

Articles in the Journal of Equipment Lease Financing are intended to offer responsible, timely, in-depth analysis of market segments, finance sourcing, marketing and sales opportunities, liability management, tax laws regulatory issues, and current research in the field. Controversy is not shunned. If you have something important to say and would like to be published in the industry's most valuable educational Journal, call (703) 527-8655.

JOURNAL

OF EQUIPMENT LEASE FINANCING



Legal Guide to Leasing in Russia for Foreign Lessors

By Irma Foley

Favorable changes in Russian leasing law are making leasing more attractive than other financing methods for both Russian lessees and foreign lessors. Increased economic effectiveness, flexibility, and accessibility are some of the positive changes.

The Response to Customer Default: Captive Versus Non-captive Lessors

By Itzhak Ben-David and James S. Schallheim, PhD

Repossession or write-off? The default remedies of captive and non-captive leasing companies can vary significantly. This Foundation-commissioned study explores the behavioral differences between captives and non-captives in instances of default.

Management of a Diverse Workforce: Meanings and Practices

By Jenny Hoobler, PhD, Tim Basadur and Grace Lemmon

What does diversity management mean in a leasing setting? To find out, this study commissioned by the Foundation surveyed human resources managers in leasing companies as well as diverse individuals within those same firms.

Legal Guide to Leasing in Russia for Foreign Lessors

By Irma Foley

Following significant amendments to the Financial Leasing Law in 2002, the Russian legislature further deregulated leasing by amending Russian tax, currency control, and customs laws during the past three years and by bringing legislation in line with the UNIDROIT Convention on Financial Leasing. (UNIDROIT stands for the International Institute for the Unification of Private Law).

A new customs code adopted international standards and simplified clearance procedures, while amendments to the tax code, effective January 1, 2006, expanded preferential treatment for financial lease transactions. Those changes made leasing more attractive than other financing methods for both Russian lessees and foreign lessors due to economic effectiveness, flexibility, and accessibility.

RUSSIAN LEASING LEGISLATION

The Russian civil code contains general provisions governing all types of leases, including financial leases,¹ leases of transportation equipment, short-term property rentals, and housing leases. The more recent Financial Leasing Law of 2005,² however, contains more detailed rules governing only financial leasing transactions, and the Russian tax code contains a number of provisions that apply specifically to financial leasing activities. In addition, the UNIDROIT Convention on Financial Leasing may apply to certain financial leasing transactions entered into with a Russian party, as discussed in this article.

FINANCIAL LEASES

Parties to Financial Lease

As a general rule, to qualify as a financial lease under Russian law, a transaction must involve three parties: a *lessor*, which undertakes to purchase nonconsumable items³ (identified by a *lessee*) from a *seller*, designated by the lessee, and

must provide the lessee with such property for temporary possession and use for commercial purposes. The lessee, in return, must make the required lease payments to the lessor. If a lessor is leasing property it already owns, such a lease does not qualify as a financial lease, as expressly confirmed in the Financial Leasing Law.

The amendments to the Financial Leasing Law of 2005 specifically provide that the lessee can be the seller, thus setting up the possibility of sale-leaseback transactions. According to recent reports by Russian leasing companies, the Russian tax authorities take a dim view of the accounting of such transactions: the tax code does not expressly address sale-leasebacks; thus such accounting appears suspicious.⁴

The lessee typically selects the seller of the property, but the parties may agree in the financial lease agreement that the lessor may select the seller. In the latter case, only the seller is liable to the lessee for the seller's performance under the purchase agreement entered into by the seller and the lessor. In any event, the lessee may not terminate the purchase agreement without the lessor's consent.

If the seller breaches its obligations under the purchase agreement, Russian law generally deems the lessor and the lessee to be joint and several creditors of the seller, such that either may demand full compensation from the seller. If the lessor selects the seller, the lessor must notify the seller that the acquired property is intended for lease to a specific person. A Russian court found a financial lease agreement void because the lessor did not inform the seller that the acquired property was intended to be leased.⁵

This decision demonstrates the importance of fully complying with all of the technical requirements of the law. Both the seller and the lessor are liable to the lessee for the seller's noncompliance with the terms of the purchase agreement, and the lessee may present its claims at its discretion to either the seller or the lessor.

The legal environment
for cross-border
leasing in Russia has
gradually become
more stable and is
giving Russian industry
access to more flexible
means of financing the
acquisition of much
needed equipment.

Lease payments may be structured as fixed sums paid once or periodically, as a fixed share of production, or as income derived from the leased property.

Subject of Financial Lease

Under Russian law any nonconsumable tangible items, other than land plots and other natural objects, may be the subject of a financial lease.⁶ In addition, title to the property that is the subject of a financial lease may or may not be transferred to the lessee at the end of the lease term, depending on the parties' agreement as to whether the lessee has an option to buy out the leased property.⁷

Required Provisions of Agreements

For a financial lease agreement to be valid, certain issues must be addressed therein at a minimum: the property, the seller, the amount of the lease payments, the payment due dates, and the procedure for making lease payments. A lease agreement that fails to adequately identify the property is deemed void under Russian law.

Because a financial lease under Russian law requires there to be a seller of the property, a sale-purchase agreement between the seller and the lessor is required to complement the lease agreement. Other agreements—pledges, guarantees, or financing agreements—may be part of the transaction, but those agreements are not required to make a financial lease transaction valid.

Lease Payments

Lease payments may be structured as fixed sums paid once or periodically, as a fixed share of production, or as income derived from the leased property. They may be paid in-kind with property or services, or in any other form agreed on by the parties to the lease agreement. Lease payments under a financial lease agreement are deemed to include the total amount of payments to be made during the term of the financial lease. Thus, Russian law presupposes that the lessor will include in the lease payments the expenses the lessor incurred in connection with the acquisition and transfer of the leased property, the costs of other services that the lessor may provide to the lessee, and the lessor's commission.

The lessor should keep this in mind when negotiating the amounts of lease payments, because the lessor will not be permitted under Russian

law to charge the lessee any extra amounts in addition to the lease payments during the lease term (with the exception of late fees and similar penalties for delays in payment).

Lease Term

A financial lease agreement generally may run for any term to which the parties agree. If the parties fail to expressly indicate a lease term in the lease agreement (which generally is not recommended), the lease is deemed to run for an indefinite period, until one of the parties terminates it in accordance with the termination provisions of the agreement and applicable law.⁸

Unless the lease agreement provides otherwise, a lessee that has properly performed its duties during the lease term has a priority right to prolong the lease agreement for a new term, in which case the terms of the lease agreement can be renegotiated by the parties (potentially negating the lessee's priority rights). If the lessee continues to use the leased property after the expiration of the initial term and the lessor does not object to such use, the lease agreement is deemed renewed for an indefinite period of time on the same terms and conditions as the initial lease agreement.

The Financial Leasing Law expressly permits the parties to agree on whether a financial lease agreement will be extended on the same terms as the initial agreement or whether the parties will renegotiate the terms. Thus, to avoid application of such mandatory Russian law in favor of the lessee, the lessor should (1) define the lease term in the lease agreement and (2) negotiate with the lessee to expressly waive its priority right for a new lease term. If the lessee surrenders the property even one day after the expiration date, the lessor should immediately object and should also collect penalties for such delay (in the amount of an increased lease payment for the delay period).

Statutory Grounds for Lease Termination

In addition to the grounds for lease termination set out in the lease agreement itself, the civil code provides grounds for a court to terminate a lease if one of the parties fails to perform its obligations under the lease agreement. Before

seeking a termination order from a court, the party wishing to terminate the lease agreement must send notice to the breaching party warning that party that it must fulfill its obligations under the lease agreement.

A lessor may ask a court to terminate a lease if the lessee (1) uses the property in a way that substantially breaches the terms of the lease agreement or the designation of the property, (2) substantially damages the leased property, (3) misses more than two consecutive lease payments, or (4) fails to carry out major repairs to the property that are the lessee's duty.⁹

A lessee may ask a court to terminate a lease for four reasons: (1) the lessor fails to provide the leased property to the lessee or creates impediments to its use, (2) use of the leased property is prevented by unexpected defects that were not previously known to the lessee and could not have been discovered by an inspection of the property at the time the parties concluded the lease agreement, (3) the lessor fails to carry out major repairs to the property that are its duty,¹⁰ or (4) the leased property is unsuitable for use due to circumstances for which the lessee is not responsible.

Remedies for Breach of a Lease Agreement

Perhaps the most important benefit of leasing over other forms of asset financing in Russia is the lessor's ability to recover the property in the event of the lessee's default. Only through lease financing does a provider of equipment retain the right to repossess the equipment if the lessee defaults on its obligations.

Although a seller of property under an installment sales agreement or a lender may take a pledge of the property, a pledge does not give the pledgee the right to take possession of the pledged property upon the occurrence of the event of default. Instead, the pledged property must be auctioned off in lengthy proceedings that can result in the pledgor receiving less than the fair market value of the property.

Because under Russian law the lessor retains title to the leased property, the lessor can regain

possession of the leased property. Unless the lessee returns the leased property voluntarily, the lessor must obtain a court order to repossess the property in the event of default. Unfortunately, disreputable lessees frequently abuse the system, but ultimately the lessor should be able to repossess the property. In any event, in Russia, repossession of property via court order is much more preferable to an auction of pledged property.

