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ANALYSIS OF REPLIES RECEIVED BY THE SECRETARIAT TO THE QUESTIONNAIRE ON THE CONTRACT OF FACTORING

(Secretariat memorandum)

Rome, December 1977

I. INTRODUCTION

In accordance with the instructions given by the Governing Council at its 54th session in April 1975, the Secretariat prepared a detailed preliminary study on the contract of factoring dealing essentially with three questions, the practical aspects of factoring operations, factoring under national law and the specific problems raised by international factoring. This study, together with a questionnaire also prepared by the Secretariat, was communicated to a restricted number of academic lawyers who are experts in this matter and to the business circles directly concerned.

The present document contains an analysis of the replies to the questionnaire which will be submitted to a restricted group of members of the Governing Council, the constitution of which was decided by the Council at its 56th session in May 1977. On the basis of this analysis the restricted group will report back to the Governing Council on the desirability of setting up a Study Group or a Committee of Governmental Experts to prepare uniform rules on the contract of factoring.

II. REPLIES TO THE QUESTIONNAIRE

Question no. 1 - Is it necessary - or at least useful - to proceed to the preparation of uniform rules on factoring ?

The replies to the questionnaire indicated widespread support for UNIDROIT's initiative. One reply in particular laid stress on the capacity of factoring to respond to needs which other financing techniques fail to meet to the same extent. In addition, the importance of international factoring was underlined in view of its contribution to the financing of small and medium enterprises, which thereby grants them access to international markets, notwithstanding the limits on their financial and administrative means.

Almost all the replies therefore[1] emphasized the value of drawing up uniform rules governing the factoring contract[2]. Some warnings were nevertheless sounded regarding the scope of such rules and one reply, while noting that the establishment of uniform rules for factoring would be of assistance, pointed out that this would be a major undertaking involving the treatment of a whole range of priority problems not confined to factoring and should thus be seen as part of a larger, long-term objective.

Another reply in similar vein indicated that if the rules were to be designed to cover all factoring transactions and all issues arising therefrom, then this would involve widespread and fundamental changes in various branches of general law which would take decades to resolve. With special reference to English law, the author of these remarks observed that factoring transactions are governed by the general law relating to the assignment of receivables which would thus involve the law relating to contracts, property, security rights and principles of equity and trusts law. In addition, in international factoring difficult conflicts of law questions would arise which would not be easy to resolve since there appeared to be

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(1) One reply, while recognizing that uniform rules on factoring might be useful, indicated however that they were not indispensable in view of the fact that over the last ten years European factoring companies had been born, developed and in general prospered.

(2) In view of the significant position and extent of international operations of United States factors, the importance of the laws and practice of factors in that country was stressed in one reply.

less uniformity and more uncertainty as to conflicts rules in this area than in most others. In consequence a factoring agreement and transactions carried out under it raise general questions such as whether a debt can be assigned, the formalities of assignment, the extent to which the assignee takes the debt subject to defences and rights of set-off, whether such defences can be excluded in the original contract, the resolution of priority conflicts where the same debt is subjected to two or more interests, the impact of insolvency on the assignee's rights and so on.

He therefore suggested that the task could be kept within reasonable bounds only if certain initial restrictions were imposed and cited the following:

(a) confining the harmonizing measures to the factoring of receivables arising from export transactions;

(b) excluding registration and priority rules from the scope of the proposed convention;

(c) excluding the impact of insolvency from the scope of the proposed convention and

(d) restricting the harmonizing measures to basic principles and rules that can be readily agreed, leaving differences in details between the laws of one State and those of another to be resolved by uniform conflict of law rules.(1)

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(1) The author further motivated the limiting of the scope of the future rules on factoring by the following arguments:

"Property issues relating to the factoring of receivables (with which must be linked public notice requirements, such as registration) form part of a much wider complex of problems not confined to factoring. Receivables financing is closely intertwined with stock-in-trade financing (the former usually stemming from the latter) and questions of perfection and priorities need to be regulated by an entirely distinct convention on security over movables, along the functional lines of Article 9 of the Uniform Commercial Code. (For this same reason, I have submitted in a separate memorandum to UNIDROIT that the security aspects of leasing should be excluded from any model leasing law).

