

# THE LEASING OPTION: LESSOR AND LESSEE PERSPECTIVES

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## Introduction

The following article discusses court practice in leasing cases and outlines the problems in resolving leasing disputes. These situations are not unique. The article contains our observations and subjective opinions.

Kazakhstan creates relatively favorable conditions for leasing at the legislative level. Leasing is regulated by the *Civil Code*, the *Law on Finance Lease*, the *Tax Code*, the *Customs Code*, the *Law on Rehabilitation and Bankruptcy*, and the *Law on Currency Regulation*.

Kazakhstan's legislation guarantees the lessor's ownership rights of the leased asset. It provides legal protection against seizures of the asset by customs and tax authorities, as well as protection against including the leased asset in the lessor's property if the lessor declares bankruptcy. In addition, lease payments can be recalculated to minimize currency fluctuation risks for the lessor (for example, significant fluctuation in the tenge exchange rates). The lessor also enjoys tax benefits such as exemption of interest from corporate income tax and VAT.

Separately, it should be noted that leasing operations are included in investment activities. This means that, in theory, the lessor can use the guarantees provided by bilateral and multilateral international agreements on promotion and protection of capital and investment such as most favorable treatment, protection against expropriation, and the opportunity for international arbitration in disputes with the government. However, in most cases the lessor is pursuing claims against private companies, not against the government.

From the point of view of legislative regulation, we believe the lessor benefits from favorable conditions. Nonetheless, despite these positive aspects, disputes between lessors and lessees make up a significant proportion of court cases.



## Prerequisites for Disputes

The vast majority of disputes are initiated by the lessor due to lessee's failure to meet the required lease payments. The reasons for non-payment are generally the following:

- Instability of the tenge exchange rate (the lessor is protected from fluctuations in the national currency but the lessee is more vulnerable). The lease payments thus become unaffordable to the lessee if payments are calculated in foreign currency or are indexed.
- Lack of proper planning and business organization. For example, the government finances (partially or in full) many infrastructure projects that require significant quantities of heavy construction equipment. This is why entrepreneurs acquire expensive equipment on lease. However, in many cases, after advance payments and in the project's final stages, payments are delayed to correct shortcomings; construction deadlines are not met; certain types of equipment are needed at different stages of the project, the general contractor is dishonest, or for other reasons.
- Most lessees cannot afford a competent financial advisor to plan and manage cash flows correctly, and to prevent accumulation of debt.
- The low level of legal expertise of the lessees. Unfortunately, most lessees do not pay proper attention to the legal aspects of the leasing agreements (very often due to economic savings). As a result, failure to understand contract obligations such as penalties, early termination of the contract, and returning the leased asset is not evaluated properly and claims are brought to court.
- Bankruptcy and rehabilitation of the lessees is also possible. In the worst-case scenario, the lessee becomes insolvent. Naturally, the lessor will try to collect the debt and reclaim the leased asset. However, the lessor's claims are at the end of the debt repayment queue. Therefore, lessors who properly monitor their customers turn to the courts at the first sign of the lessee's potential insolvency.

A lessor encounters the following problems in recovering the debt and reclaiming the leased asset.

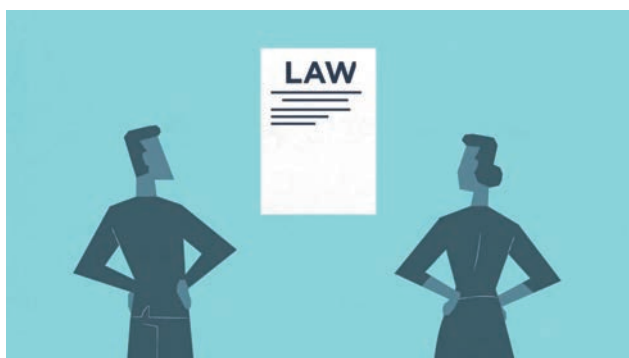
## Penalty Reduction

Generally, courts do not question the amount of principal debt, indexation of payments, losses related to the lessor's tax payments, and even debt collection in foreign currency. However, courts increasingly tend to reduce the penalty by up to 10% of the claim. In our opinion, the motivation of the courts is not entirely justified.

The courts reason that if the lessor turns to the judicial system to collect a penalty accumulated over more than 2 years, the lessor has failed to seek redress in reasonable time to justify increasing the penalty. The courts also argue that the penalty should be reduced because the debtor made the payment even if it was late. Factors that prevent lessors from going to court may include their wish to keep the client (even if the client is not always reliable), not wanting to litigate over insignificant amounts, or other reasons.

