

UNIDROIT 1987  
Study LVIII-- Doc. 31  
(English only)

U n i d r o i t

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

---

COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT

CONVENTION ON CERTAIN ASPECTS OF INTERNATIONAL FACTORING

Comments by the Government of the United States of  
America on the text of the preliminary draft  
Convention on international factoring and on the  
proposed final clauses

Rome, April 1987

The United States of America is pleased to present to the Secretariat of the International Institute for the Unification of Private Law ("UNIDROIT") its observations and proposals relating to the draft convention on Certain Aspects of International Factoring as drafted at the Meeting of the Committee of Governmental Experts, Second Session, 21-23 April, 1986, held in Rome, Italy.

#### General Observations

The most recent draft ("1986 Draft") of the UNIDROIT convention on certain aspects of international Factoring has been reviewed and considered by various interested parties in the United States under the auspices of the Department of State.

We remain of the view that the project is worthwhile and reflects a positive attitude in unifying private international law for a relatively new mechanism for financing international trade in which there are sometimes drastic differences in the law of different nations. The United States is one of the few nations which has a relatively unified statutory framework governing the rights of the various parties affected by the financing and factoring of accounts receivable, in Article 9 of the Uniform Commercial Code (the "Code"), unlike most other nations in which the pre-existing legal framework has been adapted to a new financial technique which it was not designed to accommodate. To a large degree, the matters covered by the 1986 Draft are substantially in accord with similar provisions of Article 9.

To some extent, the work on this project is similar to the process which took place in the United States in the 1960's to modernize and unify the commercial law of the different states, including the legal treatment of accounts receivable financing and factoring, which ultimately led to the general enactment of

the Code. The 1986 Draft embodies the substance of many important provisions of Article 9 of the Code and is generally consistent with its outlook and approach.

A particularly beneficial addition to the 1986 Draft was the addition, at the insistence of the professional observers, of Article 4 thereof that the assignment by the seller of goods (the "Supplier") to a third party (the "Factor") of an account receivable is effective notwithstanding any agreement between the Supplier and the buyer of goods (the "Debtor") prohibiting such assignment. This provision generally follows the views expressed by the United States Delegation at prior meetings. However, there is still left open the issue of whether an adopting state may elect a reservation with respect to this provision in its ratification. In our view, failure to make non-assignability provisions in the sales contract ineffective would negate the practical effectiveness of the proposed Convention in general, would be adverse to the U.S. commercial interests and would conflict with Section 9-318(4) of Article 9. See discussion below. However, even on the present basis, the provisions of the 1986 Draft on this issue are an improvement over the omission in the prior draft.

Particular note should be made that the 1986 Draft, in general, only covers the relationship between or among the Supplier, the Debtor and the Factor. It does not cover or create any rules as to the priority of the Factor's assignment vis-a-vis other parties, e.g., tax authorities, bankruptcy trustees and the like, other assignees of the same account receivable and judgment and other lien creditors of the Supplier. This omission was the result of possible conflicts with domestic tax and bankruptcy law as to first two circumstances and, as to the rights of private parties claiming rights in and priority to accounts receivable, a sharp disagreement as to the rule or method which should govern, e.g., the law of the Supplier's principal place of business, a public filing requirement or the order of assignment or notification of the assignment to the Debtor. We favored and still favor the latter as being consistent with the requirement and importance of such notice under the 1986 Draft, as well as being consistent with provisions of Section 9-103(3)(c) of the Code governing perfection and rights as to a Supplier located outside the United States. While this issue is significant and leaves open a substantial area of uncertainty, its practical effect may not be as adverse to the financing and factoring of multi-national accounts receivable, as discussed below, as the omission of a provision on any non-assignability covenant in the sales contract being ineffective or making such provision optional.

In general, the 1986 Draft is an improvement over prior drafts, not only for recognizing the importance of rendering prohibitions on assignments of accounts receivable ineffective, but also by refining and technically improving the language of prior drafts.

#### Specific Observations and Recommendations:

##### Preamble:

The Preamble should be read in conjunction with Article 12, since the enunciated purposes of the 1986 Draft expressed in the Preamble may have an important bearing on its construction and application by the courts. To some degree, the Preamble is similar to Section 1-102(2) of the Code on underlying purposes and policies. However, the words "this purpose" in the next to the last line should be changed to "these purposes" in order to make clear that its rules of construction encompass the entire Preamble.