The Financial Leasing Law provides that a lessor has the statutory right to have funds equal to the amount of any unpaid lease payments withdrawn from the lessee's bank account without the lessee's consent. According to the instructions of the Russian Central Bank, banks are permitted to debit a customer's account without that customer's specific consent if the debit is permitted by Russian law or by an agreement to which the customer is a party.¹¹

No court approval is necessary for debits in these circumstances. Nevertheless, some Russian courts will allow such debits only when they are specifically allowed by both the financial lease agreement and the customer's account agreement with the bank.¹² The use of this remedy, however, does not waive the lessor's rights to other remedies, such as early termination of the lease agreement, repossession of the leased property, and compensation for expenses and additional fees (such as a late fee).

When the lessee is substantially late in making lease payments, in addition to the lessor's other remedies it may demand that the lessee make upcoming lease payments in advance. This statutory remedy has little practical value, however, because it can be used for no more than two future, consecutive lease payments.

Exposure of Leased Property to Lessee's Creditors

The Financial Leasing Law prohibits third-party creditors of the lessee, in bankruptcy proceedings or otherwise, from claiming the leased property. In the case of insolvency of the lessee, the lessor has the right to reclaim its property, but the lessor has no priority over the lessee's other creditors to monetary compensation.

Perhaps the most important benefit of leasing over other forms of asset financing in Russia is the lessor's ability to recover the property in the event of the lessee's default.

The Financial Leasing

Law requires the written consent of the lessor to any sublease of property leased pursuant to a financial lease agreement.

In some circumstances a lessor may want to obtain a pledge of other assets of the lessee to improve its priority should the lessee default on its payment obligations or become insolvent. A pledge of property does not give the lessor or pledgee the right to take possession of the pledged property, but it does give the lessor higher priority to the proceeds from the sale of the pledged property. Even in that case, however, the lessor's claim would be subordinate to those of the lessee's employees, the Russian government, and other creditors who had prior claims to the pledged assets.¹³

Return of Leased Property

Upon the termination of a lease, the lessee has the duty to return the property to the lessor in the condition in which it was received (taking into account normal wear and tear) or in the condition specified in the lease agreement. If the lessee fails to return the property or returns it late, the lessor may demand that the lessee make lease payments for the period of delay and compensate the lessor for any losses not covered by the lease payments. If the lease agreement imposes a penalty for late return of the leased property, the lessor may recover any losses in excess of the set penalty so long as the agreement does not provide otherwise. If the lessee refuses to return the leased property, the lessor may repossess the leased property with a court order.

The lessee must bear all the expenses relating to the dismantling of the equipment for its return, along with transportation and insurance expenses for transfer of the equipment back to the lessor.

Lessee's Buyout of Leased Property

The parties may agree in the lease agreement that title to the leased property passes to the lessee at the end of the lease term (or sooner), provided that the lessee pays the full buyout price specified in the lease agreement. With respect to financial leases that provide for the lessee to buy out the leased property, the buyout price should be included in the total price of the financial lease agreement, or it should be set out in a supplementary agreement between the parties. In the latter case, the parties may agree

to offset lease payments that were already made against the buyout price.

Sublease of Leased Property

The Financial Leasing Law requires the written consent of the lessor to any sublease of property leased pursuant to a financial lease agreement. Unlike other provisions of the civil code and the Financial Leasing Law, the provisions allowing the lessee to sublease the leased property do not specifically indicate that the parties can agree otherwise. Consequently, the enforceability of a provision that prohibits the lessee from subleasing the subject property is uncertain.

Moreover, although the lessor's consent is required before the lessee can sublease leased property, there is still a possibility that a court would hold that the lessor cannot withhold consent arbitrarily. Although we are unaware of any Russian court that has held that a lessor cannot withhold its consent to a sublease without good reason, many foreign courts would certainly take that position.

Accordingly, there is some risk that a lessee under a financial leasing agreement could sublease the property to a third party. The best way for the lessor to control that risk is to insert a provision in the financial lease agreement providing that the lessee can sublease the property only with the consent of the lessor, and then refuse to consent to any proposed sublease unless the lessor is convinced that its interests are not prejudiced by that sublease.

If leased property is subleased, the lessee remains liable to the lessor under the original lease, while the lessee's right of claim against the seller passes to the sublessee.

Duty to Repair Leased Property

Unless the parties to a lease agreement agree otherwise, the lessor is required to carry out major capital repairs of the leased property at its own expense, whereas the lessee must appropriately maintain the property and carry out repairs other than major repairs at its own expense.¹⁴

This general provision applies to equipment leases that do not qualify as financial leases, but

it does not apply to financial leases. Instead, the Financial Leasing Law provides that all repairs of the property leased under a financial lease are the responsibility of the lessee unless the agreement specifies otherwise.

Liability for Defects

Under Russian law the lessor is liable for defects of the leased property that wholly or partially hinder the use of the property, even if the lessor did not know about those defects when it entered into the lease agreement. Upon discovery of such defects, the lessee may (1) demand that the lessor remedy them, (2) request replacement of the property, (3) withhold from lease payments the amounts incurred by the lessee to remedy the defects (after notifying the lessor thereof), or (4) demand early termination of the contract.

The lessor is not liable, however, for defects of the property that were anticipated at the time the lease agreement was signed, for defects that were known to the lessee, or for defects that should have been discovered by the lessee at the time of inspection or transfer of the property.

If the lessee’s actions (or inactions) cause the loss of the leased property or the loss of its functionality, the lessee remains liable for its obligations under the financial lease agreement, unless the parties agree otherwise. The lessor has the right to monitor the lessee’s observance of the terms of the lease agreement and other accompanying agreements and to exert financial control over the lessee’s activities with the leased property pursuant to procedures set out in the lease agreement. The lessee is required to provide the lessor access to its financial documents and the leased property and to respond to any of the lessor’s written requests for information necessary to exercise financial control.

Licensing and Registration Requirements

Since early 2002, financial lease activity is no longer subject to licensing under Russian law, and a lease agreement for movable property—as opposed to one for real estate, aircraft, and certain vessels and spacecraft—is not subject to state registration either.

UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING

In 1998 Russia acceded to the UNIDROIT Convention on Financial Leasing of May 28, 1988, which came into force on May 1, 1995.¹⁵ The UNIDROIT convention automatically applies to leases in two circumstances. The first is when the lessor and the lessee have their places of business¹⁶ in two different countries. The second is either (1) when those two countries and the country in which the seller has its place of business are parties to the convention, or (2) both the financial lease agreement and the purchase agreement are governed by the law of a country that is a party to the convention.¹⁷

The convention applies only to cross-border financial leasing of equipment, including capital goods, but it does not apply to equipment used primarily for personal purposes. Based on the above, because the United States signed the convention but has not ratified it yet, the convention at present applies to financial leases involving a U.S. and Russian party only if the chosen governing law of both the financial lease agreement and the sale-purchase agreement is Russian law, provided that the parties have not excluded the application of the UNIDROIT convention.

In acceding to the convention, Russia reserved the right to apply its own civil legislation instead of Article 8(3) of the convention, which prohibits the parties to a financial lease transaction from eliminating the lessor’s duty to warrant the lessee’s quiet possession of the leased property from third-party claims arising out of intentional or grossly negligent acts of the lessor. Accordingly, Article 8(3) of the convention does not apply to financial leases if one of the parties has its place of business in Russia, the financial lease or the purchase agreement is governed by Russian law, and the parties decide not to exclude the application of the convention, as described below.

When the above criteria are met, the convention applies to a financial lease unless *all* of the parties to the transaction, including the seller, agree to exclude its application. Alternatively, the parties may agree to derogate from any provi-

Under Russian law
the lessor is liable for
defects of the leased
property that wholly
or partially hinder the
use of the property,
even if the lessor
did not know about
those defects when it
entered into the lease
agreement.

Choosing Russian law has a practical benefit if the lessor needs to repossess property located in Russia, because Russian courts have limited experience applying the convention or laws of other jurisdictions.

sions of the convention with two exceptions: (1) the convention prohibits a provision in the agreement that would allow the lessor to recover substantially greater damages than those necessary to place the lessor in the position in which it would have been had the lessee fully performed its obligations, and (2) the lessor is prohibited from enforcing an acceleration clause for payment of future lease payments if the lessor has terminated the financial lease agreement.

In the latter case, the value of such future lease payments is taken into account when computing the lessor's damages. Russian law generally is more favorable to the lessor on both of these points; thus, the lessor should consider opting out of the convention and choosing Russian law as the governing law for a financial lease agreement.

In terms of the creditor's right to the lessee's assets, when the convention applies and when the property is located in Russia, Russian law will nonetheless govern the rights of the lessee's creditors to the leased property. Russia generally has succeeded in bringing its legislation governing financial leasing in line with the UNIDROIT convention. As a result, the rights and duties of lessors and lessees under the convention are more or less identical to their rights and duties under Russian law, with the exceptions described above. Again, choosing Russian law to govern a financial lease agreement may therefore be a reasonable decision.

