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BRIEFING

UAE FINANCIAL LEASING LAW

APRIL 2019

- ALL ENTITIES PROVIDING "FINANCE LEASE" ACTIVITY IN THE UAE MUST BE LICENSED TO DO SO BY THE UAE CENTRAL BANK.
- ALL FINANCE LEASE CONTRACTS ARE REQUIRED TO BE REGISTERED WITH A REGISTER WHICH IS TO BE CREATED UNDER THE LAW.



UAE Federal Law No. 8 of 2018 on Financial Leasing (the "Law") came into effect on 1 January 2019, with the aim of regulating the provision of leasing activities in the UAE.

"WE ARE NOW INCREASINGLY SEEING LEASING USED AS A MEANS OF FINANCING SHIPS AND OTHER MARITIME ASSETS SUCH AS CONTAINER BOXES, WITH CHINESE LEASING AND JOLCO (JAPANESE OPERATING LEASE) TRANSACTIONS BEING TWO PRINCIPAL EXAMPLES OF THIS."

Leasing of assets is fundamental to businesses in the small to medium enterprise ("SME") space, by allowing SMEs to have the benefit and use of those assets without the need to incur significant upfront capital expenditure (either through working capital or through bank financing) to purchase those assets themselves. In particular, it is a mechanism which supports companies working on industrial and commercial projects, by allowing them to rent industrial and other production equipment, with the right or option to take ownership of such equipment at the end of the leasing period.

Leasing is also an increasingly popular financing arrangement in the transport and logistics sectors. It has long been used in relation to the leasing of aircraft and aircraft engines; however, we are now increasingly seeing leasing used as a means of financing ships and other maritime assets such as container boxes, with Chinese leasing and JOLCO (Japanese operating lease with call option) transactions being the two principal examples of this.

This note summarises the key provisions of the Law and the potential implications on:

- equipment and vehicle leasing in the SME sector;
- the aviation and shipping sectors; and
- the real estate sector.

### Key aspects implemented by the Law

Some of the key aspects of the Law include the following:

- **UAE Central Bank license:** All entities providing "Finance Lease" activity in the UAE ("Lessor(s)") must be licensed to do so by the UAE Central Bank (with the result that any Finance Lease Contract (defined below) entered into with an unlicensed Lessor would be deemed to be null and void). The Law does not specify what would be considered as Finance Lease activity "in the State" although the licensing of branches of foreign finance lease companies (which can be read to mean branches of non-UAE entities that offer finance leases to customers) is expressly referred to in Article 2(4) of the Law, so it must be the case that such branches are intended to be captured by the Law. Some further thoughts and considerations relating to this are set out in the "Questions remain" section below.
- **Contracts:** The Law addresses the arrangements contained in:
  - **"Supply Contracts"**, being contracts pursuant to which the Lessor purchases Leased Property from a supplier (which would include, for example, the manufacturer of the Leased Property) for the purpose of leasing that Leased Property to a lessee (a "Lessee") under a Finance Lease Contract; and
  - **"Finance Lease Contracts"**, being contracts pursuant to which a Lessor leases Leased Property to a Lessee for a specified period in exchange for the payment of rent and granting the Lessee the right to purchase the Leased Property. Given the interpretation of what qualifies as a "Finance Lease Contract" appears to turn on the existence of a purchase right or purchase option, this definition would appear to cover hire-purchase agreements and equivalent Islamic leasing structures such as *Ijara-wa-Iqtina* (i.e. lease and purchase).

For the purposes of the Law, "Leased Property" includes any movable property and real estate (including off-plan real estate units) over which usufruct (i.e. a right to use and enjoy) applies.

- **Registration of Finance Lease Contracts:** All Finance Lease Contracts are required to be registered with a register which is to be created under the Law (the "Register"). The obligation to register lies with the Lessor rather than the Lessee (Article 5(5)). Details of the Register will be provided in a subsequent cabinet resolution. Further, existing Lessor are required to obtain a UAE Central Bank license, and can register or annotate any leases that would qualify as Finance Lease Contracts under the Law with the Register, within one year of the Law coming into force (Article 38). Registration of a Finance Lease Contract with the Register is considered as evidence against third parties (Article 5(4)).
- **Prescriptive provisions of Finance Lease Contracts:** The Law is, in many respects, quite prescriptive as to the clauses that should be included in a Finance Lease Contract, some of which may be considered to have adverse implications on the willingness of Lessors to offer such contracts to customers in the UAE. Examples include:
  - Provisions detailing the rights and obligations of the Lessee and Lessor under a Finance Lease Contract (Articles 6-9 inclusive); although it is worth mentioning that the lists in these Articles are not exhaustive and each of these Articles states

