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Item No. 5 on the agenda: Update on certain high-priority projects on the 2023-2025 Work Programme

(a) Model Laws and Guides to Enactment

ii. Proposed amendment to the Model Law on Factoring

(prepared by the Secretariat)

<i>Summary</i>	<i>Description of technical error identified in the transition rules of the Model Law on Factoring; proposed amendment to rectify the error</i>
<i>Action to be taken</i>	<i>The Governing Council is invited to consider amending the Model Law on Factoring to rectify the error in the transition rules</i>
<i>Mandate</i>	<i>Work Programme 2023-2025</i>
<i>Priority level</i>	<i>High</i>

I. INTRODUCTION

1. The UNIDROIT Model Law on Factoring (MLF) was adopted by the UNIDROIT Governing Council in May 2023 and published in October 2023. However, during preparation of the materials for the first Working Group session to draft a Guide to Enactment (GtE) for the MLF in March 2024, a technical error relating to the instrument's transition rules was identified.

2. This document explains the error that has been identified in the MLF's transition rules and sets out the Secretariat's proposed amendments to rectify the error.

II. TECHNICAL ERROR IN THE MODEL LAW ON FACTORING TRANSITION RULES

Article 52

3. The transitional rules in the MLF are important because receivables transferred, outright or by way of security, under "prior law" (the law in force in a State before entry into force of the MLF) may continue to exist and be subject to competing claims that arise after the effective date of entry into force of the new law (the MLF). The operation of transitional rules is also quite complex. Article 52 of the MLF is designed to provide priority protection to a transferee with respect to a transfer of

receivables that occurred and was effective against third parties under prior law as long as the transferee satisfies the requirements for third-party effectiveness under the new law before the end of that transitional period. This is accomplished by Article 52(2) to the effect that, for such a transferee, the date of third-party effectiveness under the new law is the date of third-party effectiveness under the prior law.

4. While this “relation back” of third-party effectiveness was intended to cause the priority of the transferee to be determined by reference to the date of third-party effectiveness under the prior law, the current text of Article 52, read in conjunction with the priority rule of Article 13(1), does not achieve the intended result when third-party effectiveness under prior law was achieved by a method other than registration of a notice. This is because the priority rule in Article 13(1) states that priority is determined by the order of registration of notices in the MLF registry (the “first to file” rule), not the order of third-party effectiveness. As a result, in the case of a receivable that was the subject of a transfer made effective against third parties under prior law by a method other than registration of a notice, the effect of the transition rule is to incorrectly fail to give priority effect to that third-party effectiveness achieved by other means. Under Article 13(1), even if the transferee of that transfer registers a notice under the new law before the expiration of the transition period and, thus, preserves its third-party effectiveness status without interruption, a competing transferee whose rights arose after the effective date of the new law and who registers a notice with respect to that transfer before the registration of the notice by the prior-law transferee will have priority over the prior-law transferee.

5. The effect of this error is that, in certain circumstances, the current MLF text would allow a second-in-line creditor to unfairly jump ahead of a first-in-line creditor who, during the transition period, takes all the steps necessary to preserve the third-party effectiveness of its claim. While this error is highly technical in nature, it could have a significant detrimental impact in implementing the MLF in all countries without a pre-existing registry for the transfer of receivables.

Article 11

6. The same error manifests itself in the context of a different sort of transition – the situation that arises when a transferor moves from one State to another and, thus, the law governing priority of transfers made by that transferor changes. This situation is governed by Article 11, which is designed to ensure that in such a case (where a transferor moves from a different State to a State that has enacted the MLF), the priority position of a transferee under the law of the former state would be protected following the relocation of the transferor, as long as the transferee registers a notice relating to its transfer in the registry in the State to which the transferor had relocated within a specified grace period. However, because the priority rule of Article 13(1) assumes that the MLF has always governed the relevant transfers and, thus, that third-party effectiveness is always achieved by registration of a notice, the effect of applying Article 13(1) in the context of Article 11 could similarly allow a second-in-line creditor in certain circumstances to unfairly jump ahead of a first-in-line creditor under the law where the transferor had previously been located, by being the first to register a notice in the MLF Registry in the State to which the transferor had relocated.

