INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

EN

Factoring Model Law Working Group

Fourth session (hybrid)
Rome, 1 – 3 December 2021

UNIDROIT 2021
Study LVIII A – W.G.4 – Doc. 5
English only
November 2021

INTRODUCTION TO TRANSITION ISSUES IN MODEL LAW ON FACTORING

1. There are two types of transition issues for which guidance should be provided by the Model Law on Factoring or the accompanying Guide to Enactment[1]:

   i. Issues relating to the amount of time that should pass between the enactment of legislation based on the Model Law and its effective date.

   ii. Issues relating to the treatment, after the effective date of the new legislation, of transactions entered into before the effective date of the new legislation.

1. Interval between enactment of legislation based on the Model Law and its effective date

2. The subgroup on transition rules recommends that there should be a transition period between the date of enactment of legislation based on the Model Law and the effective date of that legislation. The need for such a transition period is practical – parties engaging in factoring transactions will need some time to educate themselves about the new law, assure that the business methods and forms they use for transactions under existing law will continue to work under the new legislation (or adapt those methods and forms to the requirements of the new law), identify types of transactions or transactional methods made economically viable by the new law, and develop methods and forms for those transactions. In particular, parties engaging in factoring transactions are likely to need time for education and training about the structure and use of registries for factoring transactions. Of course, debtors on receivables and others affected by factoring transactions will also need to educate themselves about the new law and its effect on them (such as, for example, the effect of the new law on anti-assignment provisions in receivables).

3. In addition, there is an important practical need for a period of time between enactment of the legislation and its effective date – the need for time to design and implement a registry of factoring transactions of the sort envisaged by the new legislation. While most states have document registries of one sort or another, a notice registry of the sort proposed in the Model Law will have a number of different characteristics than existing registries. This will require not only design and testing of the new registry but also training of registry personnel.

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[1] The following analysis assumes that the enacting State does not generally have a modern secured transactions regime with characteristics similar to those under the Model Law on Secured Transactions. Furthermore, the prominence of transition issues will vary with the level of receivables financing that occurs under the enacting State's current legal system.

4. The Guide to Enactment[2] that accompanies the Model Law on Secured Transactions makes similar points:

> Inasmuch as the new law will have been chosen because it is an improvement over the prior law, it should come into force as soon as is possible after the text of the new law is final and the registry system required to support it is operational. However, some lead time is necessary in order to, inter alia: (a) publicize the existence of the new law; (b) enable potential registry users to familiarize themselves with the operation of the Registry, including its registration and search requirements, and to undertake the necessary preparations to use the registry services; (c) educate participants in the secured transactions system about the effect of the new law and the transition from the prior to the new law and enable them to prepare for compliance with the new rules and to develop new forms of security agreements and other required documents; and (d) educate other affected constituents, for example, buyers, lessees, judgment creditors and insolvency representatives, on the impact of the new law on their rights.

5. States should also consider regulatory issues in the context of transition, as the regulatory authorities will need some time to issue implementing regulations, licenses, etc. where necessary. It is important for any regulatory framework to enter into force at the same time as the factoring law to provide certainty to the market and avoid questions, such as whether the transfer is valid because an appropriate license might not have been issued to the factor.

2. The status, under the legislation based on the Model Law, of transactions entered into under prior law

6. Transactions entered into before the effective date of legislation based on the Model Law will not disappear on that effective date. Rather, many such transactions will continue in existence after that date. In order to avoid uncertainty as to legal rights of parties after the effective date, the subgroup on transition issues recommends that the Model Law contain rules to address issues that are likely to arise with respect to such pre-effective date transactions.