From the legal point of view, however, a penalty is the legal way to ensure proper execution of civil obligations. The lessee voluntarily assumed obligations and agreed to a penalty if the obligations were not met: the lessee's fulfillment of his obligations therefore depends entirely on him, not on the lessor. The size of the penalty is thus determined by the actions of the lessee.

Taking the lessee to the court as soon as he is late with the payments should not be a reason to reduce the penalty. The legislation establishes a statute of limitations during which it is possible to seek judicial redress. However, the courts ignore the fact that a delay in meeting financial obligations is essentially fraudulent use of money. The lessor finances the lessor's business activity, but the court forgives the debt, reasoning that the debtor paid back his loan even if it was late. This is unfair and does not comply with the law.



Kazakhstan is making tremendous efforts to increase the use of pre-trial and out-of-court dispute resolution. Penalties are one of the most effective ways to secure obligations under civil law contracts, which impose discipline on the debtor. If the courts without good reason reduce the penalty stipulated by the contracts, debtors will be motivated to bring all disputes to court in the hope of significantly reducing the penalty. In turn, lenders will be motivated to bring their claims to court as soon as possible, without attempting pre-trial dispute resolution, to avoid penalty reduction entailed by a late appeal to the court.

Considering that lessors often borrow funds to purchase lease assets, losses from untimely lease payments can be significant. Consequently, penalty reduction increases the lessor's financial risks. Accordingly, lessors are forced to

increase their interest rates, thus transferring their risks to the lessees. The lessees' irresponsible behavior, supported by the courts, therefore bounces back onto the lessees themselves.

### Leased Asset Seizure

Upon termination of the leasing agreement, the lessees do not hasten to return the asset, and the lessors are forced to initiate court-ordered seizure of the asset. However, although the legislation provides for a procedure to reclaim the asset (judicial order proceedings), in practice this order can be easily cancelled and the lessor must initiate seizure through a regular court application.

The lessor may face problems at the very beginning of the trial if the court decides on a preliminary injunction. Usually, the lessor seeks the return of the asset in addition to seizure of the debtor's property, along with prohibiting transfer of the asset to third parties. In the vast majority of cases, the court refuses to grant these actions without a good reason.

This judicial refusal allows the lessee to continue using the asset for the full period of the trial (it may take as long as four months for the court's decision to come into force) and to generate income without payment. This leads to wear and tear of the equipment and allows the lessee to receive illegal benefits. Although the lessor has a right to recover all losses from the lessee, he must apply to the court again with a separate claim or amend the initial claim.

In many cases, the situation is aggravated by the fact that the lessee intentionally ignores the trial and forces the court to hold the trial *in absentia*. Then the decision *in absentia* is appealed on procedural grounds, and the whole process begins anew. In some cases, an unscrupulous lessee may continue to use the asset for up to 5-6 months from the beginning of the trial.

In the worst case, when reclaiming the asset is denied, the unscrupulous lessee has an opportunity to sell the asset, which will be discussed below. Transferring the asset to the lessor by a preliminary injunction could resolve this particular problem.



### Transfer of Leased Assets to Third Parties

There are cases when lessees sell the asset to third parties even though such transfers are prohibited both by law and a preliminary injunction during the trial, or even by a court decision allowing seizure of the asset. Often the lessor learns about the third-party transfer only when it comes time to seize the asset. Unable to execute the seizure, the lessor must turn to the court to void the third-party transaction. The buyer, of course, does not want to return the asset and demands recognition as a *bona fide* purchaser.

In most cases, the courts resolve such disputes and decide in the lessor's favor. In this case, the court justifiably indicates that ownership of the asset cannot be transferred to the lessee until certain conditions are met, that legislation and an agreement prohibit the transfer of the asset's ownership, and that the buyer should make a claim against the lessee.

However, in some cases, the court's approach is very formal and allows the lessee and buyer to delay reclaiming the asset. For example, the actions of a bailiff could be appealed on the grounds that the reclaimed property does not belong to the debtor. Territoriality of the enforcement action may also be violated if the lessee or the buyer moves the asset to another jurisdiction.

### Conclusion and Recommendations

More effective approaches to protect the lessor's ownership and to implement the preliminary injunction and final court decisions are needed - for example, to prohibit registration of the asset to third parties without the lessor's consent, to synchronize prohibiting the debtor from re-registering or transferring the asset with a prohibition to the registration authorities' to re-register the asset, and to strengthen the lessee's responsibility to obey court decisions.

Proper regulation at the legislative level alone is not enough to develop and regulate leasing effectively in Kazakhstan, yet the development of leasing is needed to accelerate Kazakhstan's industrial-innovative development programs and important infrastructure projects.



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