##### Article 1:

The 1986 Draft includes within its purview and scope all assignments of multi-national accounts receivable, both with and without recourse (which is similar to the definitions of "account" and "security interest" under the Code), and would thus apply to all financing and factoring accommodations for multi-national sales and services rendered on open account terms, provided (i) notice of the assignment is given to the Debtor and (ii) the Factor provides any two of the following: finance (i.e., loans or advance payments), maintenance of accounts (i.e., ledgering), collection of receivables (i.e., direct collections from Debtors) and protection against the risk of non-payment by Debtors (i.e., assumption of credit risk). Thus, the 1986 Draft would apply to an accounts receivable security agreement (i.e., the factoring contract) between a secured party (i.e., the Factor) and an exporter (i.e., the Supplier), pursuant to which the Debtor is notified of the assignment, loans are made by the Factor to the Supplier and the Factor receives direct collections from the Debtor, although there is no ledgering or assumption of credit risk. The 1986 Draft would also apply to an export factoring contract pursuant to which the Debtor is notified of the assignment and the Factor assumes the credit risk, collects directly from Debtors and does ledgering, although no loans or advance payments are made. In addition, it should be noted that this Article may be construed that what may initially be a "non-notification" agreement may subsequently become a "factoring

contract" (as defined in Article 1) upon notification to a Debtor by agreement and if any two of the requisite services are provided under the agreement.

Failure to notify the Debtor would not invalidate the Factor's assignment, but simply make the Convention not applicable to the transaction. Similarly, the giving of such notice would not validate the Factor's assignment if it was otherwise not valid under either the Convention or applicable domestic law. Of course, notice may be a requirement for perfection or priority under applicable domestic law, as under Section 9-103(3)(c) of the Code.

It should also be noted that in international sales transactions, directions to the Debtors to pay third party financing sources are not uncommon and carry little, if any, adverse implications.

Accounts receivable arising from the rendition of services, as well as the sale of goods are covered. However, the requirement that these be rendered pursuant to a contract "in the course of business" could lead to an issue of whether non-profit organizations or governmental entities are covered. This should be clarified by a definition that the term "business", as used in the convention, means "transactions other than transactions for the sale or purchase of goods or the supply or acquisition of services primarily for personal, family or household purposes". This suggested change basically tracks Section 9-109(1) of the Code.

In addition, there should be a clarifying definition that references to "Supplier" in the Convention also mean assignors of the Supplier, since on occasion the sale may be made by one entity and assigned to an affiliate which enters into the factoring contract.

A number of members of the United States Study Group have commented that the terms used in Article 1, paragraph 1(b) for the qualifying services under the factoring contract are not clear under U.S. commercial usage. Accordingly, Article 3, paragraph 1(b) should be changed as follows:

"(b) the factor is to provide at least two of the following services for the supplier or with respect to receivables: (i) financing, loans or advance payments to the supplier, (ii) maintenance, ledgering or bookkeeping of records on receivables, (iii) collection of

receivables from debtors, and (iv) protection against the credit risk of non-payment by debtors; and"

In addition, subparagraph (c) should be amended by inserting the words "at any time" after the word "notice" to clarify that such notice need not be given only at the time of execution of a contract or creation of a receivable.

Finally, a member of the U.S. Study Group has suggested that this Article be clarified that there may be more than one Factor of a Supplier. Accordingly, a third paragraph should be added as follows:

"3. This Convention shall also apply when the Supplier has concluded factoring contracts with more than one factor."

## Article 2

This Article establishes the requirement that the 1986 Draft is only applicable to multi-national sales and services, not purely domestic transactions. However, while the Supplier and the Debtor must be located in different nations, the Factor may be located in the nation of the Supplier, the Debtor or any other nation.

In the second paragraph, the term "closest relationship to the contract and its performance" is ambiguous and should be changed to "closest relationship to performance of the transactions under the relevant contract". In addition, the words "having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that contract" is ambiguous and only creates the potential for a dispute. This language should either be eliminated or replaced by a more precise rule of construction, e.g., "having regard to the understanding of the parties as to the places of shipment and delivery of the goods subject to the contract of sale". This language, to some extent, follows the rule of Section 9-103(1)(c) of the Code.

## Article 3:

It should be noted that, in view of the often drastic differences under different legal systems with respect to the execution and formalities of contracts, the 1986 Draft

deliberately left the issue of the legal requirements for such formalities for factoring and sales contracts to applicable domestic law under rules of private international law.

Article 3, however, is intended to validate provisions of the factoring contract covering assignments of after acquired accounts receivable in addition to those in existence at the time of execution. This is similar to Section 9-204(a) of the Code. However, in view of the present inability of the Committee to agree upon priorities between the Factor and third parties, the inclusion of the words "As between the parties to the factoring contracts" were inserted to make clear that Article 3 is not binding as to the rights of third parties other than as between the Factor and the Supplier.