Similarly, the impact of insolvency of the debtor on the factor's rights is part of the wider problem of insolvency law, best dealt with by a bankruptcy convention (the present draft European Bankruptcy Convention is a useful starting point, but requires considerable modification).

Pending harmonization measures the treatment of registration of priority issues and the impact of insolvency is best left to the applicable national law, as selected by conflict of laws rules. Similarly the detail involved in the application of a particular concept should, so far as not

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Question no. 2 - Should such rules apply only to international factoring or also cover domestic factoring ?

Opinions on this question were divided although a majority favoured the restriction of the application of the future rules, at least in the first instance, to international factoring. A number of arguments were advanced to support this view, in particular the fact that it would be extremely difficult to apply uniform rules in the various countries, each of which has its own commercial law and which, moreover, in connexion with factoring, base their caselaw on different principles. A second reply stressed that opposition to the introduction of uniform rules would be less strong for international than for domestic transactions while a third, also pleading for limitation to international factoring, pointed out that domestically each factor's own contract must set the rules as between him and his client. Only when one factor succeeds another and there is a letter of indemnity agreement between them would the matter of uniformity arise.(1)

(continuation of note)

capable of being resolved readily by agreement, be left to the appropriate national law. For example, most countries allow the debtor to set up against an assignee of a debt defences and rights of set-off that would have been available against an assignor, but the rules differ as to what may be set off and the conditions in which a right of set-off may be exercised. Insofar as agreement can be reached on uniform rules of set-off in relation to the factoring of debts arising from exports, so much the better; but there is a limit to what can be achieved in this direction in reasonable time, and residual differences can properly be left to be dealt with under the relevant national law.

For these proposals to be effective, it is essential that steps be taken to harmonize the conflict of laws rules relating to the assignment of debts. As the Working Paper rightly points out, this is an area of great uncertainty. The formulation of uniform conflict of laws rules relating to the assignment of debts (or at the very least, to the assignment of receivables arising from export transactions) would be of great value."

(1) This reply further indicated that in the United States of America a uniform letter of indemnity has been developed thorough the National Commercial Finance Conference.

Other replies, however, saw advantages in extending the scope of the future rules to cover domestic factoring also and one in particular suggested that ideally a common code should be adopted by as many countries as possible, wherever possible replacing inappropriate existing legislation. Such an international code, it was urged, would simplify the operations of factors and benefit both domestic and international trade, perhaps with some resulting saving in costs. It was also pointed out that a dual régime would certainly present difficulties and indeed conflicts and that a unified régime would provide an element of simplification which would be greatly appreciated by banks. The author of these observations also recalled that in the framework of the European Economic Community the introduction of freedom to provide banking services might well blur the distinctions between internal and international factoring.

Nevertheless some of the advocates of a unified system recognized that it might be difficult to get uniform rules accepted in the near future at domestic level and while it was suggested that by a process of "infection" the rules first devised for international factoring might come to be applied to national transactions, another contributor considered that a modest, but practical, objective would be to establish uniform rules governing the choice of law in relation to issues arising from factoring transactions and involving a foreign element. This, he suggested, would minimize the present conflict of laws so that even if different national laws still conflicted there would at least be prior knowledge of the legal system applicable at any particular stage of the transaction.

Question no. 3 - Should any uniform rules governing factoring which might be prepared take the form of:

(a) a Convention accompanied by a uniform law;

(b) a model contract;

(c) a combination of the two instruments limiting the content of the first to those matters which do not fall within the scope of the autonomy of the parties ?