7. Issues that may arise with respect to the status, after the effective date of the new legislation, of transactions entered into before the effective date of the new legislation include (i) the effectiveness between the parties of a factoring transaction that satisfies the criteria for effectiveness under the prior law but does not satisfy the requirements for effectiveness between the parties under the new legislation (or vice versa), (ii) the effectiveness against third parties of a factoring transaction that satisfies the criteria for effectiveness against third parties under the prior law but does not satisfy the requirements for effectiveness against third parties under the new legislation (or vice versa[3]), (iii) priority after the effective date as between those with competing claims to the factored receivables, and (iv) the rights of the factor to enforce a receivable against the debtor on the receivable and the obligation owed by the debtor on the receivable to the factor or the transferor of the receivable (including situations in which the receivable provides that it may not be transferred). These issues are related but distinct and should be considered separately.

8. At first blush, it might seem that a very simple transition rule for these issues would suffice – transactions entered into when the former law was in effect would be governed by that former law, while transactions entered into after the effective date of the new legislation would be governed by that law. On closer examination, however, it becomes clear that such a solution is unsatisfactory.

[2] UNCITRAL Model Law on Secured Transactions: Guide to Enactment, para. 548.

[3] This situation is not likely to occur.

For one thing, such a transition rule would lead to incoherent or inconsistent results in resolving a dispute between competing claimants to a receivable when one claim arose before the effective date of the new legislation while the competing claim arose after the effective date. In addition, if the prior law did not provide for notice registration as the method of third-party effectiveness for the right of a buyer of receivables, any potential transactions with respect to receivables created before the effective date of the new law (some of which might remain outstanding for a significant amount of time after the effective date) would remain risky because of the absence of a registry from which rights could be ascertained. On the other hand, a different simple transition rule – application of the new legislation to all issues immediately upon the effective date of that legislation – would also be problematic inasmuch as it could have an immediate negative impact on those with rights established under the former law.

9. Accordingly, following the lead of the UNCITRAL Model Law on Secured Transactions, the subgroup recommends that this second set of transition issues be addressed by a nuanced rule under which the new law provides for a second transition period, after the effective date of the new legislation, during which pre-effective-date rights are preserved and in which factors and other parties can take steps to continue those rights after the conclusion of this second transition period. One of the challenges in preparing a model set of transition rules for this second sort of transition issues is that, while we will know the new law *to which* the transition is occurring – the Model Law on Factoring – the former law *from which* the transition will occur will differ from state to state. Thus, it is possible that some portion of our effort will need to be devoted to an explanation, in the Guide to Enactment, of considerations to be taken into account in customizing transition rules in a particular enacting State in light of the nature of the prior system in that State. In this regard, the following advice appearing in the Guide to Enactment[4] that accompanies the Model Law on Secured Transactions is instructive:

> The Model Law [on Secured Transactions] provides a comprehensive legal framework to govern security rights in the types of asset within its scope … replacing rather than merely supplementing the prior law. Accordingly, [the Model Law] requires the enacting State to list the laws to be repealed upon entry into force of the new law …. The way in which the repeal is effectuated will depend on the form of the prior law. Where the prior law is set out in a free-standing statute or combination of statutes, it can be repealed in its entirety. Where the prior law is contained in statutes that also address other topics, the enacting State must specify which provisions are to be repealed and which are to be retained or amended. Where all or part of the prior law is based on judicial opinions (as may be the case, for example, in common law systems), the effect of the new secured transactions law typically will be to override the rules derived from the prior case law without the need for the enacting State to take any explicit repealing measures.
>
> Secured transactions law interacts with many other laws (e.g. civil procedure, judgment enforcement, insolvency, property and taxation laws). These other laws may contain provisions that refer to or are premised on the enacting State's prior law. Accordingly, [the Model Law] provides for the enacting State to amend these provisions to the extent needed to align them with the terminology and the provisions of its new law.

10. We further recommend that transition rules for the Model Law on Factoring should be consistent with parallel provisions of the Model Law on Secured Transactions unless there is an exceedingly persuasive justification for a difference (although the transition rules may be stated somewhat differently in the Model Law on Factoring to fit the nature and voice of the that law).

[4] UNCITRAL Model Law on Secured Transactions: Guide to Enactment, paras. 526-527.