7. The effect of the error in the Article 11 context is potentially less serious than the error vis-à-vis Article 52, as it is unlikely to arise often in practice (it would be rare for a transferor to relocate within the specific circumstances under which the second-in-line creditor would unfairly jump ahead of the first-in-line creditor). However, the effect of the error in the Article 11 context creates an ongoing problem in the MLF (as a transferor could relocate at any time), whereas the effect of the error in the Article 52 context, while more likely to have an adverse impact on parties, would be time limited to registrations made during the transition period after the entry into force of the MLF.

III. NECESSITY OF AMENDING THE MODEL LAW ON FACTORING

8. During the MLF GtE Working Group session in April 2024, the technical error described above was discussed by those expert Working Group members that were also responsible for the drafting of the MLF. Following this discussion, it was the view of the Secretariat that it would be preferable to amend the MLF to resolve the error, rather than simply explain its effect in the Guide to Enactment. The members of the MLF GtE Working Group which had been members of the Working Group that drafted the MLF unanimously supported the view of the Secretariat.

9. The Secretariat's view is based on several considerations:

- (i) The potential undesired policy consequences and inconsistent outcomes for parties that could arise from the current text of the MLF;
- (ii) The need to ensure that the MLF reflects international best practice;
- (iii) The importance of preserving the positive impression that the international factoring community has of the MLF as an error-free instrument; and
- (iv) The fact that MLF has been publicly available for only six months and thus can be amended before it has been widely adopted.

10. It was further the view of the Secretariat that the error should be rectified as soon as possible, and that an amendment proposal should be submitted to the Governing Council for consideration at its 103rd session in May 2024.

IV. PROPOSED AMENDMENTS TO ARTICLES 11 AND 52 OF THE MLF

11. In consultation with the experts that participated in the MLF Working Group, the Secretariat discussed several different approaches to addressing the identified error. It was the view of the Secretariat that the error should be rectified by way of amendments to Articles 11 and 52, which affect only a limited class of cases, rather than amending the general priority rule in Article 13, which would have the effect of making the broadly applicable general priority rule more complex. Ultimately, the Secretariat has recommended that Articles 11 and 52 be subject to minimalist amendments that address the current gap in the instrument and ensure the correct and intended policy outcome for parties. The drafting of the proposed amendments is also intended to match the drafting of the existing Articles 11 and 52.

12. The proposed amendments to Articles 11 and 52 are set out below.

13. In relation to Article 52, the Secretariat has recommended that paragraph 5 be deleted and replaced by new paragraphs 5 and 6. New paragraph 5 clarifies that in States without a notice-based registry for transfers of receivables (prior to adopting the MLF), the time that a transferee attained third party-effectiveness under the prior law in relation to a prior transfer is the priority point for the purposes of the "first to file" rule in Article 13. Similarly, paragraph 6 clarifies that in States with a notice-based registry (prior to adopting the MLF), the time that a transferee registered a notice under the prior law in relation to a prior transfer is the priority point for the purposes of the "first to file" rule.

14. The newly proposed paragraphs 5 and 6 are both in square brackets, as the exact rules to be adopted in each enacting State will depend on the prior law in that State. A State in which, under prior law, third-party effectiveness could be established only by methods other than registration of a notice would enact only paragraph 5. A State in which, under prior law, third-party effectiveness could be established only by registration of a notice would enact only paragraph 6. A State in which, under prior law, third-party effectiveness could be established either by registration of a notice or otherwise would enact both paragraphs 5 and 6.

Article 52

1. A prior transfer that was effective against third parties under prior law at the time this Law entered into force continues to be effective against third parties under this Law until the earlier of:

(a) the time it would have ceased to be effective against third parties under prior law; and

(b) the expiration of [the enacting State to specify a period of time] after the entry into force of this Law.

2. If the third-party effectiveness requirements of this Law are satisfied before the third-party effectiveness of a prior transfer ceases in accordance with paragraph 1, the prior transfer continues to be effective against third parties under this Law from the time when it was made effective against third parties under prior law.

3. If the third-party effectiveness requirements of this Law are not satisfied before the third-party effectiveness of a prior transfer ceases in accordance with paragraph 1, the prior transfer is effective against third parties only from the time it is made effective against third parties under this Law.