The requirement that present or future receivables can be assigned pursuant to the factoring contract without a need to individually describe them, if they can be identified to the contract is similar to Section 9-110 of the Code. However, the language could be improved by deleting the words "they can be identified to the contract" and inserting "they can reasonably be identified as being described in and assigned pursuant to the contract."

Under Section 9-203 of the Code, the assignment of future receivables would generally be valid against third parties, subject to the Code's priority and perfection rules, if the identification requirement has been met, value has been given and the Supplier has rights in the accounts receivable. However, Section 9-203 is subject to tax, bankruptcy and other legislation of the United States or State law which establishes a different rule.

It is our view that the provisions of Article 3 as to a factoring contract should be binding upon third parties, in order to give a greater degree of certainty to the financing relationship, unless there is a specific rule of domestic law to the contrary which governs under rules of private international law. Moreover, under Article 6, the Debtor is in effect bound by Article 3, subject to the additional requirements of Article 6. Accordingly, an additional paragraph should be added to Article 3 as follow:

"The provisions of subparagraphs (a) and (b) as to a factoring contract, subject to the other Articles of this Convention applicable to debtors and other factors, shall be valid and binding upon the debtor, other factors and other third parties unless such provisions are not enforceable as to such third parties,

other than the debtor and other factors, under the domestic law applicable under the rules of private international law."

#### Article 4:

The first paragraph of Article 4 is similar in substance to the provisions of Section 9-318(4) of the Code. The limitation on enforcement against the Factor is limited to only the prohibition of assignments of rights of payment due to the Supplier from the Debtor and not of performance under the sales contract. In this respect Article 4 follows the principles of Article 55 of the Uniform Customs and Practices for Documentary Credits, 1983 Revision (the "UCP"). This concept protects the Factor against the need to review each sales contract of Suppliers of limited financial resources, with concomitant limited bargaining power, who have the greatest need for factoring and financing services.

Absent Article 4, the Factor would either have to rely upon a representation of the Supplier (which may have limited financial resources to satisfy any breach of warranty claim) or examine each of the Supplier's sales contracts, which may be in a foreign language or unreasonably delay the consummation of the transaction. The Debtor, in any event, is protected by Article 7, which permits set-off of claims existing at the time of notification of the assignment, and Article 11 of the 1986 Revision which permits the complete exclusion of the Convention under a sales contract upon notice to the Factor, except as to receivables arising prior to such notice. In addition, the Debtor retains its claims against the Supplier for any damages suffered as a result of the breach of the non-assignability provision.

The enactment of Section 9-318(4) of the Code rendering ineffective prohibitions on assignments of rights to payment more than twenty years ago, which overruled the then existing laws of states such as New York, has not resulted in any inequities or demands for its revocation.

The opponents of Article 4 on the Committee argued that it was in contravention of freedom of contract, but this argument seemingly begs the issues that (a) the prohibition on assignment is often inserted because the Debtor has greater economic leverage than the Supplier, (b) rendering the prohibition ineffective as to rights of payment does not violate any rights of the Debtor if the Supplier has performed its obligations or the Debtor has a right of setoff for damages resulting from non-performance of such obligations, and (c) from a practical and



operational viewpoint, the continued validity of such non-assignability provisions virtually renders the entire concept of international factoring illusory and not feasible.

There is also an unfair economic disadvantage to nations, such as the United States, which have existing laws or which accept the first paragraph of Article 4 making prohibitions on assignments invalid as to Debtors located within its borders, against nations who have not accepted this rule. The financing of imports into these "accepting nations" is facilitated by these laws and rules. On the other hand, the financing of exports from "accepting nations" is discouraged if the Debtor is located in a nation in which possible prohibitions on assignments of payments under the sales contract are valid. Examining sales contracts, often in a foreign language, is simply not a realistic solution for the Factor.

In addition, failing to have a provision which is permitted under the UCP would make international factoring of sales on open account terms a far less practical financing device than letters of credit.

For the above reasons, the reservation in paragraph 2 of Article 4 is not the answer to the problem and should be deleted, since it derogates from the basic purpose of unifying private international law and the other purposes of the Preamble.

Absent the inclusion of the first paragraph of Article 4 and the deletion of the reservation in its second paragraph, we would not be able to enthusiastically support the 1986 Draft.

