UNIDROIT CONVENTION ON INTERNATIONAL FACTORING (Ottawa, 1988)
Explanatory Note by the UNIDROIT Secretariat

I. BACKGROUND

1. Although the origins of factoring date back to antiquity, and the institution underwent a new development in the nineteenth century in relations between the United Kingdom and the United States of America, it was only after the First World War that its characteristics became clear, first in Common Law countries, then in other Western countries and finally in the world at large. Since the 1960s, its considerable and uninterrupted growth, including its expansion into ever more diversified fields of activity and an increasing number of countries, bear witness to the adaptability of this means of financing to meet the needs of contemporary commercial activity. A brief explanation of the economic role of factoring and of the legal mechanisms adopted to regulate it at national level will permit a better understanding of the reasons which influenced the choices made by the authors of the Convention in their attempt to provide a suitable legal framework at international level for a device forged and employed with success by the commercial and financial worlds.

2. Recourse to factoring by a small or medium-sized manufacturer or supplier of services who sells on credit terms to its professional or commercial customers is the result of a decision to rationalise its business: it provides relief from a certain number of concerns of a financial character which are assumed by a professional who offers a wide range of services characterised by the efficiency and low cost permitted by specialisation. The services offered by the factor may be summarised as four: in the first place it may assume the risk of the insolvency of the supplier's debtors; after enquiring into the creditworthiness of each debtor, the factor will, when it judges it appropriate, establish a credit limit calculated principally by reference to the turnover in respect of the debtor and to the average term for payment, and it will assume the risk of non payment resulting from the debtor's insolvency up to the limit of the credit granted. According to whether or not this service is provided, the factoring transaction will be designated "recourse" or "non-recourse" factoring. Moreover, factoring may serve the purpose of financing debts (receivables), the factor advancing to the supplier an amount proportional to the value of the receivables, payment of which by the debtor will only be made later at the time stipulated. The two other services traditionally offered by factors are, on the one hand, the handling of the supplier's accounts with its debtors, which implies their maintenance, the conduct of correspondence and the soliciting of payment by debtors, with the aid of the most advanced technical methods of management, and, on the other hand, the recovery of receivables from debtors, the latter making payment directly to the factor who pays over the sums in question to the supplier in accordance with the arrangements upon which they have agreed. When the factor is authorised to accept payment of the receivables, it will also take the necessary steps for their recovery. The supplier may agree with the factor, on the basis of both commercial and legal considerations, whether or not to give notice to the debtor that it is bound by a factoring contract. In particular, when the recovery of receivables is included among the services for which provision is made, the debtor is by such notice informed that it can obtain discharge only by paying the factor.

3. The factor obtains payment for its services in the form of the commission it receives from the supplier, which may amount to up to two percent of the value of each receivable, calculated in accordance with the services provided and their cost in each case. Whenever it agrees to make advance payments against the receivables the factor takes the benefit of the corresponding interest. It will readily be appreciated that factoring transactions can only be based on a continuing relationship between the supplier and the debtors in question and this on account both of the nature of the services which characterise factoring and of the primordial importance for the factor to amortise its investment. It is precisely for these reasons that the factor will require the supplier to grant it the exclusive right to factor the receivables or certain categories of receivables which arise out of the supplier's commercial dealings with its customers.

4. It is apparent from this brief description of factoring that it presents many economic advantages. As has been seen, it provides financial liquidity, the certainty of payment and the handling and recovery of receivables, the choice of the combination of the services being left to the parties. In each system, legal means have been sought to ensure the development of this relatively recent technique of financing in the most satisfactory manner possible, in terms not only of facilitation and flexibility, but also of certainty and cost, which explains the fact that while in most countries it is the assignment of receivables that provides the underlying legal basis for factoring transactions, the procedures whereby such assignments are effected and the rules which govern the different aspects of them differ considerably. In consequence, when the supplier has commercial dealings with foreign buyers, the problem of distance and the difficulties facing the former in obtaining information as to the financial position of the latter, language barriers and, frequently, ignorance of the applicable foreign law make the services offered by factors all the more attractive. It is nevertheless true that the divergences in national law and the frequent uncertainty as to the law applicable to a given transaction or to one or another aspect of it create problems which the factoring industry must constantly face and which it seeks to overcome by passing on to suppliers the increased cost of its services.