4. A written agreement between a transferor and a transferee for a prior transfer is sufficient to constitute authorisation by the transferor for the registration of a notice covering the receivables described in that agreement under this Law.

~~[5. If a prior transfer referred to in paragraph 2 was made effective against third parties by the registration of a notice under prior law, the time of registration under prior law is the time to be used for the purposes of applying the priority rules of this Law that refer to the time of registration of a notice of a transfer.]~~

~~[5. Subject to paragraph 6, if a prior transfer continues to be effective against third parties under this Law pursuant to paragraph 2, the time of third-party effectiveness under prior law is the time to be used for the purposes of applying the priority rules of this Law that refer to the time of registration of a notice relating to a transfer.]~~

~~[6. If a prior transfer that continues to be effective against third parties under this law pursuant to paragraph 2 was made effective against third parties under prior law by the registration of a notice, the time of registration under that law is the time to be used for the purpose of applying the priority rules of this Law that refer to the time of registration of a notice relating to a transfer.]~~

15. In relation to Article 11, the Secretariat has recommended that two new paragraphs 3 and 4 be added, as well as a minor amendment to paragraph 2. Consistently with the proposed changes to Article 52, paragraph 3 clarifies that where the transferor has relocated from a State without a notice-based registry for the transfer of receivables, the time that a transferee attained third party-effectiveness under the prior law in relation to a prior transfer is the priority point for the purposes of the "first to file" rule in Article 13. Paragraph 4 clarifies that with the transferor relocated from a State with a notice-based registry for the transfer of receivables, the time that a transferee registered a notice under the prior law in relation to a prior transfer is the priority point for the purposes of the "first to file" rule. The proposed addition of the words "under this Law" to paragraph 2 clarifies that during the grace period after the transferor relocates, the time of effectiveness against third parties under the MLF relates back to the time of effectiveness against third parties under the law of the other State from which the transferor relocated. This clarifying amendment is required to ensure that the new paragraphs 3 and 4 operate properly.

Article 11

1. If a transfer is effective against third parties under the law of another State and the transferor relocates to this State, the transfer remains effective against third parties under this Law if it is made effective against third parties in accordance with this Law before the earlier of:

(a) the time when third-party effectiveness would have lapsed under the law of the other State; and

(b) the expiry of [the enacting State to specify a short period of time] after the transferor relocates to this State.

2. If a transfer continues to be effective against third parties under paragraph 1, the time of third-party effectiveness under this Law is the time when it was achieved under the law of the other State.

3. Subject to paragraph 4, the time of third-party effectiveness under this Law of a transfer that continues to be effective against third parties under paragraph 1 is the time to be used for the purposes of applying the priority rules of this Law that refer to the time of registration of a notice relating to a transfer.

4. If a transfer that continues to be effective against third parties under paragraph 1 was made effective against third parties under the law of the other State by the registration of a notice, the time of registration under that law is the time to be used for the purpose of applying the priority rules of this Law that refer to the time of registration of a notice relating to a transfer.

16. Collectively, these proposed amendments to Articles 11 and 52 would prevent a second-in-line creditor from unfairly gaining priority over a first-in-line creditor by being the first to register under the MLF, either during the transition period after entry into force of the MLF (Article 52), or during the grace period after a transferor has relocated (Article 11). The amendments would also preserve alignment of the MLF with the corresponding rules in the UNCITRAL Model Law on Secured Transactions.

V. NEXT STEPS

17. If the Governing Council agrees that the MLF should be amended to rectify the error in the transition rules, the Secretariat will amend the instrument in English and French accordingly, reissue the electronic version of the MLF on the UNIDROIT website, and republish the physical copies. The revised MLF will then be circulated to project stakeholders and UNIDROIT Member States, with a brief explanation of the revision.

18. The Secretariat will work with stakeholders to ensure that other translations of the MLF take the revision into account, and that States currently considering implementing the MLF utilise the revised version.

VI. ACTION TO BE TAKEN

19. *The Governing Council is invited to consider amending the Model Law on Factoring to rectify the error in the transition rules.*