Moreover, the transition rules in the Model Law on Factoring may address some transition issues that the Model Law on Secured Transactions does not address and address others in more or less detail than does the Model Law on Secured Transactions.

11. The following annexes address particular transition issues that may be expected to arise in conjunction with the enactment of the Model Law on Factoring.

ANNEX A

EFFECTIVENESS BETWEEN THE PARTIES

1. What happens if a transfer is concluded before the effective date of the Model Law on Factoring (MLF) and its effectiveness between the parties is challenged after the effective date? Two scenarios should be addressed.

Scenario #1:

2. First, what is the treatment under the MLF if the transfer satisfied the requirements of prior law but not those of the MLF? (In light of the ease of transferring a receivable that is likely to be a feature of the MLF, this Scenario will not arise often but perhaps may arise in the event of an oral transfer before the effective date of the MLF.) Under the Model Law on Secured Transactions (MLST), the pre-effective date transfer would be a "prior security right." See MLST Article 102(1)(b). Pursuant to MLST Article 104(1), prior law determines whether a prior security right was created. More specifically, MLST Article 104(2) provides that "A prior security right remains effective between the parties notwithstanding that its creation did not comply with the creation requirements of this Law." Thus, in this Scenario, the pre-effective date transfer, which was effective when made, will remain effective between the parties after the effective date of the new law. This serves to avoid retroactive invalidation of a transfer that was in conformity with the law applicable to it at the time it was concluded.

Scenario #2:

3. What is the treatment under the MLF if the transfer did not satisfy the requirements of prior law but does satisfy the simpler requirements for effectiveness between the parties in the MLF? (This Scenario will likely not arise if the pre-effective date transfer was between experienced parties who were knowledgeable about the requirements of the law at the time but can arise in the event of an error or omission with respect to formalities that might be present under prior law.) Once again, under MLST Article 104(1), prior law determines whether a prior security right was created. Under that rule, the pre-effective date transfer, which was ineffective between the parties when made, will be ineffective under the MLST. This serves to avoid a situation in which a transfer that is ineffective between the parties under prior law springs to life as a result of the effectiveness of the new law.

4. A variation on Scenarios #1 and #2 is present when the contract pursuant to which the receivables are to be transferred is entered into before the effective date of the MLF but the receivables that are the subject of the contract do not come into existence until after the effective date of the new law.

Scenario #3:

5. A master factoring agreement was made and entered into before the effective date but, under its terms, each transfer under the agreement requires a separate offer and acceptance by the factor and the client with respect to the receivables involved in the transfer. If the master factoring agreement would be effective under prior law to result in the transfers pursuant to it becoming effective between the parties but (i) that agreement would not be effective to do so under the MLF (perhaps because the master agreement does not describe the receivables in question) and (ii) the offer and acceptance of the receivables after the effective date of the new law does not satisfy the MLST (perhaps because it is not signed by the transferor), is there a transfer that is effective between the parties for the receivables covered by the offer and acceptance. The issue here lies within the

realm of what constitutes a "contract": Is the master factoring agreement the "contract" with facultative obligation whereby, after the conclusion of the contract, the factor and the client identify the receivables to be transferred? Or, alternatively, is the offer and acceptance of the individual receivables to be transferred the "contract," and the master agreement in itself just details the terms without being a stand-alone "contract" to transfer the receivables? The transition subgroup concludes that factoring practice indicates the former is the norm. Thus, applying the transition rules of the MLST, in Scenario #3 the effectiveness of the transfer between the parties will be determined by examining the master agreement, which was concluded under prior law. Here, since the agreement was effective under prior law, the subgroup recommends the conclusion that the transfers entered into pursuant to the pre-effective date master agreement be effective after the effective date of the MLF.