A very wide range of views were expressed on this question but it is probably fair to say that most support was forthcoming for a solution taking the form of a Convention accompanied by a uniform law. One reply suggested that inspiration might be sought in the Geneva Conventions on bills of exchange, promissory notes and cheques as a model for the future instrument. The author of these observations further recalled that the Fédération Bancaire of the European Economic Community had, as long ago as 1963, proposed an international

Convention which, however, had been limited to recommending the adoption in the various national laws of legislation similar to the Belgian law on endorsement.

Some of the replies favouring the preparation of an international Convention accompanied by a uniform law nevertheless recognized that the task would not be an easy one, although attention was also drawn to the fact that it would be difficult in practice to formulate a model contract acceptable to all individual factors as some of them would feel that the imposition of such a contract would result in an undesirable loss of freedom of action for them. Another contributor observed that the formula of a model contract would not be appropriate since many of the problems involved in factoring concerned relations between the contracting parties and third parties while another reply, also in favour of drawing up a Convention accompanied by a uniform law, pointed to the existence of model contracts such as the Factors' Chain International Master Agreement, so that there was no point in UNIDROIT spending its time on drawing up another.

Support was not, however, lacking for a solution falling short of an international Convention and two replies suggested as a model the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce which would avoid the disadvantage of national model contracts which differ widely from one country to another. It was also remarked that a solution along the lines adopted by the ICC permits a certain degree of flexibility and leaves room for alternative solutions, a consideration of some importance for such a varied contract as factoring. The same author, while recalling the time necessary for the elaboration of an international treaty, nevertheless felt that an international uniform law should not be excluded if one were to contemplate extending unification to the important aspects of factoring which do not depend upon the autonomy of the parties, either because they are governed by mandatory rules of law or because they touch upon relations with third parties.(1) The reply therefore came down in favour of solution (c) above.

A number of other replies favoured this solution although two others expressed a preference for a model contract, at least as a first step.

(1) One reply, while expressing a preference for a uniform law on factoring, drew attention to the fact that many questions involving third party rights touched upon general principles of private law and it would be necessary to see how far states would be prepared to go in derogating from such principles in the interests of a useful, but secondary, financing operation.

Question no. 4 - Which stage or stages of the factoring operation give rise to most problems in practice ? In particular, should the future rules:

(a) be limited to relations between the factor, the supplier and the buyer, or

(b) should they also deal with relations between the factor, the supplier and third parties other than the buyer ?

While a majority of replies favoured the application of the future rules not only to relations between the factor, the supplier and the buyer but also to relations between the factor, the supplier and other third parties,(1) arguments were advanced in favour of a more restricted scope of application. Thus one reply stressed that priority problems form part of the wider field of security over movables which needs to be the subject of a separate convention or model law while another suggested that attempts to tackle relations other than those between the factor, the supplier and the buyer would only complicate matters. Moreover another contributor, recalling his practical experience of factoring prior to 1968, stated that he had only seen problems arise in relations between factor, supplier and buyer.

On the other hand another reply indicated that in French practice the principal points were the mutual obligations of the factor and the supplier, recourse actions against the supplier in the event of non-payment by the buyer, the validity of the rights transmitted to the factor (including that of defences) and the possibility for the factor to assert his rights

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(1) One reply located the five following relationships as being of importance for an international factoring transaction, namely:

(i) between exporter and debtor - governed by the proper law, usually expressed in the contract to be that of the exporter's country;

(ii) between the exporter and the export factor - governed by the proper law of the assignment, which in the relations between these two parties will invariably be that of the country of export though in relation to the debtor it will usually be the proper law of the debt (in practice, the same);

(iii) between the export factor and the import factor - governed as between these parties by the proper law of their assignment, usually the law of the import factor's country (see the FCI Master Agreement, clause 21) but with the effect on the debtor being governed by the proper law of the debt;

(iv) between the import factor and the debtor - governed by the same law as that between the export factor and the debtor;

(v) between the import factor and a rival claimant in the exporter's country - e.g. a bank to whom the debtor has given a mortgage or charge over receivables - governed by the proper law of the debt.

over the debt against third parties and creditors in the event of bankruptcy. The author insisted that any attempt at unification would be without value unless all of these points were dealt with. While admitting that the matters referred to under (a) could be dealt with fairly easily, perhaps even without recourse to an international instrument, he pointed out that other points concerning such matters as assignment of debts, set-off and bankruptcy could not be dealt with by private agreements between the factor and the supplier.