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“A 60-WORKING DAY GRACE PERIOD, IN PARTICULAR FOR LESSEE DEFAULT, SEEMS TO BE, IN OUR EXPERIENCE, FAR TOO LONG AND "OFF-MARKET" FROM A COMMERCIAL PERSPECTIVE”

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“HELPFULLY, FROM BOTH A LESSOR AND A LESSEE PERSPECTIVE, THE LAW CLEARLY STATES HOW THE LEASED PROPERTY IS TO BE DEALT WITH ON A LESSEE OR LESSOR DEFAULT OR INSOLVENCY”

*"unless otherwise agreed in the contract", so allowing for room for negotiation and manoeuvre by the parties to the Finance Lease Contract.*

- The ability of the Lessee (Article 11) or the Lessor (Article 14) to assign or transfer its rights and/or obligations in a Finance Lease Contract to another person, subject to certain conditions. This is typically not a right that many lessors would offer a lessee although, as Article 11 only allows the Lessee to do so with the prior written consent of the Lessor, the Lessor can control the exercise of this right in any event, even if it is offered in the Finance Lease Contract.
- In one of the more interesting aspects of the new regime, the Law provides that both the Lessor and the Lessee must offer one another a grace period of 60 working days (from the date of receipt of notification from the non-defaulting party) to remedy a default under a Finance Lease Contract before the other is entitled to terminate that contract (Articles 26 and 27). The provisions of these Articles cannot be contracted out of or otherwise modified or amended, although the parties are free to add other grounds for termination in the contract should they so wish. In practice, lessees' rights to terminate leases for lessor default tend to be somewhat restricted. In addition, a 60-working day grace period, in particular for lessee default, seems to be, in our experience, far too long and "off-market" from a commercial perspective, so would require some commercial consideration and sign-off by Lessors going forward.
- The Law also refers to certain "Special Accounting Standards" which will be determined by a further ministerial resolution. These standards will seek to determine the amount owed to the Lessor or Lessee (as applicable) in the event of termination of the Finance Lease Contract or the amount due to the Lessee in the event of a liquidation or bankruptcy of the Lessor.
- **Quiet enjoyment and protections for Lessor and Lessee on enforcement against Leased Property:** Helpfully, from both a Lessor and a Lessee perspective, the Law clearly states how the Leased Property is to be dealt with on a Lessee or Lessor default or insolvency:
  - From a Lessee perspective, the Law appears to grant the Lessee a quiet enjoyment right, by making clear that the Leased Property cannot be seized by third parties in execution of a debt owed by the Lessor (Article 20). In the event of the liquidation or bankruptcy of the Lessor, the Lessee can choose either to continue with the Finance Lease Contract or to deliver the Leased Property to the liquidator or trustee-in-bankruptcy and collect any amounts due to it as an unsecured creditor of the Lessor (Article 23).
  - From a Lessor perspective, the Law makes clear that the Leased Property is not to be considered as part of the estate of the Lessee in the event of the liquidation, bankruptcy or death of the Lessee. In such a case, the liquidator, trustee-in-bankruptcy or heirs of the Lessee must either declare their intent to continue with the Finance Lease Contract or return the Leased Property to the Lessor within 90 business days of the date of issuance of the bankruptcy decision or death of the Lessee (Article 24).

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“THE LAW INCLUDES THE CONCEPT OF "SPECIAL MOVABLE", DEFINED AS "THE MOVABLE REQUIRED, AS PER THE LEGISLATION IN FORCE, TO BE REGISTERED IN THE REGISTERS DESIGNATED FOR THIS PURPOSE BY THE COMPETENT GOVERNMENT ENTITIES, SUCH AS VEHICLES, AIRCRAFTS [SIC] AND MARITIME MEANS.”

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“IN THEORY, THE LAW WILL APPLY TO FINANCE LEASES WITH UAE AIRLINES (EMIRATES, ETIHAD, FLYDUBAI ETC.), EVEN WHERE THE LESSOR ENTITY IS A SPECIAL PURPOSE COMPANY ESTABLISHED IN ANOTHER JURISDICTION (SUCH AS THE BVI, CAYMAN ISLANDS ETC.). IN THAT CONTEXT, IT WOULD APPEAR AS THOUGH THE

- **Other provisions of the Law:** The Law also contains provisions dealing with, amongst other things:
  - The clauses that a Finance Lease Contract should contain (Article 4).
  - The relationship between the Lessor, Lessee and any supplier/manufacturer of the Leased Property (Articles 10, 16 and 19) and the delivery of the Leased Property (Articles 15 and 16).
  - The Lessee's ability to exercise its option to purchase the Leased Property and the required consideration for the same (Article 21).
  - The sanctions for non-compliance with the Law (Articles 32-36), which include imprisonment and fines of various amounts, depending on the type and severity of the breach in question.