#### Article 5:

As an incident to the assignment of the receivable, the factoring contract may provide that the Factor will receive all property rights of the Supplier under the contract of sale, such as purchase money security interests or reservations of title, stoppage in transit, reclamation, etc. This is basically in accordance with the Code. The enforceability of such rights would depend upon their recognition in the nation in which the exercise of such rights is sought to be enforced. For example, a reservation of title under a sales contract executed in Germany might not be enforceable against the subject goods in the possession of a Debtor in the United States without perfection of a security interest in the goods under the Code.

#### Article 6:

This concept of this Article is similar to the provisions of Section 9-318(3) of the Code. However, the obligation to pay the Factor is limited to amounts owing on sales contracts in existence when the notice is given. From a practical viewpoint, the notice is usually given on each invoice rendered to the Debtor so that there need be no requirement as to notices affecting future contracts.

#### Article 7:

The concept of Article 7 is similar to Section 9-318(1)(a) and (b) of the Code. However, the words "or defense" should be inserted after the word "setoff" (in two places) in the second paragraph. In addition, the concept of "accepting" by the debtor in the last sentence of paragraph 2 is ambiguous, since it may mean written acknowledgement, conduct, course of dealing, trade custom, etc. The reference to "under the applicable law" is also unclear. Such language should be changed to: "where he has waived that right in a written acceptance, consent or acknowledgement of the assignment", and deleting the words "under the applicable law."

#### Article 8:

This Article follows the majority of cases under United States law that a Debtor may not recover from the Factor payments made to the Factor because the Debtor has a claim against the Supplier except when it would not prejudice the Factor (e.g., only to the extent that the Factor has a credit balance in favor of the Supplier). It should be noted that generally under the UCP the same principle applies and, to be competitive with alternative financing systems, Article 8 should remain in its present form.

#### Article 9:

This Article, to some degree, is similar to Section 9-317 of the Code. However, the purpose of the Article could be improved by inserting the words "the factoring contract, the assignment of a receivable or" after words the "reason only of" in the first paragraph. In addition, the words "or under the sales contract" should be added at the end of the first paragraph. As to paragraph 3, in order to establish a parity of treatment of

international agreements and not to incorporate by reference international agreements as to which an adopting nation is not a party, the language should read:

"Nothing in this Article shall affect the liability of the factor under any other existing or future international agreement to which the factor is subject and which expressly provides a contrary rule."

#### Article 10:

Article 10 applies to the situation, as is frequently the case, in which the Supplier's Factor assigns the accounts receivable to another Factor (the "Import Factor") generally located in the nation in which the Debtor is located, and makes the 1986 Draft apply to the Import Factor. However, in view of the several provisions of the 1986 Draft relating to notice to the Debtor, the provisions of subparagraph (b) should be amended by deleting the words "the written notice required by Article 6, paragraph 1 of the Convention" and inserting the words "the written notice to the Debtor referred to in or required by this Convention".

The second paragraph of Article 10 is a result of provisions in its factoring contracts required by the law of one particular nation.

#### Article 11:

This Article permits the sales contract, upon notice to the Factor as to receivables arising after such notice, or the factoring contract to exclude the application of the Convention in its entirety, but not in part. However, the language of paragraph 2 relating to the sales contract exclusion is somewhat ambiguous, particularly on the issue of when "receivables arise" under the sales contract. This provision should be redrafted as follows:

"The contract of sale of goods may exclude the application of this convention except that such provision or a provision requiring the debtor's consent to an assignment of receivables arising thereunder shall be ineffective with respect to the assignment of receivables arising thereunder as to which the

right of payment thereof has been earned by the supplier's performance before the factor receives notice in writing of such exclusion."

The suggested change in paragraph 2, to some degree, follows the definition of accounts receivable in Section 9-106 and the invalidity of prohibitions on assignment of receivables in Section 9-318(4) of the Code.

#### Article 12:

This Article is relatively non-controversial and, inter alia, relates to the purposes in the Preamble being applicable for construction purposes. The language in brackets should be included.

#### Article X:

This Article should be deleted for the reasons discussed above as to Article 4.