A reply from the United States of America insisted on dealing with the relations mentioned under question 4 (b) as well as 4 (a). As to the latter, and referring to the position in the United States, the author expressed the hope that the rule that a factor is not liable for the actions or inactions of suppliers should be included in the future instrument which should also deal with the obligations of buyers with notification to pay the factor. He also considered that it should cover the buyer's right of set-off. As to the matters referred to under question 4 (b), he thought that it should deal with the subject of payments to successive assignees of an account and the factor's rights vis-à-vis general creditors of the supplier. More important still, he observed, such an instrument should make provision for the establishment in each country of an official facility where the recording of factors' liens or, as they are termed in the Uniform Commercial Code, security interests, could be made as a notice to all creditors of the client and to possible subsequent assignees. This would eradicate many of the problems arising in bankruptcy or in respect of judgment creditors.

Another reply, stressing the importance of relations with third parties other than the buyer, considered that most problems arise in the context of the insolvency of the supplier. It was added that it is upon the occurrence of this event that the strength of the factor's title to the factored receivables, the priority of the factor vis-à-vis secured creditors and the treatment of the credit balances held by the factors are most likely to arise. Accordingly uniform rules should not be restricted to relations between the contracting parties but should also embrace third party rights. Some areas where problems could arise were in connexion with : credit notes, credit balances, contras, set-offs, rights of agents, attachment of debts and the other claims of creditors against a debt.

The point was further made by another contributor that while ideally any future rules should clearly define the status of the parties directly concerned, i.e. the factor, the supplier and the buyer, they should however also cover the standing in law and practice of any third parties from time to time in any way concerned in factoring transactions, who could include, for example, original suppliers/receivers following their appointment to any party concerned, liquidators with or without the powers to exercise Government priority over debts, in view of the supra-national standing of the rules to be formulated etc.

Finally, in addition to his observations on the problem raised by question 4 regarding coverage in any possible future instrument of relations with third parties other than the buyer, the author of one of the replies made detailed comments on the general question of which stages of the factoring operation give rise to most problems in practice. These remarks are of especial importance and are reproduced hereafter in full:

"(a) Disputed debts

Very frequently the debtor asserts that the goods either have not been delivered at all or (more usually) are defective or otherwise not in accordance with the supply contract. The debtor thus claims that he has a defence, wholly or partly, to the claim for the price.

(b) Set-off

The debtor claims that by reason of some obligation owed to him by the supplier on another transaction he has a claim that he can set off against the factor's claim. Typically this arises in a situation where there is a regular course of dealing between the supplier and the customer and the latter seeks to set off against the price payable under one contract assigned to the factor a claim for defective goods supplied under a previous contract.

(c) Priority conflicts

In England these may take various forms. A fraudulent supplier may have discounted his receivables to more than one factor. This is not a very common problem and would be answered by determining who would be first to give notice of assignment to the debtor. A more common priority dispute arises without deliberate fraud on the part of the supplier in a situation where it omits to inform the factor that a floating charge has been given to a bank covering all the supplier's assets, including of course its receivables. In practice factors avoid difficulty that might be created by a prior floating charge by obtaining a waiver from the bank holding the charge. A more recent type of priority problem, which is not susceptible to the above practical solution, arises from the growing use of Romalpa clauses. A foreign supplier sells goods under retention of title to an English importer which resells them, factoring the resulting receivables to a United Kingdom factor. The importer goes into liquidation and a contest then arises between the foreign supplier who claims the receivables as proceeds contracted to be assigned to it and the factor, who claims the same receivables as purchaser under the factoring agreement.

