidden to lease, on financial leasing terms, land plots, sub-soil or natural resources (e.g. coal), integral property complexes and structural subdivisions of enterprises, as well as certain other assets.

Lease agreements

Lease agreements are to be executed in written form, and notarization of such agreements may be performed upon request of one of the parties, but is not, subject to the below exception, mandatory. Lease agreements in relation to real estate objects that are entered into for more than 3 year term should be certified by a notary and are subject to state registration (currently, in the State Register of Deeds).

Control over use of the leased asset and the right to incontestable repossession of the leased asset

Current legislation does not expressly provide for the lessor's right to incontestable repossession of the leased asset if the use and service conditions of such asset are inconsistent with the terms of a financial lease agreement or intended use of the leased asset. From the legal perspective, there is also a lack of clarity in relation to whether a lessor has the right to exercise financial control over operation of the leased asset by a lessee. At the same time, this does not prevent the parties from specifying all these aspects in the lease agreement.

Furthermore, the lessor is entitled to terminate the financial lease agreement and to claim repossession of the leased asset on grounds set forth in a lease agreement or the law. As a general rule, repossession should take place through a judicial procedure. However, if

payments under a notarized lease agreement have not been made within thirty days after the due date, repossession claim may be also made through a notary's enforcement writ; such option is not available if a lease agreement has not been certified by a notary.

The right to incontestably collect lease payments

According to the Financial Leasing Law, the lessor is entitled to collect an outstanding debt from a lessee in an incontestable manner on the grounds of a notary's enforcement writ. However, current legislation is silent as to the mechanism for performance of such notary's enforcement writ with respect to collection of an outstanding debt. Thus, practical implementation of this provision remains unclear.

Issues related to transfer of title to leased asset to a lessee

The Financial Leasing Law stipulates that a lessee may have other rights and obligations in accordance with the terms of a lease agreement. The above legal rule could be interpreted as allowing the parties to incorporate relevant provisions on automatic transfer of title to the leased asset into a financial lease agreement. However, the Financial Leasing Law is not explicit about such option. Furthermore, according to the Civil Code, agreements providing for transfer of title to real estate objects are subject to notarization and state registration (currently, in the State Register of Deeds) and the title is deemed transferred to the buyer from the date of such state registration. Therefore, it remains unclear whether title to a leased asset can be transferred automatically to the lessee at the expiration of a lease agreement or a separate agreement is required for this purpose, and parties usually opt to enter into a separate sale and purchase agreement in relation to the leased asset, instead of using complex lease agreements containing provisions on transfer of title.