5. It was primarily to reduce such uncertainties and to promote international trade that UNIDROIT embarked on the preparation of uniform rules applicable to a certain type of assignment of receivables – the so-called “factoring” transaction, characterised by certain typical features – arising from international sale of goods transactions. The resulting UNIDROIT Convention on International Factoring was adopted on 28 May 1988 at the conclusion of a diplomatic Conference convened by the Canadian Government.

6. The Conference, which adopted the UNIDROIT Convention on international financial leasing at the same time, was held in Ottawa from 9 to 28 may 1988 and was attended by representatives from 59 Governments and ten international Organisations.

7. During the preparatory work and during the final negotiations at the Conference, the aim was to ensure as much certainty as possible for the parties to the factoring transaction and to make factoring more cost-effective and hence more attractive. This led to a number of key principles being enshrined in the uniform rules regarding the validity, as between the parties, of the assignment (and subsequent assignments) of receivables and the transfer of associated rights, as well as the ensuing entitlement of the factor to receive payment by the assigned debtor. It must be noted, however, that in view of the diversity of the solutions provided by national legislations, it was not possible to reach a fully harmonised solution regarding the effect to be given to a prohibition of assignment agreed between the parties to the sale contract, which is also

why the Convention does not deal with priorities between competing claims, leaving this matter to be governed by the applicable law under the rules of private international law (in accordance with Article 4(1)).

II. THE CONVENTION PROVISIONS

(a) Preamble

8. The growing importance of international factoring is reflected in the preamble to the Convention which speaks of "the significant role" it has to play in the development of international trade. The preamble also states the primary purpose of the Convention, namely the importance of "adopting uniform rules to provide a legal framework that will facilitate international factoring, while maintaining a fair balance of interests between the different parties involved in factoring transactions."

(b) Chapter I Sphere of application and general provisions

9. The definition of a "factoring contract" for the purposes of the Convention is set out in Article 1(2) as a contract concluded between one party (the supplier) and another party (the factor), pursuant to which (a) the supplier may or will assign to the factor receivables arising from contracts of sale of goods (a concept which, under Article 1(3), includes the supply of services) made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal or household use; (b) the factor is to perform at least two of the following functions, namely finance for the supplier, maintenance of accounts relating to the receivables, collection of receivables and protection against default in payment by debtors, and (c) notice of the assignment of the receivables is to be given to debtors. In other words, the Convention is applicable to most traditional forms of factoring as described above, with the exception of non notification factoring, and is restricted to what may be termed "commercial" factoring in view of the exclusion of consumer transactions.

10. The restriction of the Convention to international transactions is framed in language well-known to those familiar with the United Nations Convention on Contracts for the International Sale of Goods (CISG). As will be seen when Chapter II of the Factoring Convention, Rights and duties of the parties, is considered, the Convention focuses not so much on the factoring contract itself as on the relations deriving from the tripartite relationship arising from two contracts, namely the factoring contract (supplier/factor) and the sales contract (supplier/debtor). Typically, the factoring contract will be concluded between parties in the same State, whereas the international element will reside in the underlying sales contract. This is the reason why Article 2(1) requires that the supplier and the debtor have their places of business in different States. It is a further condition for the application of the Convention that both those States and that in which the factor has its place of business be Contracting States, or that both the contract of sale of goods and the factoring contract be governed by the law of a Contracting State.

11. As is the case with a number of commercial law conventions, including CISG, the authors of the Factoring Convention recognised that to make it totally mandatory would (as would have been an extension of its application to domestic transactions) be fatal to its chances of success. In consequence, under Article 3(1) its application may be excluded, either by the parties to the factoring contract, or by the

parties to the sales contract, but in that case only in regard to receivables arising at or after the time when the factor has been given notice in writing of such exclusion. Given the delicate balance of interests of the three parties concerned, established by the Convention, it is, however, possible only to exclude the application of the Convention as a whole and not just certain provisions (Article 3(2)).

