

THE ROLE OF TRANSACTION "SALE AND LEASEBACK" IN SLOVENIA

Dražnik Rosana

Faculty of Law, University of Maribor, Maribor, Slovenia

Abstract: *The article analyzes the legal nature of sale and leaseback transactions. It presents legal aspects in Slovenian theory and opinions of Slovenian Supreme court. Exposed is a question of admissibility of a transaction and its' relation with a Lex commissoirum.*

Key words: *leasing, sale and leaseback, lex commissoirum, civil law, transactions, financial sources.*

РОЛЬ СДЕЛКИ "ПРОДАЖИ И ОБРАТНОЙ АРЕНДЫ" В СЛОВЕНИИ

Дражник Росана

Юридический факультет, Университет Марибора, Марибор, Словения

Аннотация: *В статье анализируется правовая природа операции продажи с обратной арендой. Представлены правовые аспекты в словенской теории и мнения Верховного Суда Словении. Подвергается вопрос о приемлемости сделки и ее отношения с lex commissoirum.*

Ключевые слова: *лизинг, возвратный лизинг, lex commissoirum, гражданское право, сделки, финансовые источники.*

Sale and leaseback transaction is, as it can be also evident from the name of the transaction, composed of two separate¹ independent transactions. The first transaction is a sale transaction and the second one a lease transaction. Nonetheless, a conclusion of a sales contract is a precondition for a valid lease contract.² A basic purpose of a sale and leaseback transaction is to ensure financial resources to the lessee. This can be achieved by selling an asset to the lessor and leasing it back in order to be able to further enjoy and exploit it.³

Gerbec and Košir have mentioned that one of the most famous sale and leaseback transactions dates from the year 1961 when one of the highest buildings in the world – the Empire State Building was sold. Due to the huge value, a leaseback contract was signed for 114 years. (Gerbec in Košir 1999, 41).

In February 2004 the International Tax Review magazine published the news that a British telecommunication company BT Group has concluded a sale and leaseback transaction for 1,3 billion pounds, which should enable them to lower their

¹ If a sales contract is not valid also a lease contract is invalid, but on the other hand if a lease contract would be early terminated that would not mean that also a sales contract is terminated or invalid and therefore the contracts are not legally related and interdependant. More on that in Varanelli, L., Pravna operacija "Sale & leaseback", Pravna praksa, Nr. 35, P. 19 – 20.

² Čotar, A., Simpozij: »Evolucija« pogodbenega prava, Pravna praksa, Nr. 14-15, 2005, P. 32.

³ Varanelli, L., Pravna operacija »Sale and leaseback«, Pravna praksa, Nr. 35, 2002, P. 17.

tax burden for the 300 million pounds in the following years.⁴ This example clearly shows that ensuring financial resources is not the only reason for a sale and leaseback transaction. There are also other reasons with a tax optimization being one of important ones.

A need for financial resources and improvement of a cash flow are therefore not the only triggers for a sale and leaseback transaction. As already stated, tax optimization can be one of the reasons, and the attempt to change financial statements is another important one. For example, a taxable person having hidden reserves in a real estate and past or current loss, can use a sale and leaseback transaction to realize the hidden reserves and with that optimize tax liabilities and in many cases also the financial statements⁵. A sale and leaseback transaction can also be used to secure the assets in case of enforcement procedures. As a lessee is not the legal owner of the asset, the asset cannot be subject to an enforcement procedure, however, a lessee can still use and exploit it without any limitations.

In sale and leaseback transaction, the owner of an asset sells that asset to a financial institution in order to lease it back. A leaseback transaction is a slightly atypical form of direct lease, where a financial institution, instead of a producer or a trader, is the seller. According to Berden, the main difference between a leaseback and a lease is the fact that with leaseback transactions the future lessee is also the seller.⁶ Mehta wrote that sale and leaseback is one of primitive technics, by which the owner sells an asset and the buyer leases back that same asset to the original owner.⁷

Contacting parties usually have their own goals when entering into a sale and leaseback transaction. A lessee usually decides for a transaction when he wishes to continue using an asset economically and at the same time getting financial resources. And for the lessor a transaction should enable a considerably safe long term investment.⁸ But when the financial crises started it became clear that also those investments were not that safe. The main reasons for that were the over valued assets, which were the object of lease contracts and a decrease in the purchasing power. Therefore, lessors have suffered a great financial damage especially by early termination of contracts due to insolvency.