Scenario #4:

6. Assume that the facts are the same as under Scenario #3 except that the master factoring agreement would be insufficient to bring about a transfer between the parties under prior law. This could arise because strict requirements imposed under prior law (such as the necessity of notarized document) result in the contract not being effective under prior law, even though it would be in conformity with the requirements provided for under the new law. In that case, by virtue of application of MLST Article 104 where effectiveness of prior security rights is determined by the prior law, the contract will not be effective under the new law to create a transfer that is effective between the parties.

Scenario #5:

7. Assume that, as in Scenarios #3 and #4, a master factoring agreement was made and entered into before the effective date but, under its terms, each transfer under the agreement requires a separate offer and acceptance by the factor and the client with respect to the receivables involved in the transfer. Assume further that, by offer and acceptance, the parties agree, after the effective date, to the sale pursuant to the master factoring agreement of certain receivables created after the effective date of the new law that contain an anti-assignment term that, under prior law but not the MLF, would prevent an effective transfer of the receivables. Is the transfer of those receivables effective between the parties? The transition working group observes that, by virtue of application of MLST Article 104 in light of the factoring practice identified in Scenario #3, the transfer will not be effective under the new law. Yet, this would result in giving effect to a post-effective date restriction that is not otherwise effective under the modern law; accordingly, this resolution of the tension between general applicability of the new law and preservation of pre-effective date determinations of effectiveness might be seen as anomalous. The Working Group may wish to address this matter. [Note that Annex E addresses other transition issues with respect to anti-assignment terms.]

ANNEX B

EFFECTIVENESS AGAINST THIRD PARTIES

Scenario #1:

1. A receivable might have been transferred before the effective date of the new law. Such transfer was effective between the parties under the applicable (prior) rule. It was also made effective against third parties by a mechanism that is not registration, which is the sole mechanism to achieve third-party effectiveness under new law.

2. New law would become applicable to this transfer on its entry into force, if it included an equivalent of Article 102(2) of the MLST. It is reasonable to assume that the mechanism used to make the transfer effective under prior law (e.g., notification of the debtor) would not be the same as the mechanism under new law (registration). Thus, the transfer would not be generally effective against third parties under new law. To ensure seamless transition and not to upset transfers effectuated under prior law, the MLF should include a "grace period" during which the transfer remains temporarily effective against third parties. If the factor registers a notice in the relevant registry, the third-party effectiveness will be continued beyond the grace period. An equivalent of Article 105 of the MLST should be incorporated in the MLF so that enactment of a new law does not disrupt pre-existing receivables finance arrangements that may smoothly transition into new law.

Scenario #2:

3. A scenario where a transfer is ineffective against third parties under prior law but effective under new law is highly unlikely. One of the fundamental objectives of the MLF is to enable transferees to make their rights effective against third parties by registration. As a result of implementation of the MLF, a registration system is expected to be established. One plausible situation that this Scenario may cover is where a registry system was established prior to the entry into force of new law voluntarily, such as by financial institutions (e.g., in Tunisia where financial institutions informally shared records about receivables transfers). New law may designate that registry system as the registry system for notices relating to transfers of receivables in which case the "prior registrations" may be effective against third parties under new law, even though they were not effective against third parties under prior law. This is not a paradigm for which a provision in the MLF should be included.

Scenario #3:

4. A scenario where a transfer is effective against third parties under both prior law and new law presupposes that the enacting State already established a registration system. This may be the case where a collateral registry applicable broadly to notices relating to security rights in movable assets, including receivables was established pursuant to the general secured transactions law. This is the case in some States already (e.g., UAE). In those States, no transition provision to cover this situation would be necessary unless the type of a transfer covered by new law was excluded from the scope of application of prior secured transactions law. Given the broad scope of secured transactions laws, as opposed to more focused scope of factoring laws, this is an unlikely scenario. It does not seem any rule is needed to be included in the MLF.

Scenario #4:

5. If a transfer was not made effective against third parties under prior law, new law would apply to such a transfer and deem it ineffective against third parties until a notice is registered. An equivalent of Article 102(2) of the MLST would make new law generally applicable without any exception. As noted above, an equivalent of this article should be included in the MLF.