12. Article 4, which is concerned with the interpretation of the Convention and the problem of gap-filling, is based almost word for word on Article 7 of CISG, the only innovation being a reference in Article 4(1) to the preamble as a source of interpretation.

(c) Chapter II Rights and duties of the parties

13. Articles 5 to 7 of the Convention are of the utmost importance in that they all establish rules, not infrequently at variance with the traditional rules of national law, governing assignments of receivables, which are aimed at facilitating factoring at cross-border level.

14. Article 5 addresses two possible obstacles to the validity of an assignment under a factoring contract as regards the parties to the factoring contract *inter se,* namely the reluctance of certain jurisdictions to recognise global assignments of receivables and assignments of future receivables. Accordingly, Article 5 provides that as between the parties to the factoring contract: (a) a provision in the factoring contract for the assignment of existing or future receivables shall not be rendered invalid by the fact that the contract does not specify them individually, on condition, however, that at the time of the conclusion of the contract or when they come into existence the receivables can be identified to the contract, and (b) a provision in the factoring contract by which future receivables are assigned operates to transfer the receivables to the factor when they come into existence without the need of any new act of transfer, thereby overcoming a procedural hurdle to be found in the law of a number of countries. A similar potential problem is dealt with in Article 7, the effect of which is that a factoring contract may validly provide, as between the parties to the contract, for the transfer, with or without a new act of transfer, of all or any of the supplier's rights deriving from the contract of sale of goods, such rights including specifically the benefit of any provision in the sales contract reserving title to the goods to the supplier or creating a security interest over the goods.

15. While many delegations at the diplomatic Conference which saw the adoption of the Factoring Convention were able without too much difficulty to accept solutions under Articles 5 and 7 which would, in the field of international factoring, involve departures from national rules of substantive or procedural law, the situation was very different in relation to Article 6 which addresses the thorny issue of whether the inclusion in a sales contract of a clause prohibiting the supplier from assigning a receivable constitutes a bar to recovery by the factor from the debtor. At the time of the Conference such a prohibition was effective, with the notable exception of North America, and a number of delegations sought either to delete any provision dealing with the question or alternatively to restate the principle of the effectiveness of such clauses, the possibility of entering a reservation being left to those States which supported the contrary solution. Stated in its simplest terms, the view was that a supplier who had accepted the inclusion of a clause in the sales contract prohibiting the assignment of receivables should not be permitted to breach its contract by a subsequent assignment to a factor.

16. The opposing opinion, which was strongly advocated *inter alia* by delegations from a number of States whose law recognised the effectiveness of a prohibition clause, was that such clauses were inimical to the development of factoring at international level and that they were most often drafted and inserted in standard form contracts by large companies dealing with weaker contracting partners who were thus deprived of recourse to a modem means of financing and thereby starved of credit. This was seen by some as being a particular disadvantage to suppliers from developing countries.

17. The final text of Article 6 not unnaturally reflects a compromise. Paragraph (1) in principle reflects the latter view, providing as it does that the assignment of a receivable by the supplier to the factor shall be effective notwithstanding any agreement between the supplier and the debtor prohibiting such assignment. Paragraph (2), however, permits States which make the appropriate declaration under Article 18 to displace paragraph (1) in those cases where the debtor has, at the time of the conclusion of the sales contract, its place of business in such a State, while paragraph (3) of Article 6 provides that nothing in paragraph (1) shall affect any obligation of good faith owed by the supplier to the debtor or any liability of the supplier to the debtor in respect of an assignment made in breach of the terms of the sales contract.