(d) Impact of insolvency

Questions may arise as to the validity of an uncompleted assignment in the event of insolvency. English law regards an equitable assignment to the factor as binding on the liquidator and creditors even if notice has not been given to the debtor at the time of the winding-up, but questions do from time to time arise with liquidators as to how far the powers of the factor under the factoring agreement continue to be exercisable after the commencement of the winding-up. For example, can the factor continue to utilize the power of attorney given to execute a formal assignment of the debts in the name of the debtor company ? Does the factor retain the power that is usually conferred by the factoring agreement to compromise disputes with debtors, bearing in mind that whilst the factor is the owner of the debt and therefore able in principle to deal with the debt as it pleases, the effect of giving up a claim against a debtor, wholly or in part, is to increase the debit balance or reduce the credit balance on the supplier's account with the factor and this adversely affects the position of the general body of creditors.

(e) Inter-group transactions

A factor will not, save in exceptional cases, factor inter-company indebtedness, e.g. between a supplier and parent company, because it obviously wishes to confine its factoring operations to the purchase of receivables arising from arms-length transactions. Difficulties do, however, sometimes arise because a company which was initially an independent customer of the supplier becomes an associated company; and it is also not unknown for re-arrangements to take place within a group of companies by which one company which had previously sold goods on its own behalf ceases to act in this way but becomes a selling agent for the group. This can create problems for the factor if the question arises as to who is the real supplier under the transaction and as to rights over the goods.

(f) Credit notes

Factors not uncommonly give the supplier freedom to issue a credit note because there will obviously be cases where goods supplied are defective and neither the factor nor the supplier wishes to disturb good customer relationships. Nevertheless the issue of credit notes which are not notified to the factor can create problems because the effect of such issue is to reduce the value of the receivables which the factor has purchased. Furthermore, problems arise if the supplier company goes into winding-up without having furnished substitute goods. The factor may wish to honour the credit note by giving a cash refund to the customer but the liquidator of the supplier company may object."

Question no. 5 - In connexion with international factoring operations, are the problems raised by it those referred to in the report, namely:

(a) the validity of the double transfer of the debt: from the supplier to the export factor and from the latter to the import factor;

(b) that of the validity of a retention of ownership clause - inserted in the initial factoring contract - vis-à-vis creditors of the importer, i.e. the buyer ?

How are these various problems resolved in your country ?

A number of replies indicated that these were the two most pressing problems in international factoring although it appears that the difficulties caused by double transfers are more acute. One reply noted that in theory the double transfer of the debt, from exporter to export factor and from export factor to import factor, should cause problems, because of the expense and inconvenience of having to prove foreign law in an action by the import factor against the debtor but that in practice it is surprisingly rare that these difficulties arise. Obviously the harmonization of domestic laws relating to factoring would do much to obviate the problem, particularly if coupled with a rule of evidence raising the presumption that the relevant law in the import factor's country is the same as that of the export factor's country.

Another reply suggested that the validity of the double transfer of the debt was bound up with the manner of transfer, which should be determined by the law. The author of these remarks also argued in favour of a single mode of transfer such as invoices which may be protested ("facture protestable"). On the other hand, it was stated in another reply that the experience of Factors Chain International showed that the validity of the double transfer of the debt appeared to present no significant problems although in the case of double transfer there could still be difficulties regarding the validity of assignments where these relate to both domestic and international business. Some replies denied that problems were raised at all by double transfers of the debt.

Wide differences of opinion were expressed concerning the importance of retention of ownership clauses. Thus one reply from the United Kingdom stated that it would be extremely unusual for a British factor to insert a retention of ownership clause in the factoring contract. Factors, it was argued, do not want to take title to the underlying merchandise except in the case of goods returned by the debtor or repossessed by the supplier from the debtor. Of course if the supplier himself were to use retention of title

the factor would wish to take over the benefit of that clause but that would not create a problem for the factor. The problem of title retention would arise in the reverse situation previously described where a factor is met with an opposing claim to receivables as proceeds of goods sold under retention of title. In another reply, the view was expressed that retention of title causes no problems in international factoring as countries which do not know the institution declare it null and void. Validation would thus be limited to those countries which employ retention of ownership clauses where, it was suggested, no problem would arise.