ANNEX C

PRIORITY

Scenario # 1:

1. If there has been a purported transfer of a receivable before the effective date that is effective between the parties under the applicable rule and another claimant has a competing claim to the receivable that arose after the effective date of the new law, is priority determined by prior law or new law?

2. Under the general rule in Model Law on Secured Transactions Article 102(2), priority is determined by the new law.

> Example: Before the effective date of the new law, Transferor entered into an agreement with Transferee 1 to transfer all present and future receivables. After the effective date of the new law, Transferor entered into an agreement with Transferee 2 covering the same receivables and Transferee 2 registers the transfer under the new law. Under prior law, a transfer was effective against third parties on conclusion of the transfer agreement and priority between competing transfers was determined by the order in which the agreements were concluded. Under the new law priority between competing transfers is determined by the order in which the transfers are registered. Transferor1 does not register before expiry of the transition period in Article 105.

3. In this example, the new law applies, and Transferee 2 has priority under the first-to-register priority rule in the new law even though Transferee 1 would have had priority under the old law. The result is fair since Transferee 1 could have preserved the priority it had under the old law by registering the transfer before expiry of the transition period in Article [105].

Scenario #2 :

4. If there has been a purported transfer of a receivable before the effective date that is effective between the parties under the applicable rule and another claimant has a competing claim to the receivable that arose before the effective date of the new law, and the prior law gives the competing claims a different priority order than the new law, which priority rule applies?

5. Article [106(1)] provides an exception to the general rule in Article [102(2)] that the new law applies to all transfers of receivables, including prior transfers. Prior law determines the priority of a prior transfer if the rights of all competing claimants also arose before the effective date of the new law. This exception protects the expectations of prior transferees and prior competing claimants *provided* the prior transfer is registered before expiry of the transition period in article 105. It is therefore subject to the condition that the priority status of the prior transfer has not "changed" since the effective date of the Model Law.

6. Article [106(2)] provides guidance on the two circumstances where the priority status of a prior transfer has "changed" with the result that the new law applies.

7. The first is where the prior transfer was made effective against third parties under prior law, but third-party effectiveness was not preserved before expiry of the transition period in Article [105(1)]. (See paragraph 2(a).)

> Example: Before the effective date of the new law, Transferor entered into an agreement with Transferee1 to transfer all present and future receivables and then entered into an agreement with Transferee2 covering the same receivables. Under prior law, the conclusion of an agreement to transfer receivables was enough to make the transfer effective against third parties and priority between competing transfers was based on the order in which the agreements were concluded. Transferee 2 registers its transfer under the new law before expiry of the transition period in Article [105] but Transferee 1 does not.

8. In this example, the new law applies, and Transferee 2 has priority under the first-to-register rule. The result is fair since Transferee 1 failed to take advantage of the opportunity under Article [105] of the new law to preserve the priority it enjoyed under prior law by registering before expiry of the transition period.

9. The second circumstance where the priority status of a prior transfer has "changed" with the result that the new law applies is where the prior transfer was never made effective against third parties under prior law. (See paragraph (2)(b)).

> Example: Before the effective date of the new law, Transferor entered into an agreement with Transferee1 to transfer all present and future receivables and then entered into an agreement with Transferee2 covering the same receivables. Under prior law, a transferee had to notify the debtor of the receivable of the transfer for the transfer to be effective against third parties. Neither Transferee1 nor Transferee2 did so before the effective date of the Model Law. Transferee2 registers its transfer under the new law before Transferee1 does so.

10. In this example, the priority rules of the new law apply with the result that Transferee2 has priority under the first to register priority rule of the new law. The result is fair since neither prior transfer was effective against third parties under prior law.