#### Additional Article on Priorities

A major omission in the scope of the 1986 Rules is the failure to enunciate any rule on priorities between or among competing claims to the Supplier's accounts receivable. Generally this conflict will arise upon the Supplier's insolvency. These competing claims will generally fall into the following categories:

(a) Multiple assignees of the same receivables by the Supplier ("Voluntary Assignees") either as security or by sale. Although it has been commented that "non-notification" factoring does not fall within the scope of the 1986 Draft by virtue of Article 1, this is not completely correct. The Voluntary Assignee may initially not notify Debtors to make payment pursuant to Article 6, but at a later date by agreement or after default by the Supplier, such notification may be delivered to the Debtor. At that point, the assignment may become a "factoring contract" as defined in Article 1. For example, under Article 9-502(1) of the Code under United States law, the Voluntary Assignee may at any time by agreement with the Supplier and in any event upon default may notify the Debtor of the assignment. Thus, when a "non-notification" Factor enforces its rights under its agreement, its contract becomes a "factoring contract" as defined in Article 1 if two of the other essential services are provided in the agreement. The "finance" condition

will almost invariably be met because the Factor would have no incentive to claim an interest in the receivable if it had not advanced funds to the Supplier. Thus, if any one of the other service conditions has been met, the "non-notification" Factor would then be within the scope of the 1986 Draft. Accordingly, each of the competing Voluntary Assignees at the time when the dispute or priority arises, generally when the Supplier becomes insolvent, will in all probability be within the scope of the 1986 Draft.

(b) Creditors of the Supplier having judgment or other involuntary liens against receivables of the Supplier under domestic law under applicable rules of private international law as a result of unpaid claims ("Involuntary Claims").

(c) Claims of bankruptcy trustees, receivers and the like who take control of the Supplier and its assets under applicable domestic law ("Trustee's Claims").

(d) Tax liens and other claims of governments against the Supplier and its assets under applicable law ("Government Claims").

As to the priority of Involuntary Claims, Trustee's Claims and Government Claims, vis-a-vis the rights of the Factor in the Supplier's receivables, valid policy arguments can be made that these issues should be resolved under applicable domestic laws of the nation having jurisdiction under rules of private international law.

However, there is no valid reason why the priorities between or among Voluntary Assignees in the Supplier's receivables should not be determined by the Convention, particularly since their agreements with the Supplier and relation to the Debtor in other respects would probably be subject to the Convention.

In furtherance of the above, subparagraph (c) of the first paragraph of Article 1 should be amended for purposes of clarity to read as follows:

"(c) notice at any time of the assignment of the receivables is or may be given to debtors pursuant to the factoring contract and in any event upon or after the occurrence of any default under the factoring contract."

The issue then arises as to what rule of priority should govern when the Supplier has more than one Voluntary Assignee of the same receivable and there is no agreement as to priority between such Voluntary Assignees.

As noted above and in the commentary prepared by the UNIDROIT Secretariat, a number of alternative solutions to the problem have been suggested. In our view, taking into consideration both the most practical method of ascertaining the existence of another Voluntary Assignee and the importance of notice in the 1986 Draft, priority should be based upon the time and order of delivery of notice to the Debtor.

Obviously, reliance upon representations by the Supplier are not sufficient. Absent deliberate "double assignments" by the Supplier, the Supplier may have executed or granted two or more assignments in the same receivable without being aware of their conflict, (e.g., when the Supplier has a domestic Factor, a Factor for foreign sales and another creditor which has been granted a security interest in its inventory and the proceeds thereof). Searches for possible conflicts under a central international recordation or filing system for notices of assignments of receivables are not possible because such an international system does not presently exist and is unlikely to exist in the near future. Accordingly, the best method for ascertaining whether a conflict exists is through contact with the Debtor, either by specific inquiry or through a response to a notice of assignment.

In addition, the notice of assignment to the Debtor is a key aspect of the 1986 Draft. The notice is required for a factoring contract to be subject to the 1986 Draft (under Article 1, paragraph 1(c)). The notice of assignment is necessary for the Debtor's obligation to pay the Factor under Article 6. The notice of assignment cuts off the Debtor's right of setoff under Article 7, paragraph 1.

It is relatively easy for a Voluntary Assignee to ascertain from the Debtor whether it has received a prior notice of assignment and, in any event, it is probable that it will quickly be advised by the Debtor or a previous notice of assignment after giving the second notice.

For the above reasons, priority of conflicting assignments to Voluntary Assignees in the same receivables should be determined in the order of notification to the Debtor.

It is interesting to note that the drafters of the Code came to a similar conclusion in Sections 9-103(3)(c) and 9-312(5) of the Code in effect in the United States, which ranks priority among conflicting Voluntary Assignees in receivables of a Supplier which does not have an executive office in the United States according to priority of notification of the assignment to the Debtor.

For the reasons indicated above, we recommend that the following provision be added to the 1986 Draft:

"Priority in receivables due from a debtor and payments received therefrom assigned by a supplier to more than one factor under more than one factoring contract shall be determined in favor of the factor named in the earliest notice of assignment of such receivables received by the debtor, except as otherwise agreed in writing between such factors."

AFR4a/U01/jdf