A reply from the United Kingdom, on the other hand, stated that the retention of ownership clause could prove to be an impediment to all aspects of financing. Since, in the event of insolvency, any security is threatened, it was felt that provision should be made for retention of title to be registered by the purchaser and that when an international transaction was involved then, in addition to any registration in the exporter's country, registration should be required in the country of the importer. As to the existing situation, this same reply stated that retention of title has not yet been covered in present factoring agreements as traditionally factors have confined their activities to the purchase of debts under transactions in which title passes immediately to the buyer. Questions could, however, arise as to the advisability of factors taking subrogation rights to retention of title taken by suppliers. In this context, another reply from a professional quarter indicated that factors would not wish to see an increase in the use of retention of ownership clauses in contracts.

One reply indicated that the question of the validity of retention of title clauses is not peculiar to factoring and that it is, indeed, of marginal importance in connexion with that contract although the clause would provide the factor with an important guarantee in those countries where it is recognized.

Reference should also be made to one reply which stated that the authors had not hitherto been confronted with either of the specific problems mentioned in question 5 and that it was likely that in any of the United States the law of the state of the situs of the account debtor (buyer) would apply. They considered that the largest problems existing internationally and especially between members of Factors Chain International are

(a) the nature of the import factor's assumption of the credit risk when a dispute or claim by a buyer occurs, and

(b) the right of the import factor to withdraw an approval of credit prior to the shipment of goods by the supplier, the client of the export factor.

It was further observed that those two matters are presently dealt with poorly in the F.C.I. Master Agreement and not at all in conformity with the practice and custom developed in the United States between factor and client or as they are established in most Factoring Agreements in the United States. As a general principle, in the United States: (1) the factor is responsible only for the financial ability of the account debtor (buyer) of an account which is approved by the factor, which approval has been communicated to the client and subsists at the time of delivery of the goods or services to the buyer; (2) should a buyer's dispute or claim (valid or otherwise) delay the buyer's payment the factor's responsibility terminates, not again to be reinstated. These principles, it was added, are not fully recognized in the F.C.I. Master Agreement and the excuse is that distance and the triparite nature of the arrangement make the United States practice unworkable. It could easily be argued to the contrary and the key to the resolution of the issue, it was suggested, is that method and effective time of communication be uniformly agreed and established.

Finally, in connexion with specifically international factoring, one reply indicated that for most purposes the applicable law is likely to be that of the exporter/export factor. If this law were indulgent to factoring, as in the United Kingdom, no great problem should arise. If it were inimical, as in France, there would be potential difficulties. Relations between the export factor and the import factor could readily be resolved by the terms of the contract between them. Hence it was not this contract that created difficulties, though the importer might have to prove that the assignment accorded with the proper law of the assignment.

In the view of the author, it followed that, broadly speaking, what was necessary was not so much the regulation of the international transaction as such but the impact of domestic laws concerning factoring, including, for example, rules as to set-off by the debtor against an assignee of the debt.

There were, however, he suggested, two aspects of international factoring that do involve consideration, namely:

(i) the need for the import factor to pay the export factor, and for this purpose to secure his country's exchange control permission; and

(ii) the willingness of the courts of the debtor's country to recognize the applicability of the law of the exporter's country and give effect to it.

As to the first question, it should logically be no more difficult for the import factor to get permission to pay the export factor than it is for the importer himself to obtain permission to pay the exporter; but the writer understood that in some countries, such as France, difficulties in obtaining permission are experienced and this might inhibit international factoring. He considered it desirable to harmonize these aspects of exchange control which relate to international factoring. On the second point, recognition of the applicability of the law of the exporter's country might not always be as easy as it should, particularly in countries which require considerable formalities for the assignment of debts and which might not be particularly happy to recognize foreign assignments not attended by such formalities.