18. The three remaining articles of Chapter II, Articles 8 to 10, may be seen as providing the necessary protection to the debtor who is, after all, not a party to the factoring contract. Thus Article 8(1) specifies that the debtor is under a duty to pay the factor *if, and only if*, the debtor does not have knowledge of any other person's superior right to payment and notice in writing of the assignment (a) is given to the debtor by the supplier or by the factor with the supplier's authority; (b) reasonably identifies the receivables which have been assigned and the factor to whom or for whose account the debtor is required to make payment; and (c) relates to receivables arising under a contract of sale of goods made at or before the time the notice is given. Under paragraph (2), payment will be effective if made in accordance with paragraph (1), irrespective of any other ground on which payment by the debtor to the factor discharges the debtor from liability.

19. The question of which defences a debtor may raise against a factor claiming payment of receivables under a factoring contract is dealt with in Article 9. In accordance with paragraph (1), the debtor may raise all defences arising under the sales contract of which the debtor could have availed itself if such claim had been made by the supplier, while paragraph (2) deals with the more specific right of set-off, permitting the debtor to assert against the factor any right of set-off in respect of claims against the supplier in whose favour the receivables arose and available to the debtor at the time a notice in writing of assignment conforming to Article 8(1) was given to the debtor.

20. Article 10 addresses the not uncommon problem in practice of a debtor who alleges breach of contract by the supplier. The approach adopted under paragraph (1) is that while the debtor's rights under Article 9 remain intact, non-performance or defective or late performance of the sales contract does not by itself entitle the debtor to recover a sum already paid to the factor if the debtor has a right to recover that sum from the supplier. If such a right against the supplier does however exist, then the debtor is entitled under Article 10(2) to recover sums paid to the factor to the extent either that the factor has not discharged an obligation to make payment to the supplier in respect of the receivable in question or that the factor made payment to the supplier at a time when it knew of the supplier's non performance or defective or late performance as

regards the goods to which the debtor's payment relates.

(d) Chapter III Subsequent assignments

21. International factoring frequently involves more than one assignment of a receivable. Typically, the supplier in State A will assign the receivable to a factor in the same State who reassigns to its correspondent, a factor in State B, who will then seek recovery from the debtor, also located in State B. Article 11 addresses the possible complications which might arise in the application of the Convention from such successive assignments, and paragraph 1 (a) in effect states that the rules set out in Articles 5 and 10 shall, subject to subparagraph (b) of Article 11(1), apply to any subsequent assignment of the receivable by the first factor or by a subsequent assignee, while sub paragraph (b) equates, for the application of Articles 8 to 10, the position of a subsequent assignee to that of the factor. Finally, paragraph (2) of Article 11 settles the problem of deciding when notice is actually given to the debtor by providing that notice to the debtor of the subsequent assignment also constitutes notice of the assignment to the factor.

22. Article 12 deals with a situation which is less common in practice but which was a cause of major concern to one delegation, namely that of a subsequent assignment made in breach of the terms of the factoring contract, and the article accordingly provides that the Convention shall not apply to such assignments.

III. IMPLEMENTATION OF THE CONVENTION

23. At the time of the closing date for signature, 31 December 1990, the Factoring Convention had been signed by the 14 States (Belgium, Czechoslovakia, Finland, France, Germany, Ghana, Guinea, Italy, Morocco, Nigeria, the Philippines, Tanzania, the United Kingdom and the United States of America). In accordance with Article 14(1) of the Convention, the Convention entered into force six months after the deposit of the third instrument of ratification, acceptance, approval or accession, i.e., on 1 May 1995. Since Germany ratified the Convention (with entry into force on 1 December 1998), the number of Contracting States stand at seven, i.e., France (with a declaration under Articles 6(2) and 18), Germany, Hungary, Italy, Latvia (with a declaration under Articles 6(2) and 18), Nigeria and Ukraine (for the status of the Convention, see: http://www.unidroit.org/status-1988-factoring).

24. It is worth noting that the substantive provisions of the Convention have been used as a reference by a number of jurisdictions (such as Lithuania and Russia) which have modernised their legislative framework for factoring and assignments of debts. The Convention was taken as a starting point by the United Nations Commission for International Trade Law (UNCITRAL) in its preparation of the Convention on Assignment of Receivables in International Trade, which was adopted on 12 December 2011 by the United Nations General Assembly (to date, this Convention is not in force).

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