In addition, choosing Russian law has a practical benefit if the lessor needs to repossess property located in Russia, because Russian courts have limited experience applying the convention or laws of other jurisdictions. Moreover, even if the parties choose the law of another jurisdiction to govern their agreement, Russian courts often decide that Russian law must be applied to certain issues.

TAX ISSUES

The 2002 amendments to the Financial Leasing Law were enacted to bring the leasing legislation into compliance with the tax code,

which already provided preferential treatment for lease transactions. Amendments to the tax code specifically related to financial leasing took effect on January 1, 2006.

Profits Tax Considerations

Under the Financial Leasing Law and the tax code, the lessor and the lessee may choose which of them will record the leased property on its balance sheet. This decision determines which party is entitled to take profits tax deductions for depreciation of the property.

For Russian tax purposes, the decision as to whose balance sheet will reflect the leased property is not affected by the laws of other jurisdictions. Consequently, in the case of financial leases, even if a foreign lessor must record the property on its balance sheet under the laws of its jurisdiction, a Russian lessee still may record the property on its books. For leases other than financial leases, however, the parties have no choice: only the party that has title to the asset (that is, the lessor) may take depreciation deductions for profits tax purposes.

Under Russian tax law, to be subject to depreciation, property must have a useful life of over one year and an initial cost of over 10,000 Russian rubles (approximately US\$350). The 2006 amendments to the tax code added that investments—in the form of integrated improvements to leased property made by the lessee with the consent of the lessor—are also deemed assets subject to depreciation. The depreciation method depends on whether the value of such investments has been compensated by the lessor.

Russian tax law provides a significant incentive to use financial leasing in the form of accelerated depreciation for property that is the subject of a financial lease. A taxpayer can depreciate leased property for Russian profits tax purposes at up to three times the standard rate of depreciation applicable to that type of property.¹⁸ The benefit of accelerated depreciation is available to either the lessor or the lessee, depending on whose books the property is recorded on. However, accelerated depreciation is not available for assets not acquired through leasing. Thus, the benefit has induced some Russian companies to set up

their own leasing companies specifically to take advantage of the accelerated depreciation allowance.

The lessee is entitled to deduct its lease payments pursuant to a financial lease agreement when determining its profits tax liability. If the leased property received pursuant to a finance lease agreement is recorded on the lessee's balance sheet, and the lessee takes depreciation deductions on that equipment, the lessee's tax deductions for its lease payment expenses must be reduced by the amount of the depreciation deductions. The 2006 amendments to the tax code added that when the property is recorded on the lessee's balance sheet, the lessor should claim as expenses the costs incurred to acquire the property to be leased out, in addition to the lessee being able to deduct as expenses lease payments less the accumulated depreciation.

For the purpose of profits tax, the lessee's costs (in terms of buyout price of leased property at the time of transfer of title to the leased property to the lessee) are deemed "expenses for the acquisition of depreciated property." As such, the lessee may not deduct such costs from its taxable profits because the tax code deems the benefit of depreciation a sufficient advantage.¹⁹ The lessee may still deduct lease payments as described above, but the buyout price, included in the lease payments, may not be deducted for the purpose of profits tax.

In its November 2005 letter, the Russian Ministry of Finance emphasized the importance of specifying the buyout price in a finance lease agreement. It stated that if the agreement provides that title to the leased property is to be transferred to the lessee after all lease payments are made but such agreement does not specify the buyout price separately, all lease payments are deemed expenses for the acquisition of the depreciated property already included in the initial value of the depreciated property. That is, all lease payments are treated as the buyout price and may not be deducted by the lessee for profits tax purposes.²⁰

If a foreign lessor operates through a branch in Russia, the net income of that branch will be

taxed at the standard profits tax rate of 24%. If a foreign lessor does not operate through a branch in Russia, a Russian lessee must withhold Russian profits tax at the rate of 20% (10% on the lease of ships, aircraft, and containers used in international shipments) from lease payments to that foreign lessor, unless an applicable double tax treaty, such as the one signed by Russia and the United States, exempts lease income from Russian tax.

Value-Added Tax

Russian value-added tax (VAT) applies to lease payments at the standard rate of 18%. When the lessor is a foreign entity with no presence in Russia, the Russian lessee must withhold Russian VAT from payments to the foreign lessor.

This withholding system is not a reverse-charge mechanism as is used in other jurisdictions that impose VAT. Under the Russian system, the Russian lessee is required to withhold 18% of the amount of any lease payment due to a foreign lessor. To ensure that the foreign lessor receives the full amount due, the lease agreement should state that the amounts of lease payments indicated therein do not include Russian VAT, and any invoice sent to the Russian lessee should be "grossed up" by 18%.

Assets Tax

In deciding whether to record property on the balance sheet of the lessor or the lessee, another important consideration is the Russian assets tax imposed on the movable and immovable property recorded on a company's balance sheet. For finance leases, the decision as to which party will record the leased property on its balance sheet determines which party will incur the assets tax liability on that property.

The assets tax applies to foreign entities only if they conduct activities in Russia through a "permanent establishment"; otherwise, a foreign lessor is not subject to the assets tax on leased property located in Russia. If the lease agreement specifies that the property should be recorded on the foreign lessor's balance sheet, the Russian lessee is not liable for the assets tax on the leased

In its November
2005 letter, the
Russian Ministry of
Finance emphasized
the importance of
specifying the buyout
price in a finance
lease agreement.

Under a temporary import regime, foreign goods can be imported and used in Russia for a limited period of time, with full or partial exemption from customs duties and fees and VAT.

property, too. (The leased property escapes Russian taxation.)

The downside of specifying that the property will be recorded on the foreign lessor's balance sheet is that it eliminates the ability of the lessee to take advantage of the accelerated depreciation benefit and the possibility of a double-dip on depreciation deductions. Consequently, the effects of the net profits tax and assets tax need to be considered before deciding which party's balance sheet should show the leased property.

CUSTOM LAW CONSIDERATIONS OF CROSS-BORDER LEASING

The adoption of a new Russian customs code effective January 1, 2004, and amended during the past two years had a positive effect on cross-border leasing because it adopted international standards and simplified customs clearance procedures. Accordingly, leased property may be imported into the Russian Federation territory under two different customs regimes, depending on circumstances of the given lease transaction and desired consequences: (1) the permanent import regime, called "clearance for internal consumption," or (2) the temporary import regime.

Permanent Import

"Clearance for internal consumption" is a customs regime under which imported goods²¹ are released into "free circulation" without any obligation to be re-exported out of Russia. This regime requires full payment of customs duties and fees and VAT at the time the property enters Russia. Customs duties rates vary from 5% to 30% of the value of the property being imported, and VAT at the rate of 18% is assessed on the value of the property as increased by the applicable customs duties.

Temporary Import

Under a temporary import regime, foreign goods can be imported and used in Russia for a limited period of time, with full or partial exemption from customs duties and fees and VAT. The temporary import of goods is allowed subject to the condition that the goods are identified

by the customs authorities at the time of their export back out of Russia. Temporarily imported goods must remain unchanged other than for natural wear and tear. The Russian customs authorities generally demand a guarantee from the lessee that it will re-export the goods at the end of the temporary import term.

If the parties to a cross-border lease want to use the temporary import regime, the lessee will need to import the property, because a foreign company may not import goods into Russia in its own name. Temporarily imported goods may be used only by the entity in whose name they are imported. Use by anyone else requires permission of the customs authorities.

Generally, goods can be imported under the temporary import regime for up to two years. However, goods and equipment classified as fixed assets for the purpose of Russian accounting can be imported under the temporary import regime for a period of 34 months if used by a Russian entity that does not own them. At the end of the temporary import term the goods must be exported out of Russia or switched to another customs regime.

When property is imported under the temporary import regime, the importer typically must pay a monthly fee equal to 3% of the customs value of the property. That fee is not refundable if the property is re-exported, but if the customs regime is switched to free circulation, those payments are credited against the customs duties then due. The total of all of monthly fees cannot be greater than the amount of customs duties, fees, and taxes that would have been due if the property had been imported for free circulation. Accordingly, the obligation to make these payments ends if the property remains in Russia for more than 34 months ($3\% \times 34 = 102\%$).

If goods that were temporarily imported are switched to the free-circulation regime, the applicable customs duties are based on the customs value of the goods at the time they were imported under the temporary import regime, whereas the applicable rates of customs duties and taxes are those in effect at the time the of the change of customs regime. The customs code allows the

temporary import of goods with full exemption (without monthly fees) only in three circumstances: (1) goods imported in connection with international aid, (2) goods imported in connection with cultural, scientific, sports, and tourism activities, and (3) containers, pallets, and other reusable packaging.

CURRENCY CONTROL ISSUES AFFECTING CROSS-BORDER LEASING

In July 2006, the Russian government eliminated major currency control restrictions with respect to advance lease payments, thus making cross-border leasing much less complicated. The remaining restrictions described below are not nearly as cumbersome as the previous requirements of establishing special accounts and the mandatory reservation of the percentage of the lease payments.

A Russian lessee needing foreign currency to make lease payments to a nonresident lessor can purchase foreign currency only through an authorized Russian bank²² and can make payments in foreign currency to either the foreign lessor's account abroad or its foreign currency account in Russia. In order for a nonresident lessor with no permanent presence in Russia to open any bank account (in Russian rubles or foreign currency) for the purpose of receiving lease payments in Russia, such lessor must register with the Russian tax authorities (which adds an administrative burden).