Šuler is of an opinion that an economic interest of contracting parties is the same with a sale and leaseback transaction as with a loan, where a receivable is secured with a security interest or a transfer of ownership as insurance (Šuler 2013, 19). Many authors and Slovenian courts are of the same opinion. Therefore, a sale and leaseback transaction is based on their opinion only a legal variation of a financial transaction and that is why special regulations for protection of creditors apply here.

⁴ Mehta, A., *International Taxation of Cross-Border Leasing Income*, IBFD, 2004, P. 1.

⁵ That is usually achieved when a leaseback presents an operative lease where assets and liabilities are not recognised. This is known as off balance accounting, which has an important role in the financial world and that is also a reason why new IFRS 16 was adopted in January 2016. IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted if IFRS 15 has also been applied.

⁶ Varanelli, L., *Pravna operacija »Sale and leaseback«*, *Pravna praksa*, Nr. 35, 2002, P. 24.

⁷ Mehta, A., *International Taxation of Cross-Border Leasing Income*, IBFD, 2004, P. 85.

⁸ Varanelli, L., *Pravna operacija »Sale and leaseback«*, *Pravna praksa*, Nr. 35, 2002, P. 12.

Varanelli states that a sale and leaseback transaction is considered from an economic point of view as a single financial transaction, but from the legal point of view, the situation is more complex. Legally it is a complex transaction composed of two legal transactions – sales contract and lease contract. Although when entering into both contracts, contracting parties have the same economic aim, which is the link between them, in fact both contracts have their own goal.⁹

Even if both contracts are concluded at the same time and sometimes even in the same document and the contracting parties usually link both contracts in order to achieve an economic goal, Varanelli is of the opinion that the two contracts are separate. Varanelli concludes that we cannot speak about coexistence of two contracts or better to say about legally linked contracts as:

- Lease contract ceases to exist if a sales contract is early terminated or invalid, but that is due to the general civil law principles;
- If the lease contract is early terminated that does not influence the sales contract.

Varanelli also stated that for the sales contract general provisions of the Code of Obligations are used. Therefore, the ownership title must be transferred to the purchaser, even if he will later not have direct tenure on item. A purchaser is therefore obliged to pay the purchase price, although he cannot dispose with the leasing object and must enable transfer of the ownership back to the original owner after the lease contract expires, if the lessee has called for an option to buy.¹⁰

By that, we should emphasize that Varanelli considers a sale and leaseback transaction, as a transaction where in a leaseback a purchase option is given. In Slovenia in most cases contracting parties, do not conclude sale and leaseback transactions with an option to purchase, but usually agree that the ownership title should be transferred automatically upon payment of the last installment. Varanelli says that a lease contract could hardly be considered as a sales contract, when the purchase price paid by the last installment is considerably lower than the market price. As the purchase price is already included in the instalments paid based on the lease contract, he says there is no sale in the contract. This argumentation is a part of discussions in Slovenia how should a leaseback or a lease contract be interpreted from a civil law, when we it is clear that the ownership title will be transferred with the expiry of the lease contract or there is a purchase option agreed. When defining a transaction the judgment of the Slovenian Supreme Court Nr II Ips 280/2002 should be taken into consideration, where it is clearly stated that in case the ownership in a leaseback transaction is transferred automatically with the payment of the last installment, that is a clear case of a sales contract. When defining a leasing contract, the majority of writers use the assumption that a financial lease includes only a purchase option and not that the ownership should be transferred by the last installment as that is common practice in Slovenia.

Based on Varanelli a sale and leaseback transaction could be compared with a sales contract including a purchase option. Its characteristic is that the seller is allowed to repurchase the sold asset. Such a contract is usually concluded when the

⁹ Ibidem, P. 12.

¹⁰ More on that in Varanelli, L., Pravna operacija »Sale and leaseback«, Pravna praksa, Nr. 35, 2002, P. 12–13.

seller needs financial resources, but is expecting that he will be able to repurchase the sold asset, when his financial situation improves. In case of a repurchase of an asset, the purchaser is obliged to return the sold asset and the seller is obliged to return the purchase consideration. Economically such a transaction is very similar to a sale and leaseback transaction. But from a legal point of view Varanelli is emphasizing important differences:

- Different structure of transactions – a purchase right is with sale and leaseback transaction a part of the lease contract (purchase option, call option), whereas in case of a sales contract, the right of repurchase is a part of a sales contract. That is very important when a leasing contract is invalid. As the purchase option is a part of a leasing contract, the seller is not able to repurchase the item;