Looking now to the application of the Law to particular asset classes:

**"Special Movable" (i.e. vehicles, aircraft and maritime assets)**

The Law includes the concept of "Special Movable", defined as "*the movable required, as per the legislation in force, to be registered in the registers designated for this purpose by the competent government entities, such as vehicles, aircrafts [sic] and maritime means*".

The Law doesn't carve-out Special Movable from the scope of its application but simply provides:

- that any Finance Lease Contract relating to a Special Movable must be mentioned in any relevant register for that asset type in each Emirate (Article 5(3)). The requirement to register Finance Lease Contracts over such Special Movable with the Register under the Law therefore does not negate the need for such leases to also be registered with the other designated registers applicable to such assets (Article 5(2) and (3)); and
- for a specific timeframe (15 working days) for the lessor to "assign" (i.e. transfer ownership of) the leased property and reflect that in the records of any relevant competent government authority, if the lessee exercises its option to purchase the leased property either during the lease period or on its expiry (Article 22(2)). On the contrary, for Leased Property other than real estate or Special Movable, title to such Leased Property is deemed to be transferred to the Lessee, and the Lessee is deemed to be the owner of such property, simply on and by virtue of its notification of the exercise of its purchase option to the Lessor (Article 22(3)).

## LESSOR SPC WOULD NEED TO BE LICENSED UNDER THE LAW.

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“ON A STRICT INTERPRETATION OF THE DEFINITION OF "FINANCE LEASE CONTRACT", A NUMBER OF "HYBRID" STRUCTURES (INCLUDING IN MANY CASES IN THE CONTEXT OF A CHINESE LEASING ARRANGEMENT OR JOLCO) ARE SEEN IN THE MARKET WHEREBY THE LESSEE/AIRLINE MAY BE GRANTED A PURCHASE OPTION WOULD BE COVERED IN THE LAW.”

### Equipment and vehicle leasing in the SME sector

All industrial movable equipment and vehicles (such as industrial vehicles, cranes etc.), whether considered "roadworthy" or not, would be considered to be Leased Property if the subject of a Finance Lease Contract and, therefore, the provisions of the Law would apply to such equipment; however, Article 5(3) of the Law implies a distinction between "roadworthy" assets (which require registration with their own designated register at the RTA (the Road and Transport Authority in the UAE) and other vehicles which do not require such registration. Finance Lease Contracts over the former will, going forward, also need to be registered with the RTA as well as with the Register.

### Aviation

Given the nature and structure of leasing transactions over aircraft and aircraft assets (such as engines), the application of the Law to such assets is not entirely straightforward.

In theory, the Law will apply to finance leases with UAE airlines (Emirates, Etihad, FlyDubai etc.), even where the lessor entity is a special purpose company established in another jurisdiction (such as the BVI, Cayman Islands etc.). In that context, it would appear as though the lessor SPC would need to be licensed under the Law.

The Law will not typically apply to finance leasing structures that are more prevalent in the financing of corporate jets, whereby the lessee entity is an SPC incorporated in another jurisdiction (e.g. BVI, Cayman Islands etc.), even where the aircraft is registered in the UAE, and the structure is guaranteed by a UAE domiciled ultimate beneficial owner ("UBO") as, in that case, the finance lease itself is not normally with a UAE counterparty and, arguably, the relevant leasing activity itself is not being exercised in the UAE.

Note, however, that most commercial aircraft leasing transactions are structured as operating leases not finance leases (which, on their face, would not be caught by the Law). Saying that, a number of "hybrid" structures (including in many cases in the context of a Chinese leasing arrangement or JOLCO) are seen in the market whereby the lessee/airline may be granted a purchase option. In that case, irrespective of how the lease itself is described, it would seem to us that, on a strict interpretation of the definition of "Finance Lease Contract", such a structure would be covered by the Law.