Thus, a nonresident lessor may open a Russian ruble account in Russia and receive lease payments in Russian rubles into that account. However, in that case, the lessor would need to convert the rubles into foreign currency and transfer the funds to its account abroad; this payment structure shifts the currency conversion costs to the lessor. The most effective way for a foreign lessor with no permanent presence in Russia to receive foreign currency lease payments is to receive them directly into its account abroad, because the administrative burden of opening accounts and preparing necessary documentation for the transfer²³ is on the resident lessee.

The legal environment for cross-border leasing in Russia has gradually become more stable and is giving Russian industry access to more flexible means of financing the acquisition of much needed equipment. Continuing improvements in legislation will create further incentives for development of the Russian leasing sector, and foreign lessors are likely to enjoy even more favorable leasing conditions in Russia.

ENDNOTES

1. The meaning of the term "financial lease" under Russian law differs from the meaning of such term (or any similar terms such as capital or finance lease) under U.S. law. For the purposes of Russian law (tax, accounting, and so on), "financial lease" is strictly defined (in one definition) at the beginning of the Financial Leases section. Moreover, Russian law and accounting practices do not formally distinguish between operating and capital leases.
2. Russian Federal Law No. 164-FZ, "On Financial Leasing," October 29, 1998 (last amended on July 26, 2006).
3. Nonconsumable items for the purpose of financial leases under Russian law include buildings, structures, equipment, transport vehicles, and other movable and immovable items, which can be used for commercial purposes and which in the process of their use do not lose their natural qualities. Land plots and natural objects may not be the subject of a *financial* lease under Russian law, but they may be the subject of a general lease subject to certain restrictions.
4. Tax specialists at leasing companies expressed this concern at the seminar "Financial Leasing in Russia: Legal Regulation and Issues in Practical Application," held on November 17-18, 2006, in Moscow.
5. Decision of the Federal Arbitration Court for the Far East Region, April 3, 2001.
6. See endnote 3.
7. For more details on the lessee's buyout option, see the section Lessee's Buyout of Leased Property.
8. For mandatory Russian law in respect of the parties' right to terminate the lease agreement, see the section Statutory Grounds for Lease Termination. Parties may provide additional grounds for lease termination in the lease agreement.

The most effective way for a foreign lessor with no permanent presence in Russia to receive foreign currency lease payments is to receive them directly into its account abroad.

9. For discussion of the parties' respective duties to repair, see the section Duty to Repair.
10. *Ibid.*
11. Instruction of the Russian Central Bank No. 2-P, "On Wire Transfers in the Russian Federation," October 3, 2002.
12. See, e.g., Decisions of the Federal Arbitration Court of the West-Siberian Region, November 23, 2000, and November 11, 2003, and Decision of the Federal Arbitration Court of the Povolzhoskiy Region, July 16, 2002. Case law in Russia does not create legal precedents, as it does in the United States and the United Kingdom, but serves only as guidance.
13. Article 134 of Russian Federal Law No. 127-FZ, "On Insolvency (Bankruptcy)," October 26, 2002 (as amended).
14. Russian law does not define what repairs are deemed capital or major repairs, as opposed to minor or current repairs. However, case law and commentaries suggest that this determination is based on the characteristics of the equipment, the relevant magnitude of the repair, and the cost of such repair. Minor or current repairs may be deemed those repairs that fall under the category of maintenance; that is, they allow the equipment to function throughout its useful life, whereas capital or major repairs result in significant expenses and are done over longer periods of time during which the equipment generally may not be used.
15. Russian Federal Law No. 16-FZ, "On the Accession of the Russian Federation to the UNIDROIT Convention on International Financial Leasing," February 8, 1998. The convention entered into force for Russia on January 1, 1999.
16. If a party has a place of business in more than one country, the place of business with the closest relationship to the relevant agreement and its performance should be used (Article 3(2) of the UNIDROIT Convention).
17. Nineteen countries are signatories of the convention: Russia, France, the United States, Belgium, Uzbekistan, Latvia, Italy, Hungary, Belarus, the Czech Republic, Finland, Ghana, Guinea, Morocco, Nigeria, Panama, the Philippines, Slovakia, and Tanzania. The convention entered into force after three ratifications. So far only nine countries, including Russia but excluding the United States, have ratified the convention.
18. Accelerated depreciation may not be applied to leased property in the form of fixed assets belonging to the first three depreciation groups if the taxpayer elects not to use the straight-line depreciation method. The first depreciation group includes all short-life assets with a useful life from one to two years inclusive (such as tools). The second group includes assets from two to five years inclusive (such as drilling, medical, and construction equipment). The third group includes assets from three to five years inclusive (such as wooden structures, cranes, loading machines, oil field development drilling equipment, geological prospecting equipment, and transport vehicles). Decision of the Russian Government No. 1, "On the Classification of Fixed Assets Included in Amortization Groups," January 1, 2002.
19. This position is reaffirmed in Letter of the Department of Tax and Customs Policy of the Russian Ministry of Finance No. 03-03-04/1/348, November 9, 2005.
20. *Ibid.*
21. "Goods," for the purpose of the customs code, represents all movable property moved across the customs border of the Russian Federation.
22. Authorized banks are credit institutions and their branches that were established in compliance with Russian law and licensed by the Central Bank of Russia to effect foreign currency transactions. Article 1(8) of Russian Federal Law No. 173-FZ, "On Currency Regulation and Currency Control," December 10, 2003 (last amended on July 26, 2006).
23. Under Instruction of the Central Bank of Russia No. 117-I, June 15, 2004 (as amended on August 8, 2006), the resident lessee must execute a "transaction passport" with its bank to be able to make payments to a foreign lessor under a lease agreement, and some Russian banks may perform this function on a resident lessee's behalf. The requirement of the transaction passport is currently set to expire on January 1, 2007, but it may be that the Russian government will extend it. Transaction passports are prepared on the basis of the supporting documents for the transaction, including the lease agreement.

**Irma Foley**

ifoley@orrick.com

Irma Foley is an attorney with the global finance/corporate group in the international law firm of Orrick, Herrington & Sutcliffe LLP in Washington, D.C. From the summer of 2004 through the summer of 2006, she worked in the firm's Moscow office advising mainly non-Russian clients on cross-border commercial and corporate transactions and inbound investments in Russia. Before joining Orrick, Ms. Foley worked for the international law firm of Coudert Brothers LLP in its Moscow and Washington D.C., offices, and was a law clerk at two other law firms in Washington D.C. She was recently invited by Rosleasing, the Russian association of leasing companies, to represent it in working groups of Leaseurope, the European Federation of Leasing Company Associations. Ms. Foley earned her BA in political studies at Bard College, Annandale-on-Hudson, N.Y., and her JD at the American University-Washington College of Law in Washington, D.C.

The Response to Customer Default: Captive Versus Non-captive Lessors

By Itzhak Ben-David and James S. Schallheim, PhD

A better understanding of how lessors respond to default could help increase efficiency in the leasing market. Market participants would better understand how to react to default themselves by knowing how other institutions behave under similar situations. In addition, knowledge of a leasing company's specialization in core assets and its accompanying default remedies could help other lessors target their market niches.

In further support of this belief, several economic theories have suggested that default response may be an important differentiating factor between captive and non-captive lessors. For these reasons, this study focused on default procedures—specifically, how captive and non-captive lessors differ in their default remedies.

Using the PayNet database, we documented several characteristics of the lease contracts.¹ These include asset type, contract size, and term of the contract as well as default remedies implemented. This research revealed:

- Captive leasing companies (in which at least 50% of the lease portfolio consists of products produced by a parent or affiliates) are significant participants in the leasing marketplace. According to the Equipment Leasing Association's 2005 *Survey of Industry Activity* (SIA), 25% of new-lease volume in 2003 and 2004 was reported by captive lessors.²
- Most captive lessors are subsidiaries of equipment manufacturers that specialize in leasing a range of products that is narrower than the variety leased by non-captive lessors.

Captives seem to have two conflicting motivations when it comes to default response. On the one hand, captives can incur higher indirect

costs than non-captives when repossessing assets in default. For example, captives risk their brand reputation as well as their long-term relationship with a customer when they repossess an asset. Hence, captives may prefer to renegotiate the loan instead of taking the more drastic measure of repossession.

On the other hand, captives have the ability to generate higher values from repossessions than non-captives, because they can resell used equipment at a price based not on a cursory reading of the market but on proprietary information that they or their parent companies have amassed about the asset and its customers.

Recognition of this conflict led to the formation of a simple, testable hypothesis.

Hypothesis: Captive lessors are more likely to repossess equipment as a default remedy than are non-captive lessors.

Support for an alternative hypothesis can be found in arguments concerning a captive's relations with its parent's customers. Wilner (2000) argues that vendors are more inclined to renegotiate bad loans rather than to repossess assets, because they can lose their reputation and destroy current and future relationships. Brennan (1988) reasoned that vendors provide financing to their customers in the first place because it is an effective marketing tool that delivers better value to credit-constrained customers. Hence, vendors may attract customers with low credit that prefer to lease assets from a more lenient captive lessor.