- Conceptual – if a characteristic of a sales contract with a purchase option is that the seller can repurchase the item if he returns the purchase consideration, a leaseback is different as the installments already include a part of the purchase price. When a lessee considers calling an option, a part or even the whole price has already been paid with installments.¹¹

Varanelli is also questioning the legal admissibility of a sale and leaseback transaction and is by that exposing a *lex commissoria* principle.¹² Based on *legem commissariam* a pledged item belongs to the creditor, if the debt is not settled and such an agreement is void per se. Sale and leaseback transaction is very similar, as the future debtor firstly sells the item to the creditor and then receives financing and a possibility to repurchase the item if the debt is paid, but due to differences sale and leaseback is allowed.¹³ The line between both transactions is very thin. In case of *lex commissoria* the creditor therefore becomes the owner, if the debtor does not repay his debt and in case of a sale and leaseback, the creditor remains the owner, if the debt is not repaid. Based on the opinion of Varanelli a sale and leaseback transaction cannot be considered the same as fiduciary transfer of ownership as insurance. As different legal transactions can lead to the same economic result, a leaseback transaction is only legal if possibility of abuse is excluded.¹⁴

As previously described, a leaseback can involve a transfer of ownership or not. If there is no transfer of ownership in a leaseback transaction (operative lease), then there is no doubt based on Varanelli that such a transaction is always allowed, as there is no potential risk for a breach of *lex commissoria*. In case of an operative lease agreement a subject of lease can namely not present a security, as the subject of lease is originally sold and then only leased back without any intention of transferring the ownership back. In Slovenia, we do not have many such transactions, as it is

¹¹ More on that in Varanelli, L., *Pravna operacija »Sale and leaseback«*, *Pravna praksa*, Nr. 35, 2002, P. 12–14.

¹² *Lex commissoria* is an agreement based on which pledged item becomes an ownership of the creditor, if the debt is not settled. Such an agreement is in general forbidden, except when special clauses or agreements exist, that are protecting the debtor.

¹³ A Supreme court of Slovenia has stated in its judgment Nr II 427/2003, dated 26.8.2004, that sale and leaseback is allowed when it is not used as a cover for a *lex commissoria*, therefore if it includes provision that protect a debtor from a misuse. A creditor is therefore not allowed to receive more than the repayment of the claim and any surplus from selling the leasing asset must be returned to the debtor.

¹⁴ More on that in Varanelli, L., *Pravna operacija »Sale and leaseback«*, *Pravna praksa*, Nr. 35, 2002, P. 15–16.

common that the ownership has been transferred after a lease contract had been terminated.

There is a potential risk that a transaction would involve a *lex commissoria* if there was a financial lease with an agreement that the ownership right will have been transferred at the expiry of the leaseback agreement, that is with the last installment paid. Varanelli is of an opinion that when there is only a purchase option after the expiry of a leaseback contract, than such an agreement is clearly different from a fiduciary agreement.¹⁵ A conclusion can be made that a sale and leaseback transaction as well as a lease agreement as such are very complex as they do not present a fix type of an agreement and contracting parties are free to adjust the agreement to their needs. The economic nature of the transaction strictly depends on what is indeed agreed, regardless of the title of a legal form. A sale and leaseback transaction is even more complex due to its similarities to the financing with a pawn and as it is in general an upgrading of a fiduciary structure.

In Slovenia, we can notice in practice that in many cases for legal purposes a leaseback transaction involving a transfer of ownership is usually treated completely the same as an independent financial lease contract. Financial institutions usually even use the same general terms and conditions for both variations of contracts. In my opinion that could be a burden for the financial institution as there is no *lex commissoria* tendency in a mere financial lease contract. Therefore in a later one there is no need for the financial institution to follow the principle of unjustified enrichment. Namely, where a financial institution buys an object of lease from an independent third party and then leases it to the lessee, there could not be any unjustified enrichment for the lessor even if there is an early termination of a lease contract. If a lessor sells the lease object for a higher value than his claims towards the lessee and makes a profit out of it, there is still no unjustified enrichment for the lessor on the account of a lessee. A secured item was namely never in legal ownership of a lessee and therefore he does not have any unjustified financial damage in case the object of lease is of greater value than the liability towards a leasing company. Lessee namely paid only the installments for the period an asset was used and potentially some damage claims due to a breach of contractual terms.

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¹⁵ Varanelli, L., Prenos lastninske pravice v zavarovanje, Odvetnik, št. 5 (26), april 2005, str. 10.

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