### Shipping

Many of the considerations noted above in relation to leasing in the aviation sector are equally applicable to the chartering of ships and leasing of other maritime assets (such as container boxes) where the lessee or charterer is a UAE shipping company. The Law is silent as to whether "the State" includes free zones in the UAE but,

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“IN PRACTICE, THE MARITIME INDUSTRY’S EXPOSURE TO THE LAW SHOULD BE LIMITED TO ONLY THOSE TRANSACTIONS INVOLVING UAE ENTITIES AND UAE-FLAGGED SHIPS.”

assuming it does, this would, theoretically, extend to shipping companies registered in those free zones. Having said that, most shipping transactions are structured through entities registered or established in offshore jurisdictions and are flagged and mortgaged in jurisdictions where there are open registries such as Bahamas, Liberia, Marshall Islands and Panama. So, in practice, the maritime industry’s exposure to the Law should be limited to only those transactions involving UAE entities and UAE-flagged ships.

#### Real estate

The definition of "Leased Property" contains a reference to "Real Estate" (a term which is not, itself, defined) and, more specifically, to "*off-plan real estate units which may be subject to legal acts in accordance with the provisions of the legislation in force*".

The general applicability of the Law to leases over real estate assets in the UAE which give the lessee/tenant a right to purchase the property means that so-called "rent-to-own" arrangements would be captured by the Law. Care therefore needs to be taken to ensure that any leases providing for such arrangements do not fall foul of the provisions of the Law and are dealt with and registered as required by the Law.

#### Questions remain

Questions remain on a number of aspects of the Law, both in terms of the drafting or interpretation of the text of the Law as well as its application in practice going forward. For example:

- What would be considered to be finance lease activity "*in the State*" (i.e. the UAE) under Article 2(1) of the Law? Presumably, this is intended to capture leases entered into with UAE counterparties (lessees); however, would the location of the lessor, or the location of the Leased Property, be considered relevant to this? Given the nature of movable assets generally, and Special Movables in particular, determining the applicability of the Law based on their location would seem to be counterintuitive. What about leases granted to foreign entities but either owned by, guaranteed or otherwise supported by a UAE established or resident UBO? Whether the scope of the Law captures these arrangements remains unclear, as things currently stand. That said, the Law does not appear to be intended to regulate entities located in the UAE that lease assets outside of that jurisdiction, as such activity would not, in our view, involve lease activity "*in the State*". It would be useful if the implementing regulations could help to clarify this uncertainty.
- Does "the State", as referred to in Article 2(1) of the Law, include free zones in the UAE and, therefore, companies incorporated or established in those free zones when acting as lessees in finance leasing transactions?
- Article 22(3) of the Law (i.e. the provision providing for deemed transfer of title to certain Leased Property to the Lessee simply on notification by the Lessee to the Lessor of the exercise of its purchase option) makes no reference to the fact that, in practice, the owner of an asset must, itself, transfer the ownership of that asset to the transferee/purchaser. It also ignores the fact that, in practice, the parties to a transaction typically require written evidence of the chain of title to an asset and that, as a result, it is customary for a bill of sale (or equivalent document) to be signed by the transferor in favour of the transferee to evidence the transfer of title. It would appear that, if the parties are to reconcile this inconsistency of approach, this will need to be written into the lease agreement itself.

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- Article 28 of the Law states that the nullification or termination of a Supply Contract shall have no effect on a Finance Lease Contract. This cannot be right as, if a Supply Contract is terminated and no asset has been supplied under that contract, there is no asset to put on lease under a Finance Lease Contract. Ideally, this particular aspect of the Law should be clarified in any subsequent resolutions and regulations.
  - How will lessors view the 60 working day grace period, given this is unlikely to be commercially agreeable in the context of a lessee default?

#### Comment

The Law has the potential to provide a systematic change to the regulatory landscape surrounding finance leasing in UAE.

In the SME sector, it is hoped that the Law makes it easier for SMEs to obtain finance to fund their business and operations.

For bigger ticket assets in the aviation and maritime sectors, the application of the Law depends as much on the underlying structure as it does on the identity and jurisdiction of the lessee entity.

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“THE LAW HAS THE POTENTIAL TO PROVIDE A SYSTEMATIC CHANGE TO THE REGULATORY LANDSCAPE SURROUNDING FINANCE LEASING IN UAE.”

Some aspects of the Law (such as the 60 working day grace period) may be hard for lessors to swallow and may, in fact, have the unintended consequence of adversely affecting lessor appetite to provide such financing in the UAE.

Further details about the Law are expected to be provided in subsequent cabinet resolutions. In particular, further guidance in relation to the establishment of the Register, the process for registration of Leased Property with the Register, what information will be publicly available on the Register and any applicable time limits, notarisation requirements and registration fees, is awaited.

We will continue to monitor developments in this area and issue a further update on the Law and any implementing regulations in due course.

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## FOR MORE INFORMATION

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Should you like to discuss any of the matters raised in this briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



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