<u>Draft statutory language</u>

11. Article [106]. Application of prior law to the priority of a prior transfer as against the rights of competing claimants arising under prior law

> 1. The priority of a prior transfer as against the rights of a competing claimant is determined by prior law if:
>
> > (a) The rights of all competing claimants arose before the entry into force of this Law; and
> >
> > (b) The priority status of the prior transfer and the rights of the competing claimants has not changed since the entry into force of this Law.
>
> 2. For the purposes of paragraph 1 (b), the priority status of a prior transfer has changed only if:
>
> > (a) It was effective against third parties when this Law entered into force but ceased to be effective against third parties; or
> >
> > (b) It was not effective against third parties under prior law when this Law entered into force, and only became effective against third parties under this Law.

ANNEX D

ENFORCEMENT

1. Transition issues may also arise in the context of enforcement, such as where the default occurs prior to the entry into force of a new law, but the receivables are collected after the entry into force. The general rule of the MLST stated in Article 102(2) would make new law applicable to post-default collection or other disposal of the receivables. This enables the secured creditor to benefit from what would likely be a more efficient enforcement regime. In some States, enforcement may require special notification or involvement of the court. Under Article 103(2) of the MLST if a step were taken to enforce a prior security right before the entry into force of this Law, enforcement may continue under prior law or may proceed under new law. It is unclear what benefit the inclusion of Article 103(2) would provide to factors. If default did not occur prior to the entry into force of a new law or no step was taken, only new law would be applicable to any enforcement action. Furthermore, it may not be entirely clear what actions would constitute a "step" that would entitle the factor to enforce under prior law. Incorporating an equivalent of Article 102(2) would seem to be sufficient to cover any transitional issues concerning enforcement.

ANNEX E

TO WHOM IS THE DEBTOR'S OBLIGATION OWED?

1. Either because of contract or rule of law, there may be a restriction under prior law as to the ability of the assignor to assign a receivable to an assignee. The effect under prior law of a purported assignment of such a receivable in violation of such a restriction may result in the assignment being ineffective or it may result in a situation in which the assignment is effective as between the assignor and the assignee, but the debtor is answerable only to the assignor. What is the effect, after the effective date of the new law, of such a purported assignment?

Scenario #1:

2. Under the terms of the receivable entered into before the effective date of the new factoring law, a purported assignment of the receivable is void and ineffective. Under the law in effect at that time, that anti-assignment term would be effective. Nonetheless, before the effective date of the new factoring law, the creditor on the receivable enters into an agreement purporting to assign the receivable to an assignee. The assignment would be ineffective under the former law but would be effective under the new factoring law. Is the assignment effective after the effective date of the new law?

3. MLST Article 104(1) appears to resolve this issue. Under that provision, prior law (as defined in the MLST) determines whether a prior security right (as defined in the MLST) was created. The purported assignment of the receivable in this Scenario would qualify as a prior security right, so its effectiveness would be governed by prior law. Since, under prior law, the assignment was not effective, it would not be effective under the new law.

Scenario #2:

4. Under the terms of the receivable entered into before the effective date of the new factoring law, a purported assignment of the receivable is void and ineffective. Nonetheless, before the effective date of the new factoring law, the creditor on the receivable enters into an agreement purporting to assign the receivable to an assignee. Under the law in effect at that time, that anti-assignment term would not prevent the assignment from being effective between the assignor and the assignee, but the effect of the anti-assignment term would be that the debtor is answerable only to the assignor and, thus, only the assignor could enforce the receivable against the debtor. The assignment would be fully effective under the new factoring law. After the effective date of the new law, is the debtor answerable to the assignee so that the assignee can enforce the receivable against the debtor?

5. The transition rules in the MLST do not appear to have contemplated this question. Article 102(2) states that "Except as otherwise provided in this chapter, this Law applies to all security rights, including prior security rights within its scope." This suggests that the new law, under which the assignee can enforce the receivable against the debtor, provides the answer unless an exception applies. Yet, this would mean that protection that was bargained for by the debtor and which was enforceable at the time of the bargain would cease to be effective under the new law. The transition subgroup suggests that the Working Group consider a transition rule under which such an anti-assignment term would remain effective even after the effective date of the new law.