Alternative hypothesis: Captives are less likely to use repossession as a default remedy than are non-captive lessors.

Results from researching the hypothesis and its alternative revealed the following.

Default response may be an important differentiating factor between captive and non-captive lessors. The results of this study support the hypothesis that captives are more likely to repossess in default.

Captives are in the unique position of having access to a known customer database of potential lessees. Captive lessors are also more sales- and customer-driven, whereas non-captives are more credit driven.

- Captives have the ability to remarket equipment after repossession and potentially obtain top dollar. Thus, with lower disposal costs, vendors prefer repossession over litigation or renegotiation, especially if the chances of the customer surviving are low.
- Non-captive leasing companies, including subsidiaries of some of the largest banks, specialize in providing funds and monitoring leases for equipment in a wide range of classes and manufacturers.

Captives are in the unique position of having access to a known customer database of potential lessees (Petersen 1997). Captive lessors are also more sales- and customer-driven, whereas non-captives are more credit driven. And because captives are more willing to repossess equipment in case of default, they place more weight on equipment values than on lessee credit characteristics. Therefore, captives may be willing to take on lessees with lower credit qualifications than would non-captives. These arguments led to a corollary hypothesis.

Corollary: Captive lessors are willing to provide leases to lower credit quality lessees.

DATA SAMPLE

The data sample for this study consisted of over 600,000 individual leases and loans obtained from the PayNet database. These data cover the period from January 2002 to April 2004. Contracts were randomly selected from approximately one-half of the PayNet database. When a lessee was selected, we were careful to include in the sample all contracts with lessors for the sample period.³

Table 1 shows the default frequency for the entire sample. As seen here, the default rate for non-captives is slightly higher, at 4.5%, than for captives, at 4.2%. These numbers do not indicate that captives are providing credit to lower-quality lessees in terms of default, as proposed in the corollary to our hypothesis.

But it is informative to compare this information to that from an alternative data source: the

Table 1

Sample of 608,612 Individual Contracts from the PayNet Database, 2002-2004

| Procedure | Captives | Non-Captives |
|-----------------------|----------|--------------|
| In default procedures | 4.2% | 4.5% |
| No default procedure | 95.8 | 95.5 |
| Total | 100.0% | 100.0% |
| No. of observations | 226,440 | 382,172 |

Survey of Industry Activity. The SIA does not report default rates, but does report the aging of receivables. In it, captives have higher receivables in the past-due, 30+ days categories (3.7% in 2003 and 3.1% in 2004) as compared to the non-captives, with past-due, 30+ days receivables (2.9% in 2003 and 1.9% in 2004). The SIA evidence for “late payments” is more consistent with the idea that captives’ customers may reflect higher credit risk, as suggested by the corollary.

TESTING THE HYPOTHESIS

To test the main hypothesis, that captive lessors are more likely to repossess equipment as a default remedy than are non-captive lessors, we examined default remedies by type of lessor. PayNet identifies the following default procedures in its database:

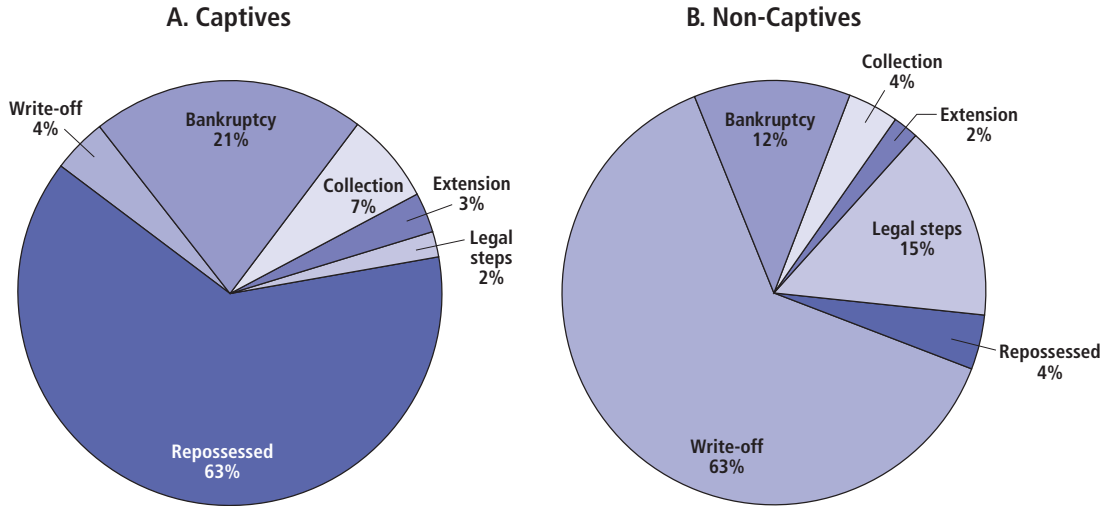
- bankruptcy
- collection
- extension
- legal steps
- repossession
- write-off

For the contracts identified as in-default, and in which the procedure is also identified, we calculated the percentage of contracts in each category by type of lessor. Figure 1 shows the results.

Parts A and B of Figure 1 offer overwhelming evidence regarding the differences in default procedure between captive and non-captive lessors.

Figure 1

Default Procedures for Captive and Non-captive Lessors



In strong support of the study’s hypothesis, 64% of the default contracts for captives used repossession as a default remedy, compared to only 4% of the default contracts for non-captives.

In strong support of the study’s hypothesis, 64% of the default contracts for captives used repossession as a default remedy, compared to only 4% of the default contracts for non-captives.

Other differences in the default procedures of captive and non-captive lessors are evident in Figure 1. Non-captives are writing off bad debts at a much higher percentage than captives (62.5% vs. 3.8%). Non-captives are also instigating legal action at a rate of 15% of default contracts, with captives reporting less than 2%.

Lastly, the data show that the lessees of captives are filing for bankruptcy at a much higher rate than the lessees of non-captives (21% versus 12%). The bankruptcy numbers are consistent with the idea in the corollary that captives are offering leases to less creditworthy customers.

In the following sections of this article, we examine more details of the contracts, as compared to default procedures, and we summarize the results of examining asset type, contract size, contract term, and core assets.

database, we categorized the equipment into 13 asset types: forklift, manufacturing, medical, office equipment, printing and photographic, railroad, real estate, retail, telecommunications, trucks, vending and restaurant, waste and refuse-handling, and other.

In the sample, both captives and non-captives had concentrations of more than 30% of their contracts in waste and refuse-handling equipment. Captives had concentrations in manufacturing (20%), medical equipment (19%), and printing equipment (16%). Non-captives showed more diversity of equipment than captives, with concentrations in vending and restaurant equipment (22%) and trucks (9%).

Focus on the default contracts revealed that captives had the largest number of defaults in manufacturing equipment, with 71% of default contracts falling into this category. Non-captives, in contrast, showed the largest number of defaults (38%) in trucks.

CONTRACT SIZE

Size appears to be a highly important determinant of default and default remedies. The entire sample was divided into three nearly equal size categories. We then examined the default contracts within each category.

ASSET TYPE

One of the most important characteristics of the lease contract is the type of equipment or asset that is under lease. Using the PayNet

Asset write-offs are most prevalent for short maturities, while repossession by captives is more common for medium- and long-term maturities.

The repossession rate among captives was found to increase with size. Larger leases showed that repossession was used in 74% of default cases. Non-captives also showed repossession as the response most often used for their largest contracts, although the response occurred at a much lower rate (12%).

Greater repossession rates for large contracts are probably related to large residual values that likely exceed the transaction costs incurred to repossess the assets.

Also consistent with transaction costs, we found that the small captive leases had a higher rate of write-offs (11.5%). As contract size increased, captive lessees were less likely to file for bankruptcy. By comparison, the data revealed that non-captive lessees showed an increase in the likelihood of bankruptcy as contract size increased.

Interestingly, for the largest leases, the bankruptcy rates among lessees of captives and non-captives were almost identical (around 15.5%). Although non-captives wrote off a large number of small contracts (62%), they also took legal action at a higher rate for small contracts (23%).

CONTRACT TERM

The maturity period of the contracts was divided into three categories. For the entire sample, the lowest contract terms averaged around two years, the medium group averaged 46 months, and the highest group averaged a little more than five years. Leases produced by captives tended to have a longer maturation period than those produced by non-captives.

The breakdown of data according to the term of the contract continues to support the main hypothesis: that captives are much more likely to repossess in response to default, whereas non-captives are much more likely to write off the debt. Another observation from the terms of the contract is that asset write-offs are most prevalent for short maturities, while repossession by captives is more common for medium- and long-term maturities. If asset lives are correlated with contract maturity—which is likely—the higher

repossession rates for longer-term contracts is probably due to the longer remaining economic life and value for these assets.

CORE ASSETS

Captive lessors were concentrated in an equipment category by definition. Non-captive lessors may concentrate in a special equipment type as well. Lessees were also likely to have “core assets” that were prominent in their businesses. As an example, trucking companies use trucks as core assets.

Lessee core assets are defined as those that generate income for lessors instead of supporting their administration and peripheral logistics. For example, trucks and forklifts were classified as core assets for farms, but copier machines were classified as peripheral or non-core. The core, or specialized, assets of *lessors* was also examined, along with their behavior when lessees defaulted.

Captive core assets were defined as holdings of more than 60% of the same asset. Because non-captive lessors were more diversified, their holdings of more than 20% in an asset group were defined as core assets. (For details, see the full “Captives vs. Non-captives” report.)

For captives that leased the lessee’s core assets, there was a much higher rate of repossession (64.5%) than for the lessee’s non-core assets (28%). There was also a higher rate of repossession of lessees’ core assets by non-captive lessors (10%) than for lessees’ non-core assets (2%). Evidence also showed that captives experience greater repossession rates for their core assets (67%) compared to non-core assets (48%), whereas non-captives are more likely to write off their core assets (66%) than non-core assets (50%).

This evidence is consistent with the idea that both lessees’ and lessors’ core assets are valuable in default and thus experience increased rates of repossession. Nevertheless, the main hypothesis still holds, that captives are more likely to repossess in the case of default, whereas non-captives are more likely to write off the default.

SUMMARY

The main result of the study is clear: More than 60% of captive contracts were repossessed when in default, whereas only 4% of defaulted contracts were written off. In contrast, more than 60% of non-captive defaulted contracts were written off, while just 4% were subjected to repossession. These results support the hypothesis that captives are more likely to repossess in default. The hypothesis continued to hold when sample data was divided into categories based on size, contract terms, and core assets. Larger contracts and longer contracts had greater repossession rates than contracts that were smaller and shorter-term, requiring more payment frequency.

Greater rates of repossession also occurred for core assets of both the lessee and lessor. Still, captives use repossession in default at much greater rates than non-captives in all segments of the sample.

The results of the study point to these important differences between captives and non-captives.

- Non-captives usually are not in the equipment business, and thus repossession is a costly default remedy for non-captives. As a non-captive member of ELA commented, "We do not have the wherewithal to evaluate condition, refurbish, and remarket equipment in order to obtain the best price."
- But in case of default, non-captives prefer to recover their investment as quickly as possible, and thus are more likely to litigate.
- Non-captives also are more likely to write off a bad debt. For example, many non-captive

lessors are financial institutions and therefore subject to regulatory requirements such as faster write-off policies.

- Captives, which are much less regulated, enjoy greater freedom in default response.

One final observation, in the form of a comment made by a non-captive ELA member, is pertinent: "A captive/manufacture is selling equipment with a huge gross margin, while the lease company is dealing in a small money spread. Clearly, the captive has much less to lose. We [non-captives], on the other hand, are desperate to recover our investment."

Endnotes

1. Headquartered in Alpharetta, Ga., PayNet Systems provides custom credit-card processing services to retail, wholesale, mail and phone order, and e-commerce businesses.
2. ELA (now known as the Equipment Leasing and Finance Association) conducts the annual Survey of Industry Activity. In 2005, it tabulated responses from approximately 130 leasing companies (out of 435 eligible companies).
3. PayNet classifies contracts as leases or loans. Our sample includes 22% loans. The rest are classified as different types of leases.

References

- Brennan Michael J., Vojislav Miksimovic, and Joseph Zechner, "Vendor financing," *Journal of Finance*, 43, no. 5 (1988): 1127-1141.
- Petersen, Mitchell A. and Raghuram G. Rajan, "Trade Credit: Theories and Evidence," *The Review of Financial Studies*, 10 (1997): 661-691.
- Wilner Benjamin S., "Relationships in financial distress: The case of trade credit," *Journal of Finance*, 55, no. 1 (2000): 153-178.

Greater rates of repossession also occurred for core assets of both the lessee and lessor. Still, captives use repossession in default at much greater rates than non-captives in all segments of the sample.



**James S.
Schallheim, PhD**

finjs@business.utah.edu

James S. Schallheim is the Jake Garn Professor of Finance at the University of Utah, Salt Lake City. His teaching and research interests are corporate finance, leasing, and stock markets in both the United States and Japan. He is the author of *Lease or Buy: Principles for Sound Corporate Decision Making* (Harvard Business School Press, 1994) and has published in numerous academic and practitioner journals. Dr. Schallheim holds a bachelor's degree in economics from the University of California at Santa Barbara; an MBA from Wright State University, Dayton, Ohio; and a PhD in finance from Purdue University, West Lafayette, Ind.



Itzhak Ben-David

ibendavi@chicagogsb.edu

Itzhak Ben-David is a doctoral student in finance at the Graduate School of Business, the University of Chicago. He received an MSc, with distinction, in finance from London Business School as well as an MSc, cum laude, in industrial engineering from Tel-Aviv University in Israel. In addition, Mr. Ben-David holds a BSc, cum laude, in industrial engineering and a BA, cum laude, in accounting, both from Tel-Aviv University.

Management of a Diverse Workforce: Meanings and Practices

By Jenny Hoobler, PhD, Tim Basadur and Grace Lemmon

EXECUTIVE SUMMARY

Purpose

The purpose of this article, which was commissioned by the Equipment Leasing and Finance Foundation, is to explore what companies now consider the components of diversity management. The article explores leading practices, explains how the effectiveness of diversity management programs is measured, and offers a window into what some leasing and finance companies are currently doing in the diversity arena.

Key Findings

1. A survey of the human resource management literature led us to categorize diversity management initiatives into (1) recruitment efforts, (2) individual development efforts, (3) organizational development efforts, and (4) external-outreach efforts.
2. Leading practices in diversity management are categorized as (1) general philosophy, (2) training, (3) development, (4) accountability, and (5) feedback, with each detailed.
3. We found that measuring the effectiveness of diversity initiatives is an important concern to companies, yet only a handful have specific measures in place at the present time.
4. A web-based survey conducted in 2006 by the authors and funded by the Foundation revealed that within the leasing and finance industry, the companies' diversity management programs focus on these workforce groups: women, African-Americans, Latino/Latina/Hispanics, Asians, those with disabilities, sexual minorities, those with religious beliefs, older employees, and younger employees.
5. Data collected in the web-based survey of leasing and finance industry firms support the claim that diversity initiatives do make a difference. The authors surveyed HR managers about the diversity policies and programs their individual firms engaged in, and, with another survey, asked diverse individuals in those same firms about their firm's diversity climate. Results support the idea that when firms engage in specific diversity management initiatives, employees in those firms hold more positive attitudes toward diverse others.

Research has shown that companies stand to benefit from a diverse workforce in many ways, including (1) the ability to sustain a competitive advantage¹; (2) greater innovation, creativity, and renewal²; and (3) heightened chances for organizational survival.³ Only companies that can manage and support diverse cultures will be able to retain talent and remain competitive in the workforce of the future.

As a result, a pro-diversity orientation is becoming standard in U.S. organizations, where

diversity initiatives (here defined as specific activities, programs, policies, and other processes or efforts designed for promoting organizational culture change related to diversity⁴) are many and varied.

The purpose of this article is to explore what companies consider the components of diversity management (diversity initiatives), describe leading practices, articulate how the effectiveness of diversity management programs is measured, and offer a window into what some leasing and

What management practices have leasing companies adopted with respect to a diverse workforce? How do those practices compare with those of the Fortune 1000? A study commissioned by the Foundation brings these practices to light.

Overwhelmingly, companies report a concerted effort to recruit minority employees. Many report including diverse employees in the minority recruiting process.

finance companies are currently doing in the diversity arena.

WHAT IS DIVERSITY MANAGEMENT?

Broadly, the types of diversity management initiatives that companies pursue fall into the following categories: (1) recruitment efforts, (2) individual development efforts, (3) organizational development efforts, and (4) external-outreach efforts. See Table 1 for specific examples of initiatives relating to each of these four categories.

Recruitment Efforts

Overwhelmingly, companies report a concerted effort to recruit minority employees. Many report including diverse employees in the minority recruiting process.⁵ Additional common practices include going beyond posting newspaper and web-based job advertisements—that is, sending job postings to ethnic organizations, being visible at career fairs, and traveling to a wider range of universities to recruit.

Individual Development Efforts

Second, and again to a great degree, companies' diversity initiatives include some type of

diversity-awareness, appreciating-differences, or sensitivity training for employees. The objectives of these training efforts are to reduce stereotyping, to increase cultural sensitivity, and to develop skills for working in multicultural environments.⁶

Many companies do not take a one-size-fits-all approach. For example, they take into account the occupations and the level of interaction with customers and fellow employees. Increased development opportunities for high-potential minority employees and mentoring are commonly cited practices, designed to give employees enhanced skills and access to powerful others in the organization.⁷

Organizational Development Efforts

Third, efforts aimed at organizational effectiveness include cultural audits to assess how both organizational insiders and outsiders perceive the success of the organization in its quest to embrace diversity.⁸ Diversity advisory boards composed of organizational outsiders who are knowledgeable in the area of diversity can guide and consult companies on diversity management programs and progress.⁹

Table 1

Diversity Management Initiatives

| Type of initiative | Description |
|------------------------------------|---|
| Recruitment efforts | Recruit diverse employees via expanded job postings Send job announcements to ethnic organizations Be visible at career fairs Recruit at a wider range of universities |
| Individual development efforts | Create a diversity awareness/cultural sensitivity program Increase availability of mentoring programs for high potential minority individuals Increase development opportunities for high potential minority individuals |
| Organizational development efforts | Cultural audits Develop diversity advisory boards Emphasize fairness and equity in mission statements and visioning action plans Organize work/life balance programs Mandate performance and accountability initiatives |
| External-outreach efforts | Support the local community Target qualified minority-owned and minority-operated vendors Fund research activities that focus on the well-being of minorities Allocate funds for philanthropy and/or scholarships for minorities |

Sources: Rosner, 1999; Wentling, 2001; Gasorek, 1998; MacDonald, 1993; Wentling & Palma-Rivas, 2000

A principle of organizational development is that fairness and equity should be clearly mandated in company policies. Diversity should be front and center in mission statements and visioning action plans.¹⁰

Work-life balance programs are often seen as a part of diversity management, because their focus is to make work arrangements more flexible and to acknowledge workers' personal life commitments such as caring for children, older parents, and employees' own health-related issues.¹¹

The best companies are working to ensure that diversity is talked about but also is a focus of real action and organizational improvement. These companies mandate performance and accountability initiatives specific to diversity goals. In other words, these companies hold their managers responsible for meeting diversity goals, via their compensation and promotion.

External-Outreach Efforts

Lastly, community support is an outward sign of a diversity commitment. Many companies report targeting qualified minority-owned and minority-operated vendors with their purchasing activities.¹² To a lesser extent, these companies fund research activities related to minorities and women, including their health and well-being.

As an example, Toyota has designated 15% of its philanthropic spending for minority-focused community programs.¹³ Many organizations sponsor scholarships for minorities in the communities in which they do business.¹⁴ Other organizations give back to their communities by releasing their employees to lecture at schools and universities, to serve as role models for students.

WHO ARE DIVERSE INDIVIDUALS?

Figure 1 presents the results of a study of 121 Fortune 1000 companies to determine the workforce groups they target for their workforce diversity initiatives.¹⁵ Likewise, the authors collected data to understand what workforce groups are the focus of leasing and finance industry companies' diversity management programs.

A web-based survey conducted in 2006 and funded by the Equipment Leasing and Finance Foundation provided the data presented in Figure 2. This sample of leasing and finance firms complements the broader results from the Fortune 1000 sample.

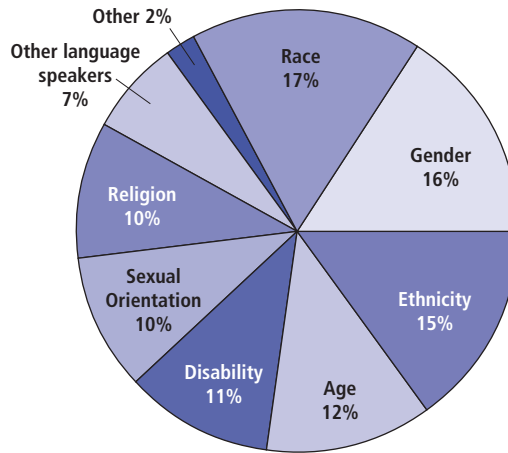
WHAT ARE LEADING PRACTICES IN DIVERSITY MANAGEMENT?

The following five categories summarize the writings on leading practices in diversity man-

The best companies are working to ensure that diversity not only is talked about but also is a focus of real action and organizational improvement. These companies mandate performance and accountability initiatives specific to diversity goals.

Figure 1

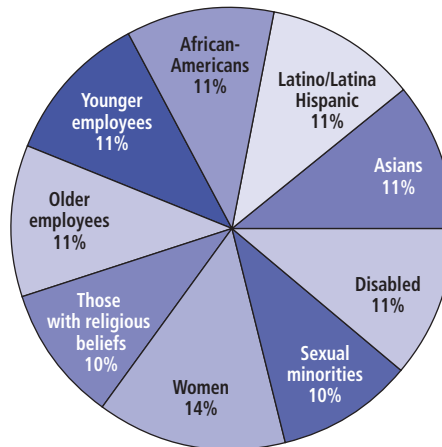
Groups Targeted by Workforce Diversity Initiatives (Fortune 1000 Companies)



Source: Gresing-Prophal, 2002

Figure 2

Groups Targeted by Equipment Leasing and Finance Organizations



Best practices in training start with diversity training as a part of the orientation process for new employees, with its principles and behaviors continually reinforced throughout an employee's tenure with the organization.

agement: (1) general philosophy, (2) training, (3) development, (4) accountability, and (5) feedback.

General Philosophy

Although many organizations have a broad philosophy of working to maintain respect regardless of gender, ethnicity, or race,¹⁶ others take the more targeted approach of integrating diversity initiatives into corporate goals and priorities. The latter approach involves recognizing that diversity is more than a human resource issue. It is a business imperative for the reasons mentioned in the first paragraph of this article.

Marchant¹⁷ says there are three pillars on which successful workplace diversity rests.

1. **Direction.** Only the CEO or company head has the clout to lead an equity or diversity plan.
2. **Strategy.** Improved policies and practices are fine, but not nearly enough. Equity plans must be incorporated into overall business strategy.
3. **Perseverance.** Diversity and equity measures need continual refining. Regularly assess where you are. There is no cause for discouragement, as change can take a long time. Indeed, the test of a successful diversity program is endurance.¹⁸

Many authors echo the cry that diversity management is not a sprint. Leaders must be willing to hear bad news, accept solutions, and implement employees' suggestions and ideas. They must be consistent and equitable in recognizing and rewarding employees' accomplishments, while providing a working environment that supports and encourages flexibility, inclusion, and change.¹⁹ Leaders should recognize, celebrate, and connect with small wins, to aggregate small changes into a larger change process with more impact.²⁰

Training

Best practices in training start with diversity training as a part of the orientation process for new employees, with its principles and behaviors continually reinforced throughout an employee's tenure with the organization. That is, managers at all levels must be well trained in diversity management so as to convey a consistent mes-

sage to employees. With respect to the administration of training programs, attendance must be mandatory for all; moreover, programs should be evaluated for inclusion of diverse groups and evaluated for effectiveness. Attendance is a start, but it is not the only goal.

Development

In the interest of promoting diverse individuals, awarding promotions simply because of an employee's diversity status is not the answer. For leaders to disregard qualifications and experience, putting someone in a position strictly due to his or her minority status, helps neither that employee nor the organization as a whole. In fact, this practice can do more harm than good in promoting respect for diverse others.²¹

Accountability

Managers' performance reviews should factor in how well they manage diversity. It is axiomatic of "what gets measured gets done." Middle managers have the greatest need to be informed, sensitized, and coached. But top management must support, endorse, and commit to these practices.²²

Feedback

Career counseling and advising are vital. They can remedy turnover problems. Moreover, minority individuals (and majority-group employees for that matter) who have excellent opportunities elsewhere may leave if they are unaware of their opportunities with their current employer.²³

When minorities do leave, the exit interview is an opportunity for the manager to listen and learn. If the organization can meet with individual groups of minorities for feedback sessions, its leaders can see whether these employees have ideas to share when in the company of persons of the same background.²⁴

HOW ARE COMPANIES MEASURING THE EFFECTIVENESS OF THEIR DIVERSITY INITIATIVES?

A survey of the literature reveals that measuring the effectiveness of diversity initiatives is an important concern that many companies say they

are aware of and pledge in the future to focus on—yet many have no specific measures in place at the present time. Indeed, some shy away from the issue out of the fear that the results will be disappointing, from the return-on-investment point of view.²⁵ A 1997 study confirmed the idea that few diversity initiatives, when measured for their effectiveness, have a significant effect on overall firm performance.²⁶

Companies report using the following tools to measure diversity effectiveness.

- Employee surveys: change of attitudes
- Employment data: tracking numbers of employees with regard to turnover, absenteeism, and promotion
- 360-degree feedback: assessments of managers' handling of diversity issues
- Focus groups: employee perceptions of diversity efforts
- Benchmarking: comparing company efforts to competitors' best practices
- Diversity-specific surveys: asking diverse employee groups about company climate
- Annual performance reviews of managers: monitoring business units' achievement of financial results with a diverse workforce

- Employee feedback: how all employees feel about diversity initiatives
- Customer feedback: whether diverse customers are well served

Table 2 offers examples of how to measure the effectiveness of diversity initiatives.^{27,28}

Those who seek to quantify effectiveness cite the performance, retention, promotion, turnover, hiring, and absenteeism rates of minority employees. Yet Thomas Kochan of the Wharton School and others argue that the business case for diversity efforts simply does not exist and that the results have been exaggerated. Kochan and scholars argue that despite an immaterial business case, companies must still frame diversity efforts as a labor-market imperative that has value to society at large.²⁹

Discrimination lawsuits can be costly and damaging to an organization's reputation. From this perspective, training and culture change can help companies avoid them.

General advice from both practitioners and scholars is to use demographic data—race, gender, marital status—in the analysis of issues using both hard data (turnover rates, sales figures, productivity) and soft data (satisfaction and attitudes). Benchmarking research will pinpoint best practices in the industry and enable leaders

Discrimination lawsuits can be costly and damaging to an organization's reputation. From this perspective, training and culture change can help companies avoid them.

Table 2

Measurement of Diversity Management Initiatives

| Measurement question | Type of measure to use |
|---|--|
| How do I measure change in employee attitudes about diversity? | Employee surveys |
| How do I find information about turnover, absenteeism, and promotion? | Tracking employee data |
| How do I assess if managers are handling diversity issues appropriately? | 360-degree feedback |
| What are my employees' perceptions of diversity efforts? | Focus groups |
| In comparison to my competitors' best practices, how does my organization fare in terms of diversity effectiveness? | Benchmarking |
| How do my employees view the organization's diversity climate? | Diversity-specific surveys |
| Have my business units achieved financial results with a diverse workforce? | Annual performance reviews of managers |
| What do my employees feel about diversity initiatives? | Employee feedback surveys |
| Are my diverse customers served well? | Customer feedback surveys |

Sources: Hansen, 2003; Wentling & Palma-Rivas, 2000

Benchmarking helps to specify the gains or benefits to be achieved by the diversity program.

to compare their company with others that reflect their needs and position.³⁰ Moreover, benchmarking helps to specify the gains or benefits to be achieved by the diversity program. Designing the appropriate program from the beginning will make it easier to evaluate the success of the program after implementation.³¹

THE IMPORTANCE OF THE SOFTER SIDE OF DIVERSITY

As Kochan and other scholars maintain, the business case for diversity may not always add up when it comes to return-on-investment or other quantitative measures; however, diversity management is nevertheless important. That is, the inclusion and valuation of diverse employees not only is an important goal for society but also, on a more local scale, is critical to attract and retain a diverse workforce. Women hold half of all management, professional, and related occupations³² in the United States, and African-Americans and Latinos combined make up 24% of the U.S. labor force.³³

Data from leasing and finance industry firms support the claim that, in a softer way, diversity initiatives do make a difference. That is, as part of our Foundation-supported research effort, we surveyed employees working in human resources and diverse employees from the same leasing and finance firms. With one web-based survey, we asked the HR managers about the diversity policies and programs their individual firms engaged in. Then, with another survey, we asked diverse individuals in those same firms about the diversity climate at their firms.

Results support the idea that when (as reported by HR employees) a firm engages in specific diversity management initiatives, the diverse employees in those firms reported that their fellow employees held more positive attitudes toward diverse others. That is, diversity initiatives seemed to be working—working as far as making diverse others feel more welcome and valued (Table 3).

In this vein, many authors and managers alike support the philosophy of “diversity for diversity’s sake” or “diversity for societal change.” As an example, the following eight-step model reflects much of what has been discussed in this article: slow and steady progress, attitude change, and results on the softer side.

1. Exposure
2. Experience
3. Knowledge
4. Understanding
5. Appreciation
6. Respect
7. Modification of attitudes and behavior
8. Healthy interaction³⁴

In summary, based on their research, the authors of this article contend that diversity is an intrinsically worthy goal in and of itself as well as in the leasing industry and the business community at large.

Table 3

Research Findings

| HR employee-reported actions | Result |
|--|---|
| Offering mentoring programs to diverse employees | → Diverse employees felt others in the organization had more positive reactions to diversity programs |
| | → Diverse employees held more positive attitudes toward diversity programs |
| Incorporating diversity into mission statements | → Diverse employees felt others in the organization had more positive reactions to diversity programs |
| | → Diverse employees held more positive attitudes toward diversity programs |

Endnotes

1. McMahan, Gary C., Myrtle P. Bell, and Meghna Virick. "Strategic human resource management: employee involvement, diversity, and international issues." *Human Resource Management Review*, 8 (1998): 193-214.
2. Amabile, Teresa M. "The social psychology of creativity." *Journal of Personality and Social Psychology*, 45 (1983): 357-376.
3. Schneider, Sherry K., and Gregory B. Northcraft. "Three social dilemmas of workforce diversity in organizations: A social identity perspective." *Human Relations*, 52 (1999): 1445-1467.
4. Arrendondo, Patricia. *Successful Diversity Management Initiatives: A Blueprint for Planning and Implementing* (Thousand Oaks, Calif.: Sage, 1996).
5. Rosner, Bob. "How do you diversify a workforce?" *Workforce*. 78 (March 1999): 18.
6. Wentling, Rose Mary. "Diversity in the work force. The highlight zone: Research@work," No. 4 (2001). Columbus, Ohio: National Research Center, National Dissemination Center. www.nccte.org/publications/infosynthesis/highlightzone/highlight04/index.asp
7. Gasorek, Dory. "Viewpoint." *Business Credit*, 100 (6): 70-71.
8. MacDonald, Heather. "The diversity industry." *New Republic*, 209 (1993): 22-25.
9. "Toyota diversity initiative makes headway." *Los Angeles (Calif.) Sentinel*, Jan. 23, 2003, A13.
10. Wentling, "Diversity."
11. Wentling, Rose Mary, and Nilda Palma-Rivas. "Components of effective diversity training programmes." *International Journal of Training and Development*, 3 (2000): 215-226.
12. "Toyota diversity initiative."
13. Ibid.
14. Wentling, "Diversity."
15. Gensing-Pophal, Lin. "Reaching for diversity." *HR Magazine*, 47: 53-56.
16. Swanson, Don R. "Diversity programs: Attitude and realities in the contemporary corporate environment." *Corporate Communications: An International Journal*, 7 (2002): 257-268.
17. Marchant, Valerie. "The New Face of Work." *Canadian Business*, March 29, 2004, 36-42.
18. Soutar, Sammi. "Beyond the rainbow." *Association Management*, 56 (2004): 26-33.
19. McCuiston, Velma E., Barbara R. Wooldridge, and Chris Pierce. "Leading the diverse workforce." *Leadership and Organization Development Journal*, 25 (2004): 73-92.
20. Holvino, Evangelina, Bernardo Ferdman, and Deborah Merrill-Sands. "Creating and Sustaining Diversity and Inclusion in Organizations: Strategies and Approaches," in *The Psychology and Management of Workplace Diversity*, ed. Margaret Stockdale and Faye J. Crosby, 245-276 (Malden, Mass: Blackwell Publishing, 2004).
21. Swanson, "Diversity programs."
22. Wentling, Rose Mary. "Factors that assist and barriers that hinder the success of diversity initiatives in multinational corporations." *Human Resource Development International*, 7 (2004): 165-180.
23. Swanson, "Diversity programs."
24. Ibid.
25. Grossman, Robert J. "Is diversity working?" *HR Magazine*. 45 (2000): 46-51.
26. Holmes, Tyrone. "How to connect diversity to performance." *Performance Improvement*, 44 (2005): 13-17.
27. Hansen, Fay. "Diversity's business case doesn't add up." *Workforce*, 82, no. 4 (2003): 28-32.
28. Wentling and Palma-Rivas, "Components."
29. Kochan, Thomas, Katerina Bezrukova, Robin Ely, et al. "The effects of diversity on business performance: Report of the diversity research network." *Human Resource Management*. 42 (2003): 3-21.
30. Gardenswartz, Lee, and Anita Rowe. "Why diversity matters." *HR Focus*, 75 (1998): S1-S3.
31. Holmes, "How to connect."
32. Department of Labor Statistics, U.S. Department of Labor. "Women in the Labor Force: A Datebook." May 13, 2004. www.bls.gov
33. Department of Labor Statistics, U.S. Department of Labor. "Charting the U.S. Labor Market in 2005" (2005). www.bls.gov
34. Friday, Earnest, and Shawnta Friday. "Managing diversity using a strategic planned change approach." *Journal of Management Development*, 22 (2003): 863-880.



**Jenny M. Hoobler,
PhD**

jhoobler@uic.edu

Jenny M. Hoobler is an assistant professor in the Department of Managerial Studies at the University of Illinois at Chicago. She Prior to pursuing her doctoral degree, Dr. Hoobler worked at the Illinois Department of Transportation and then at the corporate offices of State Farm Insurance. Dr. Hoobler's research focuses broadly on work and personal life intersections and gender and diversity in organizations. Her current efforts include understanding abusive supervisors and exploring the intersection of domestic violence and work. She was the recipient of an Equipment Leasing and Finance Foundation grant to study diversity in the leasing and finance industry in 2005. She earned her undergraduate degree from the University of Illinois at Urbana-Champaign and her MBA from the University of Illinois-Springfield. She received her PhD in business administration in 2002 from the University of Kentucky, Lexington.



Tim Basadur

tbasad2@uic.edu

Tim Basadur is a doctoral student in managerial studies at the University of Illinois at Chicago. His research interests include diversity and individual and organizational creativity; psychological contract formation; and social network analysis. Prior to enrolling at UIC, Mr. Basadur worked as a creativity and innovation consultant, developing trainers and process leaders. He also led strategic planning, facility design, and team initiatives in client organizations including Pfizer CHC, Goodrich, UBS, Tricon Global Restaurants, and Bell Canada.



Grace Lemmon

glemmo2@uic.edu

Grace Lemmon is a doctoral student at the University of Illinois at Chicago. She graduated from DePaul University, Chicago, with a BS in marketing. Ms. Lemmon's interests include mood, affect, and emotions, and their impact on organizational justice